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American Institute of Certified Public Accountants (AICPA)

THE ACCOUNTANT'S BUSINESS MANUAL

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Accountant's Business Manual Toolkit

Introduction

The *Accountant's Business Manual Toolkit, 2006–2007* is a CD-ROM that includes many of the print forms in the **ACCOUNTANT'S BUSINESS MANUAL**, as well as additional updated materials, resources, and internet links to government source materials, and other useful information.

The **Toolkit CD-ROM** has been completely updated and reorganized for 2006–2007, to make it even more user-friendly and useful.

The majority of the forms and checklists on the *Toolkit CD-ROM* were produced in Microsoft Word. Other exhibits are delivered in Microsoft Excel or portable document format or PDF. It is suggested that you copy the files to your hard drive before using. If you do not have the (Word or Excel) software installed on your PC, you may wish to consult your current software manual to ascertain whether you will be able to convert the files for use with your current software programs.

With the proper software, you may open, copy, and save the files to your local drive. Check your current software manual for instructions. Most of the forms are designed to be readily customized for your own use.

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The 2004 and 2005 versions of this chapter have been archived in PDF format.

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Accountant's Business Manual Toolkit

Installation Instructions

The **Toolkit CD-ROM 2006–2007** provided with *Accountant's Business Manual* provides forms, checklists, and other practical aids. Subject to the conditions in the License Agreement, which may be viewed on the READ-ME file on the CD-ROM, you may duplicate the files, modify them as necessary, and create your own customized forms.

Microsoft Word and Microsoft Excel. Most of the files on the CD-ROM have been produced in Microsoft Office Word for Windows 2000. Other exhibits (as indicated in the "Introduction" file on the CD-ROM) are spreadsheets created in Microsoft Office Excel for Windows 2000.

If you do not have this software (Word or Excel) installed on your PC, you may wish to consult your current software manual to ascertain whether you will be able to convert the files to your current software programs. *Note: The Toolkit exhibits are PC-compatible only.*

Word exhibits are indicated with the file extension *.doc*; Excel exhibits are indicated with the file extension *.xls.*

Several exhibits are supplied in portable document format (PDF) that requires Adobe Acrobat Reader in order to use correctly. Go to **www.adobe.com** and download the Adobe Acrobat Reader following the Web site's instructions. Once the Adobe Acrobat Reader is installed on your computer you can access the PDF files on the *Accountant's Business Manual Toolkit CD-ROM.*

READ-ONLY NOTE. Note that the Word and Excel files will initially load on your PC in Read-Only Mode due to the way the CD master is produced. In order to use the files successfully and to save your work, you must save them with a new name. For example, "IRS Appendix 3.doc" could be renamed "IRS Appendix 3a.doc" or some other variation in order to keep changes. This will allow you to always have the unaltered files available on your hard drive and to continue to customize new documents as needed. Otherwise, you will need to retrieve the files from the CD-ROM each time you wish to make new documents.

To Install and Use the Exhibits

Word Exhibits:

1. Insert the *Toolkit CD-ROM* (label side up) into your computer's CD-ROM drive and wait for CD-ROM to load.
2. Open Word on your screen. Go to *File* button and select *Open.*
3. Under the *Look in:* window, select your computer's CD-ROM drive (for example, *d* or *e*).
4. Select *All Files* in the dialog box (*Files of type:*). A list of files (READ-ME file, Toolkit-CD Instructions, and Toolkit-CD Introduction) and folders (2005–06 Toolkit files or Existing Toolkit files) will appear under the *Look in:* window. Double-click to open any of these files or folders.
5. To use the Exhibits, double-click to open the folder you've selected. A list of exhibits in that folder will appear. Select the exhibit you want to customize.
6. Note: Use the *Save As* option in Word to save the exhibits to your hard drive. You (or any user) will then be able to edit the exhibits; they will be available for a range of uses. Rename the Word exhibits as appropriate.
7. Because this *Toolkit* has been completely reorganized, you should install the complete *Toolkit,* even if you have previously installed prior years' versions.

Excel Exhibits:

1. Insert the *Toolkit CD-ROM* (label side up) into your computer's CD-ROM drive and wait for CD-ROM to load.
2. Open Excel on your screen. Go to *File* button and select *Open.*
3. Under the *Look in:* window, select your computer's CD-ROM drive (for example, *d* or *e*).
4. A list of files and folders will appear under the *Look in:* window. Select *Microsoft Excel files* in the dialog box (*Files of type:*).
5. Double-click to open the folder you're interested in (2005–06 Toolkit files or Existing Toolkit files) and select the Excel file you want to modify. You can now work on the Exhibit you have selected.
6. Use the *Save As* option in Excel to save the exhibits to your hard drive. You (or any user) will then be able to edit the exhibits; they will be available for a range of uses. Rename the Excel exhibits as appropriate.

PDF Exhibits:

1. Insert the *Toolkit CD-ROM* (label side up) into your computer's CD-ROM drive and wait for CD-ROM to load.
2. Open Adobe Acrobat Reader on your screen. Go to *File* button and select *Open*.
3. Under the *Look in:* window, select your computer's CD-ROM drive (for example, *d* or *e*).
4. Select *Adobe PDF Files* (**.PDF*) in the dialog box (*Files of type:*). A list of PDF files will appear under the *Look in:* window. Double-click to open any of these PDF files. The PDF exhibits can be filled-in.
5. Use the *Save A Copy* option in Adobe Acrobat to save the exhibits to your hard drive. You (or any user) will then be able to save a copy of the filled in PDF exhibit under a different name as appropriate. Rename the PDF exhibits as appropriate.

Note to Users: As a general rule, remember to save your data frequently.

THE ACCOUNTANT'S BUSINESS MANUAL

Volume 1

THE ACCOUNTANT'S BUSINESS MANUAL

A Two-Volume Service

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PREFACE TO SUPPLEMENT 39
MAY 2007

This is the thirty-ninth supplement to the *Accountant's Business Manual*. It reflects the most important changes affecting the *Manual*'s guidance in the last six months.

With this supplement, we have updated and expanded the materials on many of the topical areas from which client and colleague questions often arise, including: corporations, S corporations, employment regulations, workers compensation, unemployment insurance, hiring foreign nationals, investment vehicles, estates, social security and other client issues.

Several chapters were updated and expanded to include new discussions and analysis, including:

Obtaining Financing—Added discussions of SBA Disaster Business Loans and updated information about education loans and grants: Pell Grants, Perkins and Stafford Loans.
Employee Retirement and Deferred Compensation Plans—Completely revised chapter with new sections discussing automatic enrollment arrangements, Roth elective deferral plans, and updates throughout based on the Pension Protection Act of 2006.
Insurance—Updated discussions of Archer medical savings accounts (MSAs), health savings accounts (HSAs), and IRS regulations regarding premiums paid for long term care insurance.
Trusts—Added sections on special-needs trusts, deductions and taxable income and new information affecting dynasty trusts.
Cash Management—Added sections discussing issues most pertinent to small businesses, including updated information on credits and collections and a new section on electronic funds transfers.
IRS Practice and Procedure—Updated information on compromises affected by the Tax Increase and Prevention and Reconciliation Act of 2005. Added sections on collections due process hearings, a favored method of resolving collection matters with the IRS.

As always, we encourage our readers to offer comments and suggestions to help us identify topics that merit additional coverage, and we express our thanks to those who have already done so. We appreciate your help.

PREFACE

The objective of the *Accountant's Business Manual* is to provide accountants in both private and public practice with a compact reference source for timely and practical information in topical areas such as law, finance, tax, and general business economics. We believe that the *Manual* serves four important purposes:

1. Quick access to concise summaries of everyday practice in a variety of commonly encountered areas.
2. Factual, noninterpretive material provided as a refresher source.
3. Background and solutions to business problems posed by clients, colleagues, and management.
4. Semiannual updating for access to recent developments and current information in important areas of professional knowledge and interest.

The *Accountant's Business Manual* is intended to be a concise reference for professional advisers. A manual of this length cannot and does not deal in detail with the many topical areas it includes. In fact, specifics of technical analysis and historical development of statutory and regulatory provisions have been minimized or eliminated. The information is descriptive and general—expressed in language understandable to all professionals regardless of specialty. We expect that the *Manual* will be useful to all practitioners, but we have prepared it with a view to professionals who may find the Internet unwieldy and cannot rely on immediate access to large libraries, other experts, or support staff before responding to day-to-day queries.

The *Accountant's Business Manual* is a nontechnical business aid—one whose reference points are not in accounting or auditing per se, but are in related legal, business, and economic areas. We believe it can construct a bridge between providing financial information and making management decisions.

The *Manual* can be used as a a first reference—either for a quick answer or for a topical overview that can lead to in-depth research or expert consultation. For ready-reference, each of its twenty-seven topical areas is separately tabbed. Each area opens with a detailed table of contents and contains numbered subject headings and subdivisions to permit ease of cross-referencing, clear presentation and subordination of ideas, and quick location of necessary information.

We have taken care to avoid prescriptive or advisory language and lengthy narratives. Instead, the topics are presented in terms of their most salient aspects. Concise definitions and lists of characteristics or steps in processes are used frequently throughout. The text is scannable–headings are numerous and facts are easy to find. Practice tips and situational examples are sprinkled throughout for additional guidance. The *Manual* gives economical exposition of the statutory, regulatory, and practical elements that inform the business decisions and advice practitioners offer their clients and colleagues.

Each chapter concludes with a list of reference source books to permit further, in-depth reading in the topical areas. Topical areas that are affected by state-specific information include addresses and phone numbers of state offices and agencies where further information, forms, applications, and so forth may be requested. Web-centric information is provided where available.

Accompanying the *Manual* is the Toolkit CD-ROM. The Toolkit contains forms, checklists, worksheets, sample letters and agreements, Excel spreadsheets that can be easily customized and downloaded to fit the circumstance. Directories of further information contain hypertext links for instant access to Web sites.

Included on the Toolkit are selected trade organizations and associations that provide addresses, phone numbers of special interest groups, and Web addresses that may be contacted for publications and materials relative to the topics in the *Manual.* The public affairs offices of these groups are often the best sources of most recent information.

Specific information may be accessed through the alphabetical index, containing a listing of all subjects covered in the *Manual.* The index shows all major topics, subtopics, and cross-references; it is an easy and convenient way to research a topic.

The *Accountant's Business Manual* is supplemented twice yearly. All topical areas are continuously reviewed for necessary update and topical addition by the authors and by the editorial advisory board. Because the *Manual* deals with complex issues in a summary fashion, we encourage readers to refer to the reference and source materials and remember that law and practice undergo constant rapid change that cannot be immediately reflected in the semiannual updates.

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ABOUT THE AUTHORS

The *Accountant's Business Manual* has been prepared under the supervision of AICPA members who are practicing professionals in their own law and accounting firms.

William H. Behrenfeld is a member of both the New York and Florida Bars and is a certified public accountant in New York. He is a graduate of Boston University, Fordham University Law School, and New York University Law School. Presently in private practice as an attorney in Sarasota, Florida, Mr. Behrenfeld is the author of the *Accounting Desk Book* (6th edition), and *The Estate Planning Desk Book* (5th edition), formerly published by Prentice Hall. He has had articles published in *NYU Institute on Federal Taxation, Estate Planning, The CPA Journal, The Attorney-CPA,* and *Taxation for Accountants.* A former member of the Business Law Subcommittee of AICPA's Board of Examiners, Mr. Behrenfeld has spoken on estate planning and related matters before professional development meetings, tax seminars, and business associations throughout the United States. He is on the faculty of the University of South Florida, Sarasota, where he teaches courses in tax and business law.

Andrew R. Biebl is a certified public accountant and presently partner at Biebl Ranweiler Education Services, in New Ulm, Minnesota. He is a graduate of St. John's University, Collegeville, Minnesota, and attended the University of Minnesota Graduate School of Business. Mr. Biebl is a member of the American Institute of Certified Public Accountants and of the Iowa and Minnesota societies of CPAs. He is a former president of the Minnesota Society of CPAs. Mr. Biebl has coauthored several CPE courses for the AICPA and various state societies, including AICPA's *Federal Tax Update,* AICPA's *Corporate Income Tax Returns Workshop,* AICPA's *Individual Income Tax Returns Workshop, Corporate Tax Returns Videocourse,* and AICPA's *Complete Tax Update for Individuals and Sole Proprietors.* Mr. Biebl has spoken on tax and business topics at numerous conferences, seminars, and trade group meetings throughout the country.

The concept of an accountant's business manual was first introduced by the Australian Society of Accountants in conjunction with the Centre for Professional Development in Melbourne. A Canadian edition entitled *The Accountant's Manual* was subsequently developed by the Canadian Institute of Chartered Accountants and released in 1984. AICPA is especially pleased to acknowledge the generous sharing of experience and advice offered by William J.L. Swirsky, Peter J. Hoult, and David Thorpe of the CICA staff.

EDITORIAL REVIEW

All chapters of the *Manual* have been reviewed at every stage of development by AICPA members and others in practice and industry who contributed to the project through independent evaluation and commentary. AICPA and the authors wish to thank the following Institute members for their comments and sound recommendations provided at the earliest stages of this project: Peter N. Chase, CPA, Manassas, Virginia; Marvin J. Dickman, CPA, Arthur Andersen & Co.; John F.

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A work of this nature could not have been prepared and released by the American Institute of Certified Public Accountants without the considerable knowledge and experience of an editorial advisory board. We are deeply grateful for the assistance of these distinguished professionals. The *Manual* and its supplements will be subject to continuous monitoring by topical experts and practicing CPAs.

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Sole Proprietorships

SOLE PROPRIETORSHIPS

1. INTRODUCTION

Proprietorship arrangements (also known as sole proprietorships) are probably the oldest historical form of conducting business and even today can be the least sophisticated in terms of structure and accounting. Proprietorships are affected by legislation of many sorts. Individuals and their proprietorships are legally synonymous since laws designed to affect a proprietorship also affect the individual operating it.

A proprietorship is a business enterprise in which a single individual engages in that enterprise for profit as an owner-operator. The one owner bears all the liability that may be incurred. In the chapter on Partnerships, see appendix 3, "Comparison of Entity Attributes—Proprietorships, Partnerships, C Corporation, S Corporations, and LLCs."

2. LEGAL NATURE OF PROPRIETORSHIP

Legislation affecting proprietorships exists at federal, state, county, and even municipal levels. Although ordinances among cities can vary greatly, uniform business legislation has eliminated many of the inconsistencies that previously existed in state legislation.

2.1 Formalities

No specific formalities are necessary to initiate a proprietorship. The proprietor can merely open the business to the public and announce the nature of the business. Maintenance costs can be very low since the sole proprietorship is not generally subject to special reporting requirements. Using a trade name, however, may require filing a certificate of assumed name, as discussed in section 6.1 in this chapter. Consult the checklist in appendix 1, also on the *Accountant's Business Manual Toolkit CD-ROM,* to determine if permits or licenses are required to commence operations in the selected location.

2.2 Duration

A proprietorship enterprise may endure as long as the proprietor wishes or may be terminated at will. Continuity will stop upon death, incapacity, or withdrawal of the sole proprietor.

2.3 Business Purposes

There are no limitations on a proprietorship's business purposes so long as they are lawful.

2.4 Size

There are no restrictions on the size of a proprietorship; even multiemployee, multilocation, high-dollar-volume enterprises can function as proprietorships. As the size of the enterprise grows, however, it becomes increasingly difficult for one individual to maintain unless management personnel have been employed. Accordingly, as the size of the proprietorship grows, converting to the partnership or corporate format is often desirable. Moreover, having employees may, in and of itself, make using a liability-limiting entity highly advisable. Certain acts of employees, for example, getting into car accidents while on business or harassing other employees, can create liabilities in untold numbers of ways.

3. CHARACTERISTICS OF A PROPRIETORSHIP

3.1 Unlimited Liability

The distinguishing characteristic of a proprietorship enterprise is the principal interest of the owner-proprietor. Although the proprietor may delegate certain management or administrative functions to employees, the business owner ultimately assumes responsibility for all decisions, acts, or omissions.

The proprietor cannot delegate or contract away personal liability in connection with the enterprise. Personal assets outside the business remain at all times legally available to satisfy debts, obligations, or tort liability incurred in connection with the proprietorship business. However, see the Bankruptcy/Insolvency chapter for a discussion of personal assets that may be exempted from creditors' claims. The business owner may also make legal transfer of personal assets to a spouse or children to limit exposure in connection with the business.

All but a few states now permit single-member LLCs, which are limited liability companies (LLCs) with only a single member or owner. Under the so-called IRS check-the-box entity classification regulations (Regs. Sec. 301.7701-2(a) and 301.7701-3(a) and (b)), single-member LLCs are generally ignored for federal income tax purposes and, accordingly, treated as a sole proprietorship for tax reasons. Even though a single-member LLC does not protect the owner from the individual's own misdeeds, it does provide a level of liability protection for certain acts of employees not under direct supervision, adding additional protection for the proprietorship business. See the LLC chapter for additional information on proprietorships organized as LLCs.

3.2 Commingling of Personal/Business Assets/Liabilities

Proprietorships frequently commingle personal and business moneys and other property within the business accounts. The business account is often utilized to pay personal expenses, and separation of business assets and expenses from personal items is often difficult. While such commingling is not per se illegal or unethical, a tracing problem with respect both to taxation and to disposition of assets frequently arises. Results of operations may also be distorted or concealed from the owner because of commingling.

Separate checking and savings accounts should be maintained for business and personal funds. Funds transferred from the business account to the personal account should be labeled as "owner draw" for accounting and tax purposes. Similarly, funds transferred from the personal account to the business account should be labeled as "owner contribution" for accounting and tax purposes.

3.3 Term

Unlike a corporation or even a partnership, a proprietorship is active only as long as the proprietor is active. Once a decision is made to terminate operation, the enterprise terminates. When the business is sold or a divestment is ordered as a matter of law, its form assumes a new identity. If the spouse of the proprietor dies, the proprietorship remains in existence, since a proprietorship has only one owner. The proprietorship will cease when the owner dies.

3.4 Exercising Control and Independence

A proprietorship would generally not exist when another employer has the right to control and direct the individual in the methods, timing, and details by which a task is accomplished. When a proprietorship is so limited in scope that virtually all services are performed by one individual under the direction of another, that individual may actually be an employee rather than a proprietorship operating as an independent contractor.

The *right to control* not only what is to be accomplished, but also the means and methods for reaching the desired result, generally determines whether the person is acting as an independent contractor or an employee. This is not always an obvious decision and requires a *facts and circumstances* analysis. Internal Revenue Service (IRS) Form SS-8, Determination of Employee Work Status for Purposes of Federal Employment Taxes and Income Tax Withholding, provides a list of factors to consider in unclear situations. Also see the Employment Regulations chapter for an in-depth analysis of *Independent Contractor or Employee.*

4. ADVANTAGES OF PROPRIETORSHIP

In determining the most appropriate form of doing business, a comparison of various entity attributes should be consulted. Appendix 3 of the Partnerships chapter is a table of attributes that should be considered.

Partnerships by definition require at least two owners (the other owner can be the spouse). However, C and S corporations and single-member limited liability companies (in states that allow them) do not. Therefore, only these latter entities are available if there is truly only a single owner.

4.1 Simplicity

The chief advantage of the sole proprietorship is its simplicity. Accounting and taxation systems tend to be less complex than for other business entities, and the fact that one individual holds all assets and liabilities allows the individual to dedicate more time to the product or service than to bookkeeping or other entity-related matters. Accounting for owner cash withdrawals from corporations, for instance, can be very complex. Such withdrawals must be characterized as one of the following four transactions:

1. *Wages,* with the required payroll tax withholding and reporting
2. *Other compensation,* subject to the applicable information reporting
3. *Shareholder loans,* potentially subject to below-market interest rules
4. *Distributions,* potentially dividends for C corporations and S corporations that were formerly C corporations.

This complexity can be completely avoided with a sole proprietorship, in which owner cash withdrawals are simply "owner draws."

However, sole proprietors should not be fooled into thinking that bookkeeping and other entity-related matters are unnecessary or unimportant in a proprietorship; rather, the time required for the proprietor-owner to adequately maintain books and records and attend to other entity-related requirements may in some cases actually prevent the owner from dedicating the required time to the products or services of the business. As discussed in section 8.2, accounting software packages designed for small businesses may mitigate the negatives described.

The profit or loss of a proprietorship is reported in the owner's individual income tax return, using either the cash or accrual method of accounting, whichever is required. A proprietor is not required to include a balance sheet for tax reporting purposes, unlike most partnerships and all corporations. However, a balance sheet normally proves advantageous for management purposes.

In some instances, the lack of formal requirements can become a disadvantage, such as attempting to segregate business and personal transactions for IRS audits.

4.2 Owner Control

Another significant advantage of a sole proprietorship is the owner's exclusive control of the enterprise. Subject to necessary guarantees of creditors or financing parties, a proprietor is able to make the appropriate decisions and to operate the business as he or she chooses.

4.3 Commingling of Assets, Income, and Deductions

Commingling of assets, income, and deductions between the proprietor's business and nonbusiness matters can be advantageous in using deductions and loss (that is not a "hobby loss") from the formative years of a new proprietorship, and may help offset substantial nonbusiness income of the proprietor for tax purposes. Commingling can be a disadvantage if faulty bookkeeping makes tracing difficult; care must be taken to ensure that provisions of the Internal Revenue Code (IRC) are not violated with regard to assets used both personally and for business. This is particularly true with respect to "listed property" (see IRC Sec. 280F), "office in home" (see IRC Sec. 280A), and so forth, which have a high likelihood of both business and personal use. Listed property includes automobiles and other vehicles; any property of a type generally used for entertainment, recreation, or amusement; and any computer or related peripheral equipment. For more information on an office in the home, see IRS Publication 587, *Business Use of Your Home.*

4.4 No Double Taxation

Because of the flow-through nature of the financial and tax aspects of a proprietorship, double taxation of income does not occur, as it may for a corporation. The net profit or loss of a proprietorship is reported in the owner's individual income tax return. Net profit or loss is not affected by funds withdrawn or contributed by the owner. Withdrawals by an owner are treated as simple transfers of funds, and not as expenses of the business.

On the other hand, as described in section 10.5, sole proprietors are required to pay self-employment Social Security tax on all net income from the sole proprietorship business, regardless of the amount of cash withdrawn from the operation during the year. This forces many proprietorship entities to pay Social Security tax on proprietorship earnings unrelated to cash flow (for example, net income associated with the build-up of accounts receivable and net income used to pay down debt principal in excess of depreciation expense). See section 5.4 for further discussion of this issue.

4.5 Ease of Converting to Another Entity

The sole proprietorship can easily be converted to a corporation or to a partnership if additional persons want to become owners. It is also easy for the owner to convert the proprietorship to a corporation, whether a Subchapter S corporation or a regular C corporation, with the owner as the sole shareholder. (See sections 16 and 17 of this chapter.)

4.6 Employment of Spouse/Children

Sole proprietors may employ their spouses and children in the business enterprise provided they are reasonably compensated for the duties performed. In all cases, the duties should be well documented, ideally through a signed employment agreement. Wage payments to the spouse and children are a legitimate means of advantageously passing business income to the household of the proprietor. When determining reasonable compensation for a spouse or children, the pay should be similar to what would be paid to a nonrelated employee for the same services. The spouse and/or children should complete time cards showing hours worked or keep similar records to justify compensation paid to them.

Wages paid to dependent children under eighteen are exempt from the usual employee requirements of Social Security taxation. Wages paid to a spouse are subject to the same Social Security taxation as wages paid to nonfamily employees. A further discussion of the employment of family members is found in section 10 of this chapter.

4.7 Health Insurance Costs

Self-employed individuals may deduct on their individual income tax returns 100 percent of the amount paid for medical insurance and eligible long-term care insurance for themselves and their families. Prior to 2003, only a lesser percentage of those health insurance costs could be deducted in arriving at adjusted gross income. The deduction is limited to the income on the individual's Schedule C or F, after deducting one-half of the self-employment tax and the Keogh, SEP or SIMPLE contribution. The deduction is allowed even if the individual does not itemize deductions.

Proprietors may deduct health insurance premiums for employed spouses who are covered under an employee benefit plan as described in section 10 of this chapter.

A health savings account (HSA) is a tax-exempt trust or custodial account that may be set up with a qualified HSA trustee to pay or reimburse certain medical expenses. (See Insurance chapter, herein, for more details.) The benefits from having an HSA include:

- A tax deduction may be claimed for contributions to the individual's HSA even if the taxpayer does not itemize deductions on Form 1040
- Contributions to an HSA made by an employer (including contributions made through a cafeteria plan) may be excluded from gross income
- Contributions remain in the HSA account from year to year until used
- Interest or other earnings on the assets in the account are tax free
- Distributions are tax free if used to pay qualified medical expenses
- Portability allows an HSA to stay with the individual even upon changing employers or leaving the workforce

5. DISADVANTAGES OF PROPRIETORSHIP

5.1 Individual Liability

The chief disadvantage of a proprietorship is the lack of a shield from liability. While liability may be mitigated by insurance coverage or through the use of liability limiting entities such as single-member LLCs, the proprietor will, as a rule, retain ultimate personal liability—including exposure of nonbusiness assets to proprietorship liabilities. Legal or financial risk cannot be spread among a number of individuals or entities and thus mitigated. The proprietor's responsibility is total.

However, owners of small businesses operating as liability-limiting entities often hold management or employment positions, which may expose the owner to personal liability for actions such as causing personal injury or property damage by carelessness or negligence.

Creditors of small, closely held businesses often require personal guarantees and, therefore, financial liability is often not limited.

5.2 Lack of Continuity

A sole proprietorship has no continuity of existence, unlike a partnership or corporation. When the proprietor dies or ceases to operate the business, the enterprise ceases to exist. If a proprietor dies and the business passes through the estate to the surviving spouse, the surviving spouse for all practical purposes may continue operating the same business. For legal and tax purposes, however, the former proprietorship ceased upon the death of the former owner, and a new proprietorship is formed when the surviving spouse starts to operate the business.

5.3 Limitations on Employee Benefit and Ownership Programs

The enterprise may outgrow the proprietorship form as the business grows, particularly in the area of employer or employee fringe benefits, where such benefits may be either unavailable or tax-disadvantageous for the proprietorship.

A sole proprietorship cannot offer stock options or other ownership incentives to its employees. The owner will have to change the form of doing business if he or she wants to offer ownership potential to employees.

5.4 Social Security Taxes

With the taxable earnings base continuing to rise and the elimination of the Medicare earnings base, more income may become subject to Social Security taxation than is available to be drawn as salary, particularly when the proprietorship operates in a capital-intensive business. Self-employment tax is calculated on the net income of the proprietorship, although a portion of the profit generated is often used to retire debt, purchase inventory or fixed assets, or is contained in accounts receivable. This results in self-employment tax being calculated on income that may not be able to be withdrawn by the proprietor as cash.

The self-employment tax is computed on a base that is not reduced by the proprietor's contributions to his or her own qualified retirement plan or simplified employee pension (SEP) plan, or by the deductible percentage of medical insurance premiums. Therefore, the self-employment tax is likely to be higher than the FICA tax on the owner's salary when the same business is operated as a corporation, because payroll tax is simply imposed on the wages paid, and not on the entire corporate income, as occurs with a sole proprietorship.

5.5 Income Tax Rates

All income of a proprietorship is reported in the individual's tax return. A successful proprietorship will often have income taxed at high rates that, when combined with self-employment tax, can approach 50 percent. A significantly larger amount of income could be sheltered at lower tax rates by dividing the income between a personal and corporate tax return if the business was operated under that structure, although the tax costs of liquidating a corporation must also be considered. See section 17 for further discussion of the corporate form.

6. FILING AND COMPLIANCE REQUIREMENTS

6.1 Certificate of Assumed Name

If the enterprise is to be conducted under a name other than that of the proprietor, many states require that a certificate of assumed or fictitious name be filed in a local office and that public notice, usually in a newspaper in the immediate business area, be provided so that the actual operator of the business can be publicly identified. In some states, the failure to file under the appropriate name will subject the enterprise to penalties.

If the business name requires some type of protection against infringement, a reservation of that name may be available in a central state office (usually that of the secretary of state).

Conducting business under an assumed name does not in any way limit the personal liability of the sole proprietorship for the obligations incurred by the business as discussed in section 5.1.[1]

6.2 Local Licensing and Permits

All jurisdictions have local licensure requirements of varying strictness governing the carrying on of business of any type. Special licensing may be required for liquor, food, drug, restaurant, hospital, tobacco, transportation, and other activities. Inquire at the municipal level to ascertain what licenses must be obtained and to ensure that land-zoning ordinances are not violated.

Home-based businesses must also review local licensure requirements, including zoning requirements, parking requirements, and other restrictions that may apply to the operation of a business out of a proprietor's home. See section 21 for further discussion of home-based businesses.

6.3 Professional Licensing

Any necessary professional licensure or notice requirements for carrying on the planned enterprise must be met, usually through the secretary of state, prior to commencing business.

6.4 Sales Tax Permits

In most jurisdictions, provision must be made for collecting and paying state or local sales tax if the enterprise involves the sale or exchange of goods or services that are subject to such taxes. Inquiry should be made of the state revenue department and possibly the municipality to obtain the necessary permits.

6.5 Federal Employer Identification Number (FEIN)

A Federal Employer Identification Number (FEIN) must be obtained for all corporations, partnerships, and most trusts. In addition, a sole proprietor must obtain an FEIN in the following circumstances:

[1] Richard D. Harroch, *Start-Up Companies: Planning, Financing and Operating the Successful Business* (New York: Law Journal Seminars Press, 1987), pp. 1–17.

- The business has employees.
- An existing business is acquired.
- Partners are taken in or the business incorporates.
- Returns are required for employment; excise; or alcohol, tobacco, and firearms taxes.
- A nonresident alien will have withholding taxes on income, other than wages.
- The company has a Keogh plan.

A sole proprietor is not required to obtain a new FEIN when:

- The business name is changed.
- Locations are changed or added.
- The proprietor operates multiple businesses.

An FEIN is obtained from the IRS in any number of ways:

- Telephone—An FEIN may be immediately obtained by calling the Business & Specialty Line (800-829-4933).
- Fax—A completed Form SS-4 application may be faxed to the IRS service center for the state in which the taxpayer is located. The fax number may be found in the form's instructions. The FEIN is faxed back within four business days.
- Mail—Form SS-4 is mailed to the applicable IRS service center. The FEIN is mailed back within four weeks.
- Online—Through the IRS's Web site, www.irs.gov, an online form may be submitted. The FEIN is immediately provided.

A representative may obtain the number for a proprietor by completing the "Third Party Designee" section and obtaining the client's signature on Form SS-4.

6.6 Workers' Compensation

Suitable contact must be made with the local authority administering workers' compensation statutes to determine if the enterprise is subject to mandatory coverage and to provide any necessary proof of compliance. (See the Workers' Compensation chapter for additional information on this subject.)

6.7 Unemployment Compensation

Appropriate filings with, and periodic deposits to, the agency administering unemployment compensation programs must be made if the number and type of employees necessitate such arrangements under federal and state laws. State and federal unemployment taxes may be involved. Federal unemployment (FUTA) tax must be paid on a quarterly basis, using a Federal Tax Deposit (FTD) coupon, if the liability exceeds $500. Annual reporting is required on IRS Form 940 by January 31 of the following year. Some employees are exempt from federal employment taxes: Consult Circular E, *Employer's Tax Guide,* to determine necessary coverage. (See also the Unemployment Insurance chapter, herein, for further guidance.)

6.8 Withholding Taxes

Periodic payments and informational filings are required for employee withholding, income, and employee Social Security tax obligations. The IRS annually notifies employers of their specific payroll tax deposit requirement for the coming year. IRS Form 941 (or Form 943 for agricultural employers) is used to report federal income and Social Security taxes. The proprietor's self-employment Social Security tax liability is computed on the proprietor's U.S. individual income tax return as described in section 6.10. The proprietor's income and self-employment tax liabilities are often paid in via quarterly estimated tax payments, unless withholding on wages of the proprietor from other employment or from wage income of the spouse can be used to cover the tax liability arising from the proprietorship.

6.9 Other Employment Regulations

Required proof of compliance with local and federal wage/hour, safe-workplace, nondiscrimination, and other fair employment regulatory laws, such as the Americans With Disabilities Act, depends on the size and nature of the business and form of operation. For further information, see the chapter on Employment Regulations herein.

6.10 Income Tax Reporting

Proprietorship income is reported annually to the IRS on either Schedule C, Profit or Loss from Business, or Schedule F, Farm Income and Expenses, and included in the individual's Form 1040. This income must also be considered in calculating self-employment Social Security tax on Schedule SE and possibly on other tax forms included in Form 1040. For more information, see IRS Publication 334, *Tax Guide for Small Business.*

Interest expense incurred in the normal operation of a proprietorship business should be fully deductible on the proprietor's Schedule C or F as business interest expense. Regulations issued by the IRS require a tracing method to properly relate interest expense to the purpose of the debt (Reg. Sec. 1.163–8T). Fully deductible business interest expense requires that the debt be used for business purposes.

7. PROPRIETORSHIP NAME

As a rule, a proprietorship business may use any name, including but not limited to, the name of the proprietor or some variation of that name. Restrictions imposed by state law include a name that: (1) another enterprise previously protected by a copyright, trademark, or service mark filing; or (2) has acquired a specific secondary identification of its own with the other enterprise through long association. Names indicating or implying obscene or illegal activities or names that would be false or misleading are also normally prohibited.

If there is any question about the use of a name in a proprietorship business, or if the name is so unique or integral to the business that protection of its exclusive use needs to be sought, a trademark or name search should be initiated. If the name needs protection, application should be made for filing it as a unique and identifiable name or mark. Such search and filing should be on both a state and national level—governed, of course, by the need to protect the name and the scope of the business activity.

8. ACCOUNTING FOR PROPRIETORSHIPS

Any accounting system that accurately reflects the income of the enterprise and is appropriate for the particular nature of the business may be used. However, the system should adequately address the requirements for income tax purposes, while also providing meaningful management information. More information is provided in IRS Publication 1066, *Small Business Tax Workshop Workbook.*

8.1 Accounting Methods and Consistency

The accounting method chosen should allow determination of profit and loss under generally accepted accounting principles (GAAP) or an other comprehensive basis of accounting (OCBOA). The cash basis of accounting is generally the simplest and can be used by many small businesses. If inventories exist, the regulations in IRC Sections 446 and 471 require that the accrual basis be used. As described in Rev. Proc. 2002-28, the IRS has published a revenue procedure that provides relief for many small businesses with inventories to report under the cash method. Certain small businesses with average annual gross receipts up to $10 million may adopt or change to the cash method of accounting regardless of the presence of inventories. This relief does not apply to C corporations (or partnerships with C corporation partners) that have average gross receipts over $5 million. Such businesses may not use the cash method even if they are not otherwise required to keep inventories. The main advantage of the use of the cash method is deferral of income until payment is actually or constructively received instead of having to take income into account when billed. Deductions for inventory items or material items used in a business generally will have to be deferred until the later of payment or use of an item. Any method used must be consistently followed from period to period.

In filing the first Schedule C or Schedule F, an owner can choose the appropriate method of accounting without the consent of the IRS. Subsequently, if the owner wants to change the method of accounting, the owner may get an automatic consent of the IRS—usually by filing Form 3115, Application for Change in Accounting Method. Businesses qualifying under Rev. Proc. 2002-9 are not required to pay a user fee. Appendix 4 of the "Partnerships" chapter on the *Accountant's Business Manual Toolkit CD-ROM,* contains a flowchart to help determine whether a business qualifies to use the cash method of accounting. Each separate business should be reported on its own Schedule C or F. Accordingly, each business may make separate tax method elections.

Start-up expenses incurred under IRC Sec. 195 in the formation of a proprietorship must be capitalized if they exceed $5,000. The deduction limit phases out if start-up expenses exceed $50,000. Any excess costs that are capitalized are subject to a 15-year amortization period, consistent with the amortization period for Section 197 intangibles. Before October 22, 2004, all start-up costs incurred were amortized over 60 months.

8.2 Accounting Systems

The Internal Revenue Code requires that the system used clearly show income and deductions. This normally includes the checkbook and some appropriate record of cash receipts and disbursements that categorizes them by type. The double-entry accounting system greatly reduces the risk of errors in recording transactions and is necessary when using the accrual basis of accounting.

Whether computer-generated or manually prepared, it is essential that the records provide an audit trail from the basic transactions to the amounts used for financial reporting or income tax purposes.

Many low-end accounting software packages are available to small proprietorship operations. Such software packages are relatively inexpensive to acquire and easy to use, and many provide the required audit trail and financial reports to be used for both financial and income tax reporting purposes. When combined with check writing and accounts payable capabilities, these accounting software packages can prove particularly advantageous to small proprietorship operations. Similarly, integrating cash receipts and accounts receivable capabilities with the software packages allows the proprietorship to effectively automate not only its fundamental accounting system, but also many of the critical functions that go with operation of a successful and profitable business.

Many accountants and other professionals are trained to assist small businesses in the selection and implementation of accounting software packages. Proprietors using manual systems should be encouraged to upgrade to an automated system with the assistance of a professional, resulting in an efficient automated system with a clear audit trail and the required financial and management reporting system.

8.3 Accounting Periods

The tax year of the sole proprietorship must be the same as the tax year of the owner, which is usually a calendar year. If the owner wants to change the tax year, the owner must obtain permission from the IRS by filing Form 1128, Application to Adopt, Change, or Retain a Tax Year. The IRS may approve a change to a natural business year provided the change does not substantially distort income and is not motivated by tax considerations.

9. HUSBAND AND WIFE AS COPROPRIETORS

9.1 Propriety

While a proprietorship enterprise is generally viewed as the responsibility and characteristic of a single person, a determination must be made

(Text continued on page 19)

whether a coproprietorship or partnership exists between husband and wife. In absence of a partnership, a proprietorship exists, which by definition can have only one proprietor—the spouse who "substantially controls" based on the facts. The net business income of the proprietor is subject to self-employment tax. Accordingly, the remaining spouse is relegated to employee status, which should be documented by payment of a salary. The salary paid to the spouse/employee is subject to Social Security tax at both the employer and employee levels.

Generally, one spouse is designated the actual proprietor of the enterprise for management purposes but both can be equally liable for debts and obligations of the business, and the separate assets of both husband and wife would probably be reachable to satisfy creditors of the enterprise. See section 3.1 for a discussion of proprietor liability.

9.2 Divorce

Marriage dissolution often results in dissolution of the enterprise in which the spouses were engaged, or in its alteration to another form. Each spouse may be held to have an ownership interest in the business, its assets, goodwill, and continuing operation; and the business itself may be awarded to a spouse who is not interested in its continuing operation. Alternatively, a divorce court may decide that a property division requires paying cash sums that cannot be raised without the complete disposal of a small business enterprise.

In reaching a property division settlement, a business valuation is typically required. (See the chapter on Business Valuation, herein.) While property transfers between spouses as part of a divorce settlement continue to be tax-free under IRC Section 1041, the tax cost associated with selling the business needs to be considered in reaching an equitable division. For more information, see IRS Publication 504, *Divorced or Separated Individuals.*

10. EMPLOYMENT OF SPOUSE AND CHILDREN

Family members can be employed by a proprietorship with significant advantages and disadvantages if the salary is reasonable in relation to the services performed for the business. Salary payments should be documented by issuing a Form W-2 and paying the salary on a regular basis. Wages should also have the appropriate federal and state income tax withheld and, when required, FICA withholdings. As discussed in section 4.6, a record of hours worked and services performed should be kept to substantiate and justify wages paid.

10.1 Child's IRA Contribution

Salaries paid to a child may create a source of earned income to support a contribution to an individual retirement account, subject to current limitations and restrictions. Even where income tax savings are not possible, a contribution to a Roth IRA for a younger child may provide a source of significant future tax-free income. Many years of compounded growth are possible if contributions begin at an early age.

10.2 Spousal Retirement Plan Contribution

Spousal salary creates a source of earned income to allow Keogh/HR 10, 401(k), or SIMPLE IRA plan contributions after the spouse has met participation requirements.

10.3 Estate Planning

Spousal salary creates a source of earnings to solidify payment by a spouse of life insurance premiums (the spouse often owns insurance on the proprietor's life). It is also a means of building a separate estate in the spouse's name in a regular manner and facilitates separate gifts by a spouse to children. (See the chapter on Estate Planning, herein.)

10.4 Child Care Credit

Child care expenses for children under age thirteen who are eligible for income tax credit are limited to the lower-paid spouse's earned income or maximum dollar amounts provided by current tax law. Spousal salary allows the child care credit by creating earned income for the spouse.

10.5 Social Security Tax

Wages paid to a proprietor's child under age eighteen (including a foster or stepchild) are exempt from Social Security taxation (see IRS Publication 15).

Whether it is advantageous to pay spousal wages subject to FICA tax needs to be determined on a case-by-case basis. Spousal wages could actually increase the couple's Social Security tax liability beyond what it would be if no spousal wages were paid in the event the proprietor's income exceeds the FICA base.

The FICA rate and the rate for self-employed individuals are 15.30 percent up to the Social Security earnings base. This consists of 12.4 percent for Social Security and 2.9 percent for Medicare. Beginning in 1994, the 2.9-percent Medicare tax applies to unlimited earnings. Self-employed taxpayers can deduct one-half of the self-employed tax. Where the proprietor's income exceeds the Social Security maximum taxable wage base, spousal wages subject an even greater amount of the couple's earned income to Social Security taxation. (See the chapter on Social Security for a discussion of limits.)

This alone, however, should not be the only consideration. A spouse will be eligible to draw Social Security retirement benefits based upon the proprietor's lifetime earnings history. The spouse can draw benefits based on the greater of his or her own earnings history or 50 percent of the proprietor's level. In other words, it needs to be determined whether FICA tax paid on the spouse's wages will enhance benefits or have no effect. The proprietor should request a history of earnings and a computation of expected benefits from the local Social Security office.

Besides the Social Security retirement benefits issue, it may be appropriate to pay spousal wages to allow contributions to retirement plans, claim the child care or earned income credits, or participate in employee benefit plans. In addition, payment of a small amount of spousal wages—about $4,000 per year—would eventually make the spouse eligible under Social Security death and disability coverage and may be used to provide survivor benefits. The possibility of a marriage dissolution at some point in the future also needs to be considered. A decision not to pay spousal wages to save Social Security taxes may leave the ex-spouse with no Social Security earnings history on which to eventually draw benefits, even after years of legitimate service to the former spouse's proprietorship.

10.6 Earned Income Credit and Business Loss

If there are qualifying children and a taxable loss from the business exists, a spousal salary can enhance the earned income credit by combining the salary with an optional self-employment tax election under IRC Section 1402 (a). Limitations exist on how frequently the non-farm optional self-employment tax election may be used. For further information, see IRS Publication 533, *Self-Employment Tax.*

10.7 Employee Benefit Plans

If the spouse can be shown to be a legitimate employee of the business, medical insurance, medical reimbursement, and other employee fringe benefit plans can be provided under IRC Section 105. The spouse does not need to be a full-time employee to qualify, but the proprietor must consider the antidiscrimination rules of the Internal Revenue Code if other employees exist. To establish the legitimacy of the fringe benefit arrangement, using a third-party administrator will ensure that eligibility tests are met and ERISA requirements are followed. (See section 17.1, following, and the chapter on Employee Retirement and Deferred Compensation Plans, herein.)

10.8 Salary to Children and Tax Bracket

Wages paid to a dependent child can shift income from the parents' higher tax rates to the child's normally lower rates. Disadvantages may exist if a child under age fourteen is forced to file a return and has certain unearned income taxed at the parents' rate. Wages to a child could also result in the loss of the dependency exemption if salary funds are used for more than 50 percent of the child's support.

10.9 Eligibility for Section 199 Domestic Production Deduction

All manufacturing businesses, including sole proprietorships, are eligible for the deduction for Domestic Production Activities under IRC Section 199. In addition to manufacturing, construction and related engineering or architectural services also qualify for the deduction. For 2005 and 2006, the deduction is 3 percent of qualified production activities income, increasing to 6 percent in 2007–2009, and 9 percent thereafter.

The amount of the deduction allowable for any tax year may not exceed 50 percent of wages paid. This may be a hurdle for many sole proprietorships that do not employ other workers. Yet, it is common for spouses to be actively working in such businesses without pay. Compensating those spouses with cash wages may allow many small sole proprietorships to obtain the Section 199 deduction. Keep in mind that cash wages to spouses are subject to FICA tax, but reduce self-employment tax by a similar amount if under the FICA earnings base. Cash wages to children under 18 are exempt from FICA and, therefore, do not count toward the Section 199 payroll test.

11. REAL ESTATE IN PROPRIETORSHIP

Real estate used by the proprietorship enterprise may be either purchased or leased.

11.1 Held in Proprietor's Name

Real property may be held by a business enterprise, but since the business is not an independent entity, it can convey or hold real estate only in the name of the proprietor or an agent or employee authorized to sign for the proprietor. Even if an agent of the business enterprise has authority, the property owner or landlord is likely to require that the proprietor be the named owner of the property, the named lessee under a leasehold, or the personal guarantor of an obligation on the real property. Because the proprietor is normally required to personally guarantee all indebtedness, leases, and purchases, a substantial liability risk remains with the proprietor for the term of the lease or mortgage, even if the proprietor is no longer actively involved in the business enterprise.

11.2 Held in Spouse's Name

If real property is held in the spouse's name, or jointly, the sole proprietorship can lease the property from the spouse, claiming a Schedule C or F business deduction, and claiming the rent income on Schedule E. If the property is held jointly, one-half the fair market rent should be paid to the spouse.

Deducting rent on Schedule C or F and reporting the same amount as income on Schedule E does not reduce a couple's taxable income. However, the proprietor's self-employment tax may be reduced as net business income is lower. Corresponding expenses relating to the building, such as interest expense and depreciation, must be paid by the spouse and deducted against the rental income.

11.3 Documentation

To transfer real estate and enforce obligations under leasehold agreements effectively, written documentation is necessary. Informal and oral agreements should be avoided due to the pitfalls discussed in section 12.

11.4 Property Used Both Personally and for Business

Property owned by the proprietor and used both for business and personal reasons must be prorated between the business and personal use based on the business-use percentage. The business portion of any depreciation and related expenses are allowed as business deductions:

Example: Sandra has an automobile that she uses 75 percent for business and 25 percent for personal use, as determined by a written log that Sandra keeps of all mileage driven. Sandra is able to deduct 75 percent of the depreciation and the operating costs on the automobile as legitimate business deductions for her sole proprietorship.

11.5 Home Office Considerations

Under IRC Sec. 280A(c)(1), a taxpayer is able to deduct home office expenses when the space is used *regularly and exclusively:*

- As a principal place of business,
- As a place to meet or deal with clients and customers in the normal course of business, or
- "In connection with" the business if the space is a separate structure from the residence, such as a barn or detached garage.

To meet the "regular and exclusive" tests, the proprietor must use the portion of the home in the business activity on a continuing and regular basis; the space does not qualify for the home office deduction if use is only occasional. Similarly, a proprietor must use a specific portion of the home only for business purposes, with no other use of the space allowed. The Code does allow two exceptions to the "exclusive use rule" for the storage of inventory or product samples if the home is the sole fixed location of the business, and also for certain day care facilities.

Starting in 1999, taxpayers are allowed a home office deduction as long as they have no other fixed location where substantial administrative or management activities of the business are being conducted; however, as previously stated, the "regular and exclusive" rules still apply.

The tax deduction for business use of a home, other than from expenses that would otherwise be deductible, such as mortgage interest and real estate taxes, is limited to the net income from the business; the deductions cannot create or increase a loss from the business. Sole proprietors use IRS Form 8829, Expenses for Business Use of Your Home, to compute their home office deduction (however, farm proprietors report the expense of the home office on Schedule F).

Sole proprietors working out of a home office where the residence is the principal place of business within the meaning of IRC Sec. 280A are allowed to deduct daily transportation expenses incurred in going between the home office and another work location in the same business, regardless of whether the other work location is a regular or temporary work location and regardless of the distance (Rev. Rul. 94-47, 1994-2 CB 18).

However, before commencing home office deductibility, proprietors should understand the risks associated with a future sale of the residence and the resulting gain consequences to the taxpayer. In particular, even when a home office is converted back to residential property to meet the requirements of IRC Sec. 121 (dealing with the nontaxable sale of a personal residence), the proprietor is required to pay a 25 percent capital gain rate on any depreciation claimed after May 6, 1997, on the home office, limited to the overall gain recognition of the sale (IRC Sec. 121(d)(6)).

Final IRS regulations issued in 2002 revise the position in earlier proposed regulations allowing the home office portion to remain eligible for the $250,000/$500,000 gain exclusion under IRC Sec. 121. Under the proposed regulations, substantial gain recognition could have occurred on the office portion if the value of the residence has appreciated substantially since the original acquisition, or if the adjusted basis of the residence is low due to one or more gain deferrals into the current residence under old IRC Sec. 1034. Despite this favorable regulation, taxable gain can still result to the extent depreciation has been claimed.

> ***Practice Tip.*** Home offices are often inadequately covered by homeowner's policies. The coverage for business equipment is often limited to the $1,000 or $2,500 range, and the liability coverage typically does not apply to any events connected to a business. In some cases, a homeowner's policy rider may be available for an additional premium. In other cases, a separate business policy must be purchased.

12. CONTRACTUAL RELATIONSHIPS OF THE SOLE PROPRIETOR

Since the sole proprietor normally must personally guarantee any contracts signed on behalf of the business, the proprietor should exercise extreme caution in entering into contractual obligations on behalf of the business.

12.1 Nonbinding Contracts

In some instances, the law will enforce an agreement that would not otherwise measure up to a binding contract if one party has relied to its own detriment on promises made by the other party.

12.2 Verbal Contracts

As a rule, verbal contracts can be as binding as written agreements. Failure to write down the terms of a contract invites litigation, since

(Text continued on page 21)

the parties' recollections of the terms may vary widely at a later time, such as upon default of the contract.

12.3 Written Contracts

Certain types of contracts, such as for the conveyance of real estate or the sale of items above a specified price, must normally be established in writing to be enforceable as contracts.

While business convenience may suggest the use of form contracts, failure to review the detailed language may have unintended results if there is later disagreement or failure of performance of the contract.

12.4 Breach of Contract

Remedies on breach of a contract include rescinding the agreement, a lawsuit to enforce the terms of the contract itself, or litigation seeking monetary damages for a failure to perform the contract and resultant loss.

Relationships with debtors and creditors may be more personal in sole proprietorships than in corporations since the lines of responsibility and liability are clearer.

12.5 Uniform Commercial Code (UCC)

All states have adopted the Uniform Commercial Code (UCC) in some form. The UCC's general purpose is to create a framework for commercial dealing and a process to ensure workable agreements when the parties' understanding on a particular point is silent. It may therefore substantially affect proprietorships, in that the UCC may govern or affect transactions among merchants and consumers of the proprietorship's goods or services.

Article 2 of the UCC governs the sale of goods, while Article 9 deals with secured transactions. Other articles have to do with negotiable instruments, bulk transfers, warehouse receipts/bills of lading, and securities. The applicability of the various sections is governed by local law.

Article 2, probably the most widely applied to proprietorship enterprises in general, relates to forming contracts, delivery rights and terminology, express and implied warranties (as well as their waiver), allocating risk in a transaction in goods, and buyer and seller remedies when a party breaches contract.

Local law should be consulted on the application of the code's provisions to a specific issue.

13. THE PROPRIETOR AND OBLIGATIONS

13.1 Unlimited Authority

Unlike other forms of doing business, the sole proprietor has unrestricted power and authority to contract and incur obligations on behalf of the business except to the extent that a lender, contractor, or creditor may require endorsement by a co-owner of property held by the proprietor that will be used to secure the obligation. As a rule, management decisions are also in the sole discretion of the proprietor or a designee, even the ultimate decision of whether the business will continue to operate.

13.2 Financial Instability or Bankruptcy

In some instances of financial stress or instability, management decisions may be dictated by creditors, either by requiring the proprietor to provide personal guarantees or security or by the creditors' assuming some of the decision-making function.

Such circumstances may also result in a bankruptcy situation in which ongoing operation of the business may be vested in a trustee, appointed by the court, rather than the proprietor. (See the chapter on Bankruptcy/Insolvency for a detailed discussion.)

14. BUSINESS LIABILITY AND PERSONAL ASSETS

As a result of the uniquely personal nature of the proprietorship enterprise, tort or contract liability extends to the personal, nonbusiness assets of the sole proprietor, regardless of the size and complexity of the proprietorship's operations.

14.1 Personal Guarantees

The proprietor is often required to provide personal guarantees of payment, secured by nonbusiness assets. One of the risks assumed by the owner for choosing to do business in a proprietorship is the fact that the public dealing with the sole proprietor is generally entitled to reach the deeper pocket (if available) of the proprietor's additional personal assets. The proprietor's waiver or disclaimer of liability is generally not sufficient to protect personal assets.

14.2 Liability Insurance

Insurance coverage for every type of potential liability is of particular significance for the sole proprietor. The amounts and nature of protection will, of course, depend on the nature of the enterprise. (See the chapter on Insurance, herein, along with section 11.5 of this chapter on home office liability insurance.)

15. PROTECTION OF PROPRIETARY PORTIONS OF BUSINESS

15.1 Unique Knowledge

The irreplaceable element of a proprietorship is the unique knowledge of the original proprietor. It is critical that this knowledge be documented to provide a smooth transition should the proprietor become incapacitated or otherwise unable to continue in the business.

The proprietor should record this knowledge through written policy and procedure manuals, detailed job descriptions, or other training materials. Another method of protecting such knowledge is to bring competent individuals into positions of authority in the enterprise, resulting in a transfer of knowledge of the unique aspects of the enterprise.

In many cases, the unique skills and knowledge a proprietor brings to a business do not allow complete and consistent continuity of the business upon withdrawal of the proprietor. However, substantial continuity can be attained by properly training and maintaining quality employees in the proprietorship. Of course, a risk exists in the possibility of such employees leaving the operation and competing with the proprietor. This risk can be minimized with noncompete or other legal agreements.

The proprietor must therefore give close attention to relationships with key employees. Provision can be made to either eventually sell to such employees or modify the form of the business to a partnership or corporate form, which will assure the continued existence of the enterprise.

15.2 Name

The name of the business can be protected by discretionary filings of the name or other proprietory mark with the appropriate state or federal agency, as described in section 7, herein.

15.3 Goodwill

Protecting the proprietorship's goodwill can be achieved only by assuring the ongoing quality of the business operation and by delegating duties to persons capable of upholding this quality. This result is mandated by the highly personal nature of the proprietorship form itself. Even in a business of great size and complexity, the enterprise is still necessarily involved with the personality and leadership of the proprietor. (Further discussion of goodwill is found in the chapter on Business Valuations.)

15.4 Personal Property

Personal property can be protected by insuring against foreseeable risks. (See the chapter on Insurance, herein, along with section 11.5 of this chapter on home office property insurance.)

15.5 Intellectual Property

Items of intellectual property are protected by patent, trademark, copyright, and licensing arrangement, accomplished by application to and filing with the appropriate agency. To the extent permitted by local law and the negotiations of the parties involved, proprietary control of the intellectual property of the enterprise can be assured by assigning patents or other protective filings to the enterprise itself rather than to individual employees.

15.6 Estate Planning for Proprietorship

The proprietorship enterprise is often the largest asset in a sole proprietor's net worth. Personal estate planning that includes the proprietorship interest and its disposition is another means of protecting the sole proprietor's interest (or that of the heirs) in the business.

A decedent's business may be continued under limited circumstances in some jurisdictions; however, in most instances, the business will be liquidated following the death of the owner either by selling the separate assets of the business or by a sale of the business as a going concern.[2]

Consideration should be given to selling the business to family members or others involved in the business prior to death to protect the value of the enterprise to the proprietor and the heirs. Care should be taken, however, in structuring such a sale as an installment sale. If an installment obligation is canceled or becomes unenforceable, taxable income to the seller results and, additionally, a taxable gift may result.

Change to a partnership or corporation, as discussed in the following sections, is another means of easing the transfer and disposition of the proprietor's interest, since a fractional ownership interest in a sole proprietorship cannot be transferred.

16. CHANGE TO PARTNERSHIP

As discussed in the chapter on Partnerships of this manual, a change from proprietorship to partnership entails a number of decisions and formal requirements. Competent legal counsel should be obtained whenever such a move is contemplated.

A spouse may be used to fulfill the second owner requirement when a change from sole proprietorship to partnership is desired. This may be an attractive option when, for all purposes, there continues to be only one actual owner but two nominal owners are needed to gain the benefits of having a partnership.

16.1 Partners' Contribution

The initial task is to choose a compatible business associate who is suitable personally, financially, and professionally to assume a proprietary role as a business partner. The proposed relationship must then be evaluated in light of the likely division of labor and capital that would result from such an arrangement.

Assets and liabilities must be evaluated to determine the capital contribution each member will make to the new partnership. This valuation should be done at an early stage of the proposed change so that ample time for negotiation is available to each party.

Decisions on how to bring the assets and liabilities of the proprietorship enterprise into the new partnership will normally require negotiation. The newly created entity may assume the obligations and liabilities of the preceding enterprise, or these obligations may be retained by

[2]Harroch, *Start-Up Companies*, pp. 1–19.

the individuals. Depending upon the contributions to be made by the incoming partners, disposition of some existing equipment, inventory, or other assets may be necessary to assure the desired capitalization level and ownership configuration.

16.2 Partnership Agreement

The understanding of the parties should be set out in a formal partnership agreement, defining rights and responsibilities both in financial terms and with respect to the services each partner is to provide to the enterprise. The agreement should also encompass the buy-sell, operational, and disability provisions and contingencies.

The importance of a written, formal partnership agreement cannot be overstated. Issues not defined by a partnership agreement will follow the legal provisions of the Uniform Partnership Act in almost all states.

16.3 Tax Consequences

Inasmuch as the partnership form continues the ongoing business of the proprietorship, immediate tax consequences of a transfer to the new entity are generally negligible. Under IRC Section 721, no gain or loss is recognized by the contribution of property in exchange for a partnership interest. However, income may result when one partner contributes assets and another partner, contributing services only, obtains an ownership interest in those assets. Similarly, income may result when assets are transferred to the partnership with liabilities in excess of the tax basis of the assets.

The tax basis of a partner's interest is generally equal to the basis of the assets in the partner's hands, increased by any income recognized at the transfer and decreased by liabilities assumed by other partners.

16.4 Notice to Creditors and Debtors

A change in form of the business enterprise requires notices to creditors and other obligees of the business. Without timely notice, the proprietor may be retaining sole liability for obligations rightfully shared by partners and the partnership itself. Appendix 3 on the *Accountant's Business Manual Toolkit CD-ROM* contains a sample notification of change of ownership.

17. CHANGE TO CORPORATE FORM

Incorporating a sole proprietorship entails considerably greater formality than change to a partnership. (See also the chapters on Corporations and S Corporations and appendix 2 at the end of this chapter and on the *Accountant's Business Manual Toolkit CD-ROM.*) Because of the many formalities required and pitfalls that can occur in incorporating, competent professional personnel should always be consulted.

From the standpoint of individual involvement in the ongoing business, the changes may be merely formal, since the corporation may include only family members already involved in the business operation as shareholders. On the other hand, incorporation may bring in key employees as shareholders or go to the point of making a public offering of shares in the new organization. (See the chapter on Securities Regulation.)

17.1 Reasons for Incorporating

— *Limited liability.* A stockholder's liability extends only to the investment in corporate stock, so personal or other business assets are not at risk. However, it is common in small businesses for the stockholder also to hold positions of management and employment which may entail personal liability for actions performed. These actions include causing personal injury or property damage by careless or negligent actions, or from professional errors or omissions. Also, financial liability is often not limited, since personal guarantees are required in many cases by both secured and unsecured creditors, particularly for stockholders of small, closely held businesses.

— *Income tax.* A low corporate tax rate of 15 percent applies to the first $50,000 of corporate income. This allows for splitting income between the individual and corporate tax returns to achieve full use of lower tax brackets. At income levels above $335,000, the corporate rate of 34 percent is slightly below the highest individual rate. Through 2008, dividend distributions from a corporation are subject to a low 15 percent individual tax rate. However, dividends and liquidating distributions result in a double taxation, a cost that must also be considered.

— *Estate planning.* Ease of transfer of a family business from the senior generation to successor family members is facilitated by incorporating. Full use of the annual gift tax exclusion can be used by transferring a specific number of shares, and members of the family can be stockholders without many of the burdens and restrictions of family partnerships. However, restrictions under IRC Section 2701 regarding valuations in connection with gifts should be considered in planning any transfers.

— *Employee benefits.* A corporation can establish pension and profit sharing plans as well as plans that provide health insurance and medical reimbursement plans covering the owner/employer. Care must be taken to be certain that antidiscrimination rules regarding medical reimbursement plans are not violated. However, health insurance is not subject to the same antidiscrimination rules as other employee benefit plans.

— *Tax elections and accounting methods.* The corporation is a new taxpayer and can thus take advantage of the opportunity to make new tax elections and adopt new accounting methods. The corporation might also consider an election under Subchapter S, whereby many of the tax consequences continue to fall on the individual, rather than on the corporation. However, under Subchapter S, the tax advantages of many fringe benefit programs are restricted for shareholders holding more than 2 percent of the stock. (See also the chapter on S Corporations, herein.)

17.2 Valuation

Valuation of the business assets becomes even more significant when the proprietorship property is contributed to the corporation. The description and tax basis of the various assets and liabilities contributed must be calculated and made part of the corporate records, and a value must be assigned to the shares to be issued.

17.3 Items for Transfer to Corporation

Assets	
Cash	Amount needed for operation.
Receivables	Identify on balance sheet, even if no tax basis (i.e., cash basis proprietorship).
Inventory	Identify on balance sheet, even if no tax basis, to prevent "assignment of income" attack under IRC Section 482.
Machinery and equipment	Generally automatic to include. May retain and lease to corporation, but watch passive-loss rules and possible self-employment tax.
Real estate	May transfer to allow land debt to be repaid with corporate after-tax dollars. Could also retain and lease to create retirement income. Real estate rent creates a hedge against inflation and does not reduce Social Security benefits under earnings limit test. Real estate, however, may be subject to double taxation if the corporation is liquidated. For this reason, real estate is often held out of the corporation. Later sale of real estate by a C corporation does not enjoy favorable capital gains tax rate.
Liabilities	
Accounts payable	If the proprietorship was on a cash basis, the operating expense payables will be deducted when paid by the corporation.

Liabilities	
Other liabilities	Must correspond to assets transferred or be business-related. May retain personally to avoid transferring excess liabilities.

17.4 Filings

The more formal requirements to prepare and file articles of incorporation and bylaws must be met, as must local requirements to record doing business as an entity other than a proprietorship in the sole name of the owner. New bank accounts should be opened in the corporate name and all vendors and creditors informed of the name change. Title on vehicles and insurance policies should be transferred to the new corporation. All parties should be informed of the new employer identification number of the corporation, and all information reporting should occur using the corporate number.

17.5 Issuance of Stock

Issuing and recording shares (which must be done by formal delivery of the stock certificates and observing all corporate formalities) may be a relatively simple process or may entail a public offering of considerable complexity, depending upon the nature and scale of the business. The short- and long-term capital needs and structure of the business should be considered to assess the appropriate form of shares to be issued and value of the initial capitalization.

17.6 Tax Consequences

A sole proprietor can incorporate under IRC Section 351 and recognize no gain or loss on the transfer. An incorporation under Section 351 requires three steps:

Step 1. Property (tangible or intangible) is transferred to a corporation.
Step 2. The transfer is solely in exchange for stock of the newly formed corporation.
Step 3. The transferors have at least 80 percent control of the corporation immediately after the exchange.

Taxable gain will result to the incorporator if stock is taken back in exchange for services. Gain can also be recognized if the incorporator receives cash or other boot in the exchange.

Incorporation should be viewed as a long-term commitment, because double taxation will generally occur upon the liquidation or dissolution of the corporation, unless the corporation is an S corporation at all times. Even with an S corporation, tax ramifications result upon the liquidation of the corporation.

17.7 Liabilities in Excess of Basis

Under IRC Section 357(c), gain may result to the incorporator if liabilities transferred to the corporation are in excess of the adjusted tax basis of the assets transferred. Gain may also result when liabilities that lack a bona fide business purpose or have a purpose of avoiding federal income tax are transferred.

18. CHANGE TO SINGLE-MEMBER LIMITED LIABILITY COMPANY

Most states currently allow single-member limited liability companies (LLCs), and it seems likely that many or all states will eventually revise their statutes to allow them. Under the IRS check-the-box entity classification regulations [Regs. Sec. 301.7701-2(a) and 301.7701-3(a) and (b)], a single-member LLC can be treated as a sole proprietorship for income tax purposes. The advantage of changing to a single-member LLC is liability protection. (See the Limited Liability Company chapter, herein, for additional information.)

19. EFFECT OF PROPRIETOR DEATH

Because of the close identity of the sole proprietorship with the proprietor, the death of the proprietor could spell the death of the business enterprise. Estate planning and distribution of property upon death are covered in detail in another chapter of this volume (see the chapter on Estate Planning, herein), but the intricate relationship of proprietor and proprietorship is such that mention of the issue needs to be made here.

Reference should be made to section 5.2 of this chapter, which discusses lack of continuity of the proprietorship, section 15.1, which discusses the unique knowledge of the proprietor, and section 15.6, which discusses estate planning for the proprietor.

19.1 Intestate Death

If the proprietor dies intestate (without a will) or without some other specific provision for the disposition of property, one of the following could result:

— The business and the assets could pass into the decedent's estate and be temporarily operated by the estate's administrator or designee.
— Business operations could be suspended temporarily while provision is made for their ongoing operation.
— The proprietorship enterprise might have to be sold to pay the amounts due for various liens, the taxes owed in connection with the estate, and the expense of administration.
— The enterprise could pass to a family member who has neither interest in nor capacity to continue the operation of the business, resulting in the ultimate demise or disposal of the enterprise, possibly at a significant loss.

19.2 Strategies for Preserving the Business

The chief consideration remains the ongoing operation and viability of the business enterprise itself, since an interruption of even a day's duration could prove detrimental. As a result, the more detailed the estate plan that can be prepared during life, the greater the possibility of minimizing negative consequences on the death of the proprietor.

19.2.1 Conveyance by will

One method of conveying a business interest is to designate a beneficiary in a will. The beneficiary must be carefully chosen, taking into consideration the individual's capacity to operate the business as well as the cash needs of the estate, which could result in a forced liquidation.

Preparations to convey the business should, if possible, be made prior to the death or final illness of the proprietor, in the hope that a successor can be trained and financial arrangements for sale be made before there is any urgency to dispose of the proprietor's interest.

19.2.2 Sale or conversion to partnership

Valuation of the proprietorship assets and its goodwill presents a substantial problem in the owner's absence. Therefore, prior to the death of a proprietor, consideration should be given to negotiating a sale agreement with a key employee who possesses special knowledge of the business. Alternatively, consider converting to a partnership with a buy-sell agreement to readily pass the interest in the ongoing operation of the enterprise.

19.2.3 Joint tenancy

Where permitted by law, joint tenancy may be considered as a preservation alternative. Local law must be consulted as to whether such a method of holding the business would render the enterprise something other than a sole proprietorship.

20. DISSOLUTION OF PROPRIETORSHIP

20.1 Bankruptcy

A proprietorship enterprise can be dissolved by bankruptcy—either of the business itself or due to the personal insolvency and resulting bankruptcy of the proprietor. (See also the chapter on Bankruptcy/Insolvency.)

20.2 Sale of Business

The proprietorship may be sold as an ongoing business entity, resulting in the altered form of the business by virtue of its new owner. Sale price should be allocated to equipment, inventory, real property or leaseholds, unique licenses, concessions or processes, and goodwill inherent in the ongoing business as well as any items peculiar to the nature of the enterprise itself. (See the chapter on Business Valuation.)

For tax purposes, the sale of a business may require the filing of Form 8594, Asset Acquisition Statement, by both the buyer and the seller. The requirement for the proper allocation of the sale of a business is contained in IRC Sec. 1060. The regulations under IRC Sec. 1060 spell out the reporting requirements regarding allocation of the sale of a business and the filing of Form 8594.

Appendix 4 on the *Accountant's Business Manual Toolkit CD-ROM* contains a checklist of tasks to complete in a normal business sale.

20.3 Sale of Individual Assets

Business assets may also be sold piecemeal, without the goodwill of the ongoing business. The more uniquely the enterprise is identified with the name, personality, or services of its proprietor, the less likely would goodwill be a salable commodity.

20.4 Noncompete Agreements

Covenants or agreements not to compete in the same form of business for a specified time and place may be negotiated separately in the sale of a proprietorship or its assets. Such covenants are governed by relevant state laws and are generally strictly construed in favor of free competition. Although a noncompete covenant may cover a relatively short period, the Internal Revenue Code requires that noncompetes (as well as most acquired intangible assets) be amortized over a 15-year period for tax purposes.

On the seller's side the noncompete income is ordinary in character, it is nonpassive, and is *not* subject to self-employment tax.

Appendix 5 on the *Accountant's Business Manual Toolkit CD-ROM* contains a sample noncompete agreement for illustrative purposes only. Because this is a legally binding document, it is important that competent legal counsel be engaged to draft the actual agreement.

20.5 Complete Termination

Termination of a proprietorship is never fully completed until all contracts are canceled or executed, all obligations of the proprietorship fully paid, and timely notice provided to all creditors or obligors.

All parties dealing with a proprietorship must be informed of a change of ownership in order to prevent ongoing liability to the original proprietor beyond the date of transfer. See Appendix 3 on the *Accountant's Business Manual Toolkit CD-ROM* for a sample notification.

21. HOME-BASED BUSINESSES

In an era of a technology-friendly, work-at-home environment, combined with the demand for flexible work arrangements and the general need for increased efficiencies and productivity, many proprietors now operate home-based businesses.

21.1 Virtual Offices

With the technology tools available today, including fax machines, Internet and e-mail capabilities, and wireless telephones, there is no longer a need for many small proprietorships, particularly service providers, to operate out of physical space other than a portion of the residence of the proprietor. This creates a concept called a "virtual office," in which business transactions are completed without the need for the buyer and seller to physically meet face-to-face. In fact, with such capabilities as video conferencing, face-to-face communication, although not physically in the same location, might still occur.

With the continued move toward a service-oriented economy and business-to-business transactions being completed in electronic medium, more proprietors will be operating in the realm of a "virtual office." Home-based businesses can operate as successfully and profitably (and perhaps even more so) than other proprietorships; however, attention to the creation of a business plan and the execution of sound business principles is paramount.

21.2 Importance of Business Plan

Business plans summarize the financial goals and objectives of a business, including home-based businesses, and provide guidance on how the business intends to achieve the goals and objectives. A business plan is a document summarizing all factors influencing a business, including customers, employees, finances, and other market forces. Financial statements and financial projections are only one part of a business plan, with other elements of the plan representing the roadmap for successful business strategies. For start-up businesses, a business plan may represent a vehicle to obtain necessary financing (see the chapter on Obtaining Financing, herein), but overall, a business plan should represent the means to achieve the proprietorship mission.

All businesses, including proprietorship home-based businesses, should develop a business plan. The plan should be monitored and continually updated. For many home-based businesses, the successful implementation of a business plan is even more important, because of the informal nature associated with many home-based operations.

21.3 Required Discipline

Home-based businesses normally require proprietors who are self-motivated, self-disciplined, and possess the skill and experience to properly perform a job without direct supervision. Individuals who require a lot of motivation and monitoring are clearly not well suited for a home-based business environment.

It is often best to have a dedicated workspace in the home for the home-based business. Similarly, proprietors should attempt to work regularly scheduled hours, keeping in mind that one of the advantages of a work-at-home environment is often an environment void of interruptions and distractions. Home-based business proprietors must exercise extreme caution that interruptions and distractions, such as from children's play, family member discussions, and other demands, do not inhibit a productive work environment. Special equipment needs, including an additional phone line at the residence, a modem, a personal computer, a printer, an in-home fax machine, a copy machine, and other peripheral equipment, also need to be considered.

21.4 Zoning and Licensing Issues

As discussed in section 6.2, home-based businesses need to exercise particular caution in meeting zoning and licensing requirements of the local jurisdiction. Special requirements associated with signage, parking, and so forth may come into play and warrant special consideration with a home-based business.

21.5 Profit Motive

The question of whether an activity is engaged in for profit in the eyes of the IRS is often a difficult issue to assess. Determining whether an activity is engaged in for profit is based on the facts and circumstances of each case and often can be quite subjective. Reg. Sec. 1.183-2(b) recites the following factors that should normally be considered:

- Manner in which the taxpayer carries on the activity
- Expertise of the taxpayer or the advisers
- Time and effort expended by the taxpayer in carrying on the activity
- Expectation that assets used in the activity may appreciate in value
- Success of the taxpayer in carrying on other similar to dissimilar activities
- Taxpayer's history of income or losses with respect to the activity
- Amount of occasional profits
- Financial status of the taxpayer
- Elements of personal pleasure or recreation

IRS scrutiny of activities consistently showing losses requires that any business activity must show a profit motive, and the proprietors should be willing to change business tactics to mitigate losses. In *Lopez v. Comm.*, the Tax Court found that an Amway distributorship was a hobby in which the taxpayers sold products in a very unbusinesslike manner with little chance of profitability, failed to follow the advice of their accountant, and continued to use the same ineffective methods to generate business. An element of personal pleasure does not force an activity to a hobby, as the Tax Court found in *Schwartz v. Comm.* Here the taxpayers owned a racing yacht but conducted the business professionally, consulted experts, and devoted substantial time. Taxpayers also won a victory in *Burris v. Comm.*, where a cattle breeding operation was conducted with a profit motive, recordkeeping was businesslike, and they demonstrated an increased market value of the livestock.

If an activity is determined to be a hobby (that is, a profit motive does not exist), income is reported on page 1 of Form 1040 and is not subject to self-employment tax, because a hobby is not considered a trade or business (Rev. Rul. 55-258). However, under IRC Sec. 183, hobby expenses are deductible only to the extent of hobby income, and then only on Schedule A of Form 1040 as miscellaneous itemized deductions. Accordingly, taxpayers who do not itemize deductions cannot claim any deductions attributable to a hobby activity. Additionally, because miscellaneous itemized deductions are not deductible for purposes of the individual alternative minimum tax (AMT), taxpayers with significant hobby expenses may become subject to the AMT.

It is important for all proprietorships, particularly those involved in home-based businesses, to pay particular attention to the factors listed in Reg. Sec. 1.183-2, including establishment of a business plan (see section 21.2), maintenance of adequate books and records, and in general, operation of the home-based activity in a businesslike manner. Failure to properly manage and operate the home-based business, particularly when losses occur, may subject the activity to IRS scrutiny under the so-called "hobby loss rules." Appendix 6 on the *Accountant's Business Manual Toolkit CD-ROM* contains a chart of nine factors for determining when an activity is a business or a hobby.

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APPENDIX 1: Proprietorship Creation Checklist

	Date Required	To Be Done By Atty.	Acct.	Prop.	Date Finished
1. Select attorney					
2. Select accountant					
3. Select bank and set up separate accounts					
4. Set short- and long-term goals					
5. Prepare current year budget					
6. Negotiate financing arrangements					
7. Determine equipment and inventory needs					
8. Negotiate leases and other contracts					
9. Select business name					
10. Do name check and filing of assumed name					
11. Apply for professional licenses					
12. Satisfy local requirements for license to do business					
13. Apply for federal ID number (Form SS-4)					
14. Apply for sales tax ID number					
15. Determine employment requirements and hiring					
16. Apply for unemployment compensation coverage					
17. Obtain expertise for payroll tax reporting					
18. Set employment terms and benefits/employment contract					
19. Develop job descriptions					
20. Secure adequate insurance coverage					
21. Secure worker compensation coverage					
22. Secure professional or other liability coverage					
23. Develop necessary internal forms					

	Date Required	To Be Done By Atty.	Acct.	Prop.	Date Finished
24. Prepare business procedure manual					
25. Prepare personal tax projection and consider need for quarterly estimates					
26. Order office supplies					
27. Select accounting methods					
28. Set up books and records and accounting system					
29. Determine fringe benefits to be offered to employees					
30. Determine vehicle requirements and reimbursement methods and rates					
31. Consider life insurance coverage on owner					
32. Execute necessary lease agreements					

APPENDIX 2: Incorporation Checklists and Examples

The following checklists are offered as guides in reviewing the potential for and establishing a corporation for clients.

The accountant may use whatever information is deemed appropriate in individual circumstances; however, it is recommended that the checklists be completed for every corporation and retained in the corporate file.

Contents

PART I—Initial Checklist of Duties and Accountant Responsibilities

1. Discuss with client the difference between an S corporation and a C corporation.
2. Review advantages and disadvantages of incorporation with client (Part II).
3. Complete Corporate Information Sheet (Part III).
4. Be sure provisions under IRC Sections 351 and 357 have been reviewed (see also Part II, Question 9, and Part VI).
5. Review Client Responsibilities Checklist (Part IV). Give copy to client.
6. Review and follow Checklist of Items to Exchange With Attorney (Part V).
7. Draft required application for identification numbers (I.D.).
   a. SS-4
   b. State withholding (if required)
   c. State sales tax (if required)
   d. State unemployment (if required)

8. Instruct client on payroll tax requirements.
   a. Rates and deposit requirements on FICA.
   b. Federal and state withholding to be deducted? Give withholding booklets and Forms W-4 and I-9 to client.
   c. Distribute employee's earnings records and instructions to client.
   d. Transfer any previous unemployment rate.
9. Secure data for and draft Opening Corporate Balance Sheet.

   Example 1: Compilation Letter
   Example 2: Sample Balance Sheet
10. Instruct client on bookkeeping requirements and accounting software installation.
    a. Who will do bookkeeping? ______ Client ______ Accountant
    b. Will accounting software installation be required? Who will complete it?
    c. Will a financial statement be required (at year-end for bank, etc.)?
       ______ Yes ______ No
    d. IRC Section 351 transfer statement (blank form (Part VI)).
    e. Organization expense election (Part VII).
    f. For new businesses, start-up expense election (Part VIII).
11. Complete engagement letter.

PART II—Checklist of Advantages and Disadvantages of Incorporation Discussed With the Client

INITIALS ______
DATE ________

ADVANTAGES

1. Income tax savings
   A. C Corporations
      (1) Tax brackets (beware of 35 percent personal service corporation rate).
      (2) Fringe benefits:
          a. Medical insurance (*can* discriminate).
          b. Medical reimbursement (*cannot* discriminate).
          c. Group term life insurance.
      (3) Meals and lodging.
      (4) Pension and profit-sharing plans.
      (5) New tax elections/accounting methods.
      (6) Lease of house from corporation after sale.
      (7) Social Security tax (plan carefully).

B. S Corporations
   (1) Social Security tax (plan carefully).
   (2) New tax/accounting methods.

2. Estate planning
   A. Easier transferability from senior generation to successor family members or other potential part owners (watch IRC Section 2701).
   B. Life insurance—use to fund purchase of stock (be careful of ownership).
   C. Can preserve IRC Section 2032A "special use" land valuation.
   D. Can preserve IRC Section 6166 deferred estate tax payment privilege.

3. Miscellaneous
   A. Limited liability (minimal advantage for most closely held corporations).
   B. Better records (assets and liabilities—double entry system).

4. Social Security
   A. May limit tax due to wages being lower than total profits.
   B. Request earnings and benefits statement from Social Security.
   C. Fully deductible by corporation (similar to 50 percent self-employment deduction).

Comments:

Notes on follow-up possibilities:

INITIALS ______
DATE ________

DISADVANTAGES

5. Income tax
   A. Potential for "dividend" issues and double taxation
      (1) Taxation at market values in event of liquidation.
      (2) Personal benefit areas.
   B. Must plan for personal income tax from January 1 to date of incorporation (also give consideration to corporate level income).
   C. For farmers, tax payment deferred privilege is lost—quarterly tax estimates required.
   D. ACE and AMT for C corporations.
   E. Watch for multiple corporations (brother/sister, etc.).
   F. State tax rates:
      (1) Higher than individual?
      (2) Other filing fees?
6. Social Security tax and payroll tax
   A. Salaries to owner's children no longer exempt from Social Security.
   B. Lower Social Security base could reduce retirement benefits.
   C. May be subject to unemployment taxes (both federal 940 and state).
7. Increased paperwork
   A. Additional income tax return.
   B. Increased legal fees—organization and annual meetings.
   C. Payroll tax returns.
   D. Additional "state report" filings.
8. Estate and retirement
   A. Cannot transfer specific items to specific individuals without options, spin-offs, etc.
   B. Limited income to retired individual if land is in corporation (try to keep land out—plan carefully).
9. Tax traps
   A. IRC Section 351 (be sure 80 percent control requirement is met).
   B. IRC Section 357 (Excess of liabilities over tax basis of assets—strong potential for cash basis taxpayers. If potential, draft balance sheet to test and plan before proceeding).
   C. Locked-in net operating loss and capital losses.
   D. Locked-in earnings and accumulated earnings penalty tax.

E. IRC Section 179 recapture on assets kept out of corporation and rented (prorated over recovery period).

10. Miscellaneous

Discuss need for workers' compensation and possible exemption for corporate officers.

PART III—New Corporation Information Sheet

1. Name of corporation: ______________________________
2. Address of corporation: ______________________________
3. Date of incorporation: ______________________________
4. County of incorporation: ______________________________
5. Name, address, and Social Security number of incorporators:
   a. ______________________________
   b. ______________________________
   c. ______________________________
   d. ______________________________
   e. ______________________________
6. Names of officers and directors:
   President: ______________________________
   Vice-President: ______________________________
   Secretary: ______________________________
   Treasurer: ______________________________
   Directors: ______________________________
7. Corporate stock
   a. Authorized capital: $______________________________
   b. Number of shares authorized: ______________________________
   c. Number of shares issued: ______________________________
   d. Par value of shares: $______________________________
8. Stockholders and number of shares issued:

	Name	Social Security Number	Birth date	Number of Shares	Certificate Number	Date
a.						
b.						
c.						
d.						
e.						

9. Name and address of bank: ______________________________
10. Fiscal year-end: ______________________________

11. Subchapter S corporation election? ______________________
    (Note: be sure to file within fifteenth day of third month of tax year).
    Indicate who will file election ______________________
12. Stockholders' restrictive agreements (buy–sell): ______________
13. Date business was started: ______________________
14. Number of employees: ______________________
15. Date first wages will be paid: ______________________
16. Average monthly payroll: $______________________
17. Employees and annual compensation:

______________________	$__________
______________________	$__________
______________________	$__________
______________________	$__________
______________________	$__________

18. Attorney's name, address, and phone number: ______________
    ____
19. Employee residence locations: ______________________
    ____
    ____
    ____
    ____
20. Tax identification numbers (TINs):
    a. Federal tax identification number (per Tele-TIN) __________
    b. State tax identification number (if applicable) __________
21. Corporate charter number: ______________________
22. Accounting method information:
    a. Basis of accounting for tax purposes ______________
    b. Any special elections or computations required?
       (1) IRC Section 461 accrual election ______________
       (2) IRC Section 351 transfer statement (with individual's return) ______________
       (3) Organization expense amortization election ______________
       (4) Start-up expenditures amortization election ______________
       (5) ______________________
23. E-mail address: ______________________

PART IV—Checklist of Duties and Client Responsibilities

Federal Tax Identification Number: ________

1. Contact attorney to
   a. Approve name.
   b. File articles and forward a copy to accountant.
2. Provide information requested by accountant to prepare opening corporate balance sheet and help determine what assets and liabilities will be transferred.
3. Gather information and meet with accountant to do income tax planning prior to incorporation.
4. Set up corporate checking account using new federal tax identification number.
   a. Order printed checks (be sure to use *approved* corporate name).
   b. Fund the account (this *activates* the corporation for tax purposes, assuming the articles of incorporation have been filed).
5. Transfer title on vehicles, land, and contracts (discuss sales tax exemption—transfer exempt if exchanged for stock).
6. Notify other vendors (in the normal course of business dealings) of the name change and new identification number.
7. Transfer insurance policies on property, vehicle fleet policy, farm liability, and medical/disability (if group contracts are being initiated).
8. Notify creditors of name/legal status and identification number change.
9. Gather information to file any final returns (partnership, etc.).
10. Meet with accountant to set up chart of accounts and bookkeeping/accounting procedures.
11. Know and understand payroll tax withholding, deposit, and recordkeeping requirements.
12. Secure any special licenses and permits in corporate name.

PART V—Items to Exchange With Attorney

A. Need from attorney:
   1. Approved corporate name.
   2. Date of incorporation (official date per filing with secretary of state—will need to coordinate with activating corporation).
   3. Copies of articles (and bylaws if possible).
      a. Number of shares authorized.
      b. Class and par value (if any) of shares authorized.

4. Corporate charter number.
5. Copies of any final agreements between shareholders and officers of corporation (rental, lease, employment agreements, etc.).

B. Transmit to attorney:
1. Opening corporate balance sheet.
   a. Clarify types of stock to be issued and number of shares to each stockholder.
   b. Highlight land to be transferred and to be retained.
   c. Advise (per balance sheet) of items transferred for exchange agreement.

C. Inform/counsel attorney RE: Tax consequences of
1. Lease of land to corporation.
   a. Suggest nonparticipating to avoid self-employment tax.
      (1) Caution on structuring agreement to preserve IRC Sections 2032A and 6166 where in some cases cash rent may be a problem.
      (2) Caution on portfolio versus passive income or (loss).
2. Buy-Sell agreement—good idea even for closely-held family corporations.
   a. Cross-purchase versus redemption?
   b. Insurance funding? (Make reference in agreement and be careful of ownership to avoid ACE and AMT.)
   c. Should wills also be revised?
3. Items for minutes of board of directors.
   a. Medical expense reimbursement plan?
   b. Medical insurance plan?
   c. Group disability plan?
   d. Group term life insurance?
   e. Resolution regarding reclassification of ordinary and necessary business expenses by governmental authorities.
   f. Employment arrangements/Annual officer compensation (peg a high number).
   g. Vehicle use: Require corporation to inform officer of personal use element on vehicles, etc., and to authorize as additional compensation.
   h. Corporate resolutions authorizing various bank accounts/borrowing.
   i. S corporation to be utilized? (Get a copy of election to attorney.)
   j. Fiscal year-end selected?
4. Pension or Profit-sharing plan?

PART VI—IRC Section 351 Transfer Statement

____

____

On ____________________, ____________________, a sole proprietor, transferred substantially all of the assets of his/her ________________ operation to ____________________, a newly formed corporation. A copy of the assets transferred to the corporation is attached to this statement.

The assets of the former proprietorship were transferred to the corporation solely in exchange for the securities of the corporation, pursuant to IRC Section 351. Accordingly, no gain or loss was recognized on the transfer, and the tax basis of the assets in the hands of the proprietor as of ____________________ carries over to become the tax basis of the assets in the hands of the corporation.

PART VII—IRC Section 248 Election to Amortize Organization Expenditures

____

Election Re: Amortization of organization expense

In this, its first taxable year, taxpayer incurred $ ____________ as organizational expenditures incident to its creation. Under the provisions of Section 248 of Internal Revenue Code and the Regulations thereunder, taxpayer hereby elects to expense $ ____________ and amortize excess expenses over the 180-month period commencing with the date of formation, which constitutes the month in which taxpayer began business. This information is submitted as required:

Description of Expense	Date Incurred	Amount
		$
Total organization costs		$ ________

PART VIII—IRC Section 195 Election to Amortize Start-Up Expenditures

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FORM 1120

AMORTIZATION OF START-UP EXPENDITURES

Pursuant to IRC Section 195, ____________________ elects to expense $ __________ and amortize the excess start-up expenditures over 180 months beginning with ________________ , 20____ , the month in which the corporation began business. This information is submitted as required:

Description of Expense	Date Incurred	Amount
		$
Total start-up costs		$ ________

Example 1: Compilation Letter

April 4, 200X

To the Stockholders and Board of Directors
Apple Farms, Inc.
Anycity, ST 00000

We have compiled the accompanying opening corporate statement of assets, liabilities, and stockholders' equity—income tax basis and market value of **APPLE FARMS, INC.** as of March 14, 200X, and the related supplementary data in accordance with Statements on Standards for Accounting and Review Services (SSARSs) issued by the American Institute of Certified Public Accountants. The financial statement has been prepared on the accounting basis used by the company for income tax purposes, which is a comprehensive basis of accounting other than U.S. generally accepted accounting principles.

A compilation is limited to presenting in the form of a financial statement and supplementary data information that is the representation of management. We have not audited or reviewed the accompanying statement and supplementary data and, accordingly, do not express an opinion or any other form of assurance on them.

Management has elected to omit substantially all of the disclosures ordinarily included in financial statements. If the omitted disclosures were included in the financial statements, they might influence the user's conclusions about the Company's assets, liabilities, and equity. Accordingly, this financial statement is not designed for those who are not informed about such matters.

Management has elected to display the market values of all assets and liabilities on the statement in addition to the income tax basis. Market values are based on the estimates of management.

Example 2: Sample Balance Sheet

APPLE FARMS, INC.
Opening Corporate Statement of Assets, Liabilities, and Stockholder's Equity—
Income Tax Basis and Market Value
March 14, 200X

(See Accountants' Compilation Report)

	As Transferred by Greg Apple		*As Transferred by Frank Smith*		*Total*	
	Tax Basis	*Market Value*	*Tax Basis*	*Market Value*	*Tax Basis*	*Market Value*
Assets						
Inventory:						
Soybeans (11,000 bushels at $4.35 per bushel)	$ —	$ 47,850	$ —	$ —	$ —	$ 47,850
Corn (24,000 bushels at $1.75 per bushel)	—	42,000	—	—	—	42,000
Market hogs (469 head—all sizes)	—	2,488	—	76,291	—	78,779
Prepaid expenses:						
Seed	—	3,000	—	5,000	—	8,000
Diesel fuel	—	500	—	—	—	500
Feed	—	—	—	2,000	—	2,000
Breeding stock (see attached list)	—	—	2,872	9,903	2,872	9,903
Equipment (see attached list)	25,437	103,000	15,500	87,000	40,937	190,000
Total Assets	$ 25,437	$198,838	$ 18,372	$180,194	$ 43,809	$379,032

Liabilities and Stockholders' Equity

Liabilities:						
Note payable—Any Bank, Anytown, ST	$ 15,000	$ 15,000	$ 5,000	$ 5,000	$ 20,000	$ 20,000
Note payable—Green Tractor Co.	8,644	8,644	—	—	8,644	8,644
Total Liabilities	23,644	23,644	5,000	5,000	28,644	28,644
Stockholders' equity (100,000 shares, no par, voting common stock authorized: 10,000 shares issued and outstanding)	1,793	175,194	13,372	175,194	15,165	350,388
Total Liabilities and Stockholders' Equity	$ 25,437	$198,838	$ 18,372	$180,194	$ 43,809	$379,032

Partnerships

PARTNERSHIPS

SUGGESTED REFERENCES

APPENDIX 1: Partnership Agreement Checklist (*also see Toolkit CD-ROM*)

APPENDIX 2: Partnership Creation Checklist (*also see Toolkit CD-ROM*)

APPENDIX 3: Comparison of Entity Attributes—Proprietorships, Partnerships, C Corporations, S Corporations, and LLCs

APPENDIX 4: Sample Buy-Sell Agreement (*see Toolkit CD-ROM*)

APPENDIX 5: Sample Notification to Creditor of New Business Form (*see Toolkit CD-ROM*)

APPENDIX 6: Partnership Termination Checklist (*see Toolkit CD-ROM*)

APPENDIX 7: Eligibility for Using the Cash Method of Accounting (*see Toolkit CD-ROM*)

APPENDIX 8: Sample Election Under IRC Section 754 to Adjust Basis of Partnership Property (*see Toolkit CD-ROM*)

1. INTRODUCTION

In partnership arrangements, two or more entities (individuals, trusts, estates, partnerships, corporations, or nonprofit organizations) structure an agreement to work together to accomplish common business objectives.

Over the years, considerable legislation has been passed governing partnership arrangements to add formality and consistency. Uniform partnership provisions among states are common in most areas, eliminating previous inconsistencies in state legislation. The provisions of certain legislation may be invoked or avoided depending on how a partnership agreement is drafted. See appendix 3, "Comparison of Entity Attributes—Proprietorships, Partnerships, C Corporations, S Corporations, and LLCs."

2. PARTNERSHIP FORMS

2.1 Partnership

A partnership is an ongoing relationship agreed to and engaged in by two or more entities to conduct a business and to produce profits that will be divided among the parties. The partnership form can be used for any type of lawful business activity.

Because this definition is broad enough to include various forms of business associations, the hallmark of the partnership form is the *intent* shown by the partners to function in this form and to share the common purposes and risks of the enterprise.

2.2 Joint Venture

The primary purpose of a joint venture is for the venturers to share the risks and profits of some specific project or undertaking. As such, a joint venture is distinguished from a partnership in that the relationship is not so general, ongoing, or pervasive as a partnership. Joint ventures are nevertheless generally governed by the statutory and case law applicable to partnerships.

A joint venture is generally treated as a partnership for tax purposes, unless the members of the joint venture qualify and elect under IRC Section 761(a) not to be subject to the partnership tax rules.

2.3 General and Limited Partnerships

A general partnership consists of partners who are co-owners of the enterprise in every sense. General partners share the profits and may share management decisions and control of day-to-day activities of the business. General partners also share the risks of ownership, including financial losses and liability for all phases of the business. This liability may extend to the partners' personal assets unconnected with the partnership.

A partnership may consist of a limited partner or partners, in addition to one or more general partners. Generally, a limited partner does not participate in management functions. Section 303 of the Uniform Limited Partnership Act (ULPA), however, does allow limited partners to participate in controlling certain activities. The limited partner's investment determines that partner's share in profits and the liability of the limited partner is limited to that investment in the partnership.

Except in limited liability companies, as discussed in Section 2.8, a limited partner cannot manage the limited partnership. Each limited partnership has a general partner who has exclusive control over the operations of the partnership. The general partner is, however, bound by a fiduciary responsibility to the limited partners and must act in accordance with the partnership agreement. Except for limited liability limited partnerships (LLLPs), as discussed in Section 4.1, the general partner's liability is not limited to his or her investment. The death, bankruptcy, or total disability of a limited partner does not cause the partnership to dissolve.

2.4 Family Partnership

Although a family partnership consists solely of family members, it is subject to all the rules applicable to other partnerships. The family limited partnership can be used as an estate planning technique (see the Estate Planning chapter herein).

IRC Section 704 limits the ability to use a partnership as a vehicle to shift taxable income among family members. The partnership must be a bona fide entity in which compensation is commensurate with duties or responsibilities, not merely an income-shifting device, in order to be legally recognized.

Profit sharing based on duties alone is not the sole determining factor. A person is recognized as a partner if he or she owns a capital interest in a partnership in which capital is a material income-producing factor, even though no services are rendered. Thus, a partnership may be valid if a partner's share of profits is related to the capital contributed, a combination of capital contribution and services, or only services, depending upon whether the partnership business is labor-intensive, capital-intensive, or some combination of the two.

Many family partnerships fail because the formalities are not observed. Entering into a written partnership agreement, maintaining proper books and records, and filing the proper tax returns help establish the necessary legal relationship.

2.5 Professional Corporations as Partners

Because of the unlimited liability of partners, individuals may incorporate as a professional corporation (PC). Allowing such a PC to then become a member of a partnership potentially protects the individual from liability arising from services rendered by other members of the partnership.

2.6 Limited Partnership Tax Shelters

Limited partnership tax shelters are generally developed with the intention of generating passive losses to offset other taxable income. After TRA '86, which restricted the ability to offset other income with passive losses, a new breed of tax shelter has arisen. Passive income generators, or PIGs, are designed to produce passive income for a taxpayer, which, in turn, allows losses from other passive activities to be deducted.

2.7 Master Limited Partnerships

A relatively new form of partnership is the master limited partnership (MLP). Shares in MLPs are publicly traded. The Revenue Act of 1987 requires that MLPs be taxed as corporations.

2.8 Limited Liability Companies

Generally, a limited liability company (LLC) furnishes the flexibility and tax advantages of a partnership and the limited liability provided in a corporation. Income passes through to the income tax returns of the individual owners. Only the assets of the company, not the personal assets of the owners, are at risk for an LLC's debts, thereby placing limited liability company members in positions similar to limited partners.

The existence of an LLC will *not* generally shield a person from liabilities related to his or her own tortious acts (such as causing personal injury or property damage by careless or negligent actions) or from liabilities related to his or her own professional errors or omissions. See the chapter on Limited Liability Companies herein.

2.9 Registered Limited Liability Partnerships

Registered limited liability partnerships (LLPs) are similar to LLCs in their ability to limit the liability of individual partners, but with several distinctions. An LLP is a type of general partnership as opposed to the hybrid nature of an LLC. Accordingly, an LLP is generally governed by the same laws as general partnerships.

Under the LLP, partners continue to be personally liable for their own acts and omissions and those of persons under their supervision. Partners are also personally liable for commercial and other obligations incurred by the partnership in the ordinary course of business. Partners are not, however, liable for partnership liabilities arising from other partners' and most employees' negligent and wrongful acts or omissions.

Several state LLP statutes provide that LLP partners are *not* personally liable for the partnership's commercial and other obligations. In these states, LLPs are effectively the same as LLCs in terms of the liability protection offered to owners. LLPs are well suited for accounting and other professional firms that have difficulty operating under their particular state's LLC statutes because several states limit LLC use by professionals. LLPs also allow professional firms to continue to use the partnership structure and taxation.

Accounting firms organized as LLPs should be able to conduct business even in non-LLP states. The accountancy statutes of all states allow for general accounting partnerships, of which the LLP is one type. The IRS has also issued several private letter rulings on the tax aspects of LLPs. Because of differences in state statutes for those jurisdictions that have authorized LLPs, however, a careful reading of a particular state's LLP law is necessary.

3. LEGAL STATUS AND CHARACTERISTICS OF A PARTNERSHIP

3.1 Hybrid Nature

In one sense, a partnership is a legal entity with its own identity. In this sense, the partnership holds itself out as a business entity apart from the individual personalities of its owners. This identity may be established, and its name protected, through filings with appropriate state agencies. The partnership may sue and be sued as a separate entity and is subject to tax reporting and other requirements.

On the other hand, partnerships are simply conduits that allow income, losses, and other tax incidents to pass through to the individual partners. Liabilities for actions or omissions in the course of the partnership's dealings with third parties also pass through to the individuals.

(Text continued on page 9)

General partners are liable to the full extent of their individual or personal resources for partnership activity, and no activity of the partnership is ever undertaken without the full personal guarantee of its individual members. A general partnership may be considered to be an aggregation of sole proprietors linked together in a common enterprise.[1]

Although a partnership does not pay federal income taxes, it is treated as a separate entity for tax audit purposes, similar to a corporation. (See the chapter on IRS Practice and Procedure for further details.)

3.2 Legal Characteristics

3.2.1 Duration

Unless specifically limited by the statements or actions of the partners, a partnership exists for general business purposes. Similarly, unless expressly limited, the duration of the partnership's business existence is at the will of the partners. This differs from the corporate form, where the existence is eternal unless expressly limited. On the expiration of the fixed term of a partnership agreement, the partnership may continue as a partnership at will.

A partnership's continuing existence, however, is subject to the consensus of the partners. When the partners no longer hold themselves out to the public as a partnership, when one or more partners withdraw or die and are not replaced by the unanimous and mutual consent of the remaining partners, or when partners breach their duties to the other partners, the partnership may technically dissolve. Despite the dissolution, the partners will continue to be liable to third parties unless legally adequate notice is given and the partnership activities have ceased. A partnership has no continuity of life as an independent entity when only one partner remains; the partnership then either acquires a new form or ceases existence.

3.2.2 Jointly owned property

Joint ownership of property used or acquired in the course of business may be an indication that a partnership exists. However, it is not necessary that a partnership jointly own all property used or acquired in the business. Similarly, if joint ownership of property exists, this is not in itself evidence of the existence of a partnership for the business.

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[1]Richard D. Harroch, *Start-Up Companies: Planning, Financing and Operating the Successful Business* (New York: Law Journal Seminars Press, 1987), pp. 1–35.

In many cases, real estate may be held by tenants in common, which provides a form of real estate ownership in lieu of actual partnership ownership.

3.2.3 Other ownership issues

Determining ownership of property can be important for a number of reasons. Creditors have certain rights depending on whose debt is to be satisfied and who owns the property. Other events such as selling property, tax liens, and settling estates can be affected depending upon ownership.

Certain partnership property owned by the partnership may be titled in a partner's name. Even though the partnership does not have legal title, it is still partnership property. In contrast, the fact that property may be used by the partnership does not mean it is partnership property.

A partner owns an interest in all partnership property and not in any specific property. It is therefore important to provide clear documentation on what is and what is not partnership property. This may be accomplished by recording the property on the partnership books, acknowledging it in the partnership agreement, and having it titled in the partnership.

3.2.4 Profit sharing

The single most significant feature of most partnerships is the division of profits. The Uniform Partnership Act (UPA) identifies a partnership as an association of two or more persons to carry on as co-owners of a business for profit. The actual division of profits is determined by the partnership agreement (see sections 4.3 and 12, herein).

3.2.5 Management and control

In contrast to the centralized management structure of a corporation, management of a general partnership is usually decentralized. Each partner has equal right to share in the management of the partnership business unless the partners agree otherwise.[2]

4. LAWS GOVERNING THE PARTNERSHIP

4.1 Applicable Statutes and Laws

The Uniform Partnership Act (UPA) is a comprehensive legal skeleton for the partnership form of business that has been adopted by almost

[2]Harroch, *Start-Up Companies*, pp. 1–29.

all states. The UPA creates presumptive rules that apply where a subject is not addressed by the partnership agreement. The statute also provides protection to other individuals or entities who are strangers to the partnership that can override provisions of the partnership agreement.

The Uniform Limited Partnership Act, drafted in 1976 with 1985 amendments, governs limited partnerships and has been adopted by most states.

A completely revised Uniform Limited Partnership Act of 2001 was drafted and recommended for enactment in all states. A few states have introduced this legislation and the number of states adopting the revised act is expected to grow each year. The new act is a "stand alone" act and does not link directly to the Uniform Partnership Act. The new act provides for limited liability limited partnerships (LLLPs), in which no partner (whether general or limited) is liable on account of partner status for the limited partnership's obligations. Both general and limited partners benefit from a full, status-based liability shield that is equivalent to the shield enjoyed by corporate shareholders, LLC members, and partners in an LLP.

Information on the Uniform Limited Partnership Act of 2001 may be obtained from the National Conference of Commissioners on Uniform State Laws at (312) 915-0195 or the Web site www.nccusl.org.

Another source of external governance of the partnership lies in the case law involving partnership issues, and the applicable reports of state administrative agencies ruling on business activities may affect partnerships as well.

4.2 Who Can Be a Partner

The 1976 Uniform Partnership Act allows individuals, other partnerships, corporations, or any other association to be a partner. Certain individuals that lack "legal capacity," such as minors or persons declared legally insane, cannot be partners.

4.3 The Partnership Agreement

A partnership is permitted to create its own law through a partnership agreement, a formal document, consented to and executed by all partners. Although it is possible for a partnership to function well without a partnership agreement, problems can occur when a partner becomes permanently disabled, dies, or is removed from the partnership. A formal, thorough agreement will prevent resentment, disputes, and the possible inadvertent dissolution of the partnership. See appendix 1, also on the *Accountant's Business Manual Toolkit CD-ROM,* for a reference list of issues to be addressed. A summary of these issues includes:

— Name of partnership.

— Names of partners.

— Address of its principal offices.

— The purpose of the partnership.

— Its duration.

— Its executive, administrative, and capital structure; the financial, administrative, and functional relationship among its partners.

— Procedures for decision making and resolving disputes.

— Formulas for sharing profits, losses, and liabilities.

— The means of equitably terminating the partnership itself upon the occurrence of various events.

— The authority of the partners.

— Any restriction on the transfer of partnership interest.

The partners should formalize the intention of the parties in a written partnership agreement. The formal recitals of the parties to the agreement should specify:

— That the partners intend to form a partnership for a legal purpose and that the partners understand and accept the legal incidents of a partnership.

— That the partners intend to share, in some specified fashion, the profits, losses, rights, and obligations of a partnership.

— That the partners have a common interest of some variety in the property to be owned by or contributions to be made to the partnership.

— That the partners specify that they will have either an equal share or specifically delineated duties in the operation of the partnership's business enterprise.

The agreement should express a definite commencement date for the business activity, since this moment may be difficult to discern after the fact.

The acts in commencing partnership business performed by individuals representing themselves as partners or agents bind the partnership itself if those acts are consented to, or later ratified by, the other partners or agents.

4.3.1 Buy-sell agreements

Generally, a partnership has no continuity as an independent entity beyond the ongoing agreement of the original partners. This rule can be varied by the continuing agreement of the existing partners to add new partners—or, in effect, to re-create the partnership at some point by altering the form of the enterprise or substituting a new partner for a previous partner.

Another method of accomplishing this re-creation lies in a buy-sell agreement executed by the partners. This agreement provides for the sale of the partnership interest to the existing partners (or the effective buyout of a partnership interest) upon the happening of certain specified events (such as withdrawal or death). Such an agreement, executed at the creation of the partnership itself, provides for continuation of the partnership association (and serves to protect the ongoing business enterprise) by retaining all partnership interests in only those individuals desiring to carry on the business.

A buy-sell agreement is executed prior to an event that would otherwise terminate the partnership. This can avert termination and forestall any adverse consequences of a dissolution of the partnership. The agreement need not be filed in a public office for it to be legally binding.

In the absence of a written agreement, the partners may have an informal agreement that governs the day-to-day functioning of the partnership. A verbal agreement is much less desirable than a written agreement. While a verbal agreement may suffice for commonplace, relatively insignificant transactions, any substantial transaction should be documented. In almost all circumstances, courts will recognize a valid written agreement as binding even when it contradicts an oral agreement.

Appendix 4 on the *Accountant's Business Manual Toolkit CD-ROM* contains a sample buy-sell agreement for illustrative purposes only. Since a buy-sell agreement is a legal document, it should be drafted only by competent legal counsel.

5. DELEGATION OF AUTHORITY FOR MANAGEMENT DUTIES AMONG PARTNERS

The partnership agreement may specifically delegate authority for management duties to the various partners. In the absence of such agreement, each partner has an equal right to participate in the management of the enterprise and conduct the business of the partnership.

As an example, many accounting firms are structured with a managing partner, an administrative partner, and a personnel partner, among others. Although all of these partners have a right to participate in the overall management of the accounting firm, specific agreement among them allows delegation of authority in unique areas to these individuals. Each partner also has access to the books of record and accounts of the partnership, which are generally kept at the site of the principal place of business.

Since all partners have equal authority in the management of the business, any partner is free to delegate administrative functions related to the operation of the business, but such delegation is subject to the partner's fiduciary duty to the partners and to the partnership and could result in a dissolution if the delegation constitutes an assignment of the partner's interest. An unauthorized act by a partner or designee may bind the partnership if an innocent third party is defrauded by misrepresentations of authority.

6. DUTIES OF PARTNERS TO EACH OTHER

6.1 Duties of Partners to Co-partners

The specific duties of a partner to the co-partners or to the partnership itself are defined by the partnership agreement or the understanding of the partners. A partner is an agent of the partnership, whose actions will bind both the entity itself and the co-partners.

6.1.1 Fiduciary duty

A partner owes to the co-partners and the partnership itself a duty of the utmost good faith and fair dealing, based on the trust and confidence inherent in the partnership arrangement. The law refers to this trust as the fiduciary duty of the partner. As a rule, partners will be held to using their best efforts in carrying out the business objectives of the partnership.

Partners must act with undivided loyalty, complete good faith, and fairness and honesty in their dealings with each other. When partners are involved in more than one partnership, efforts should be made to avoid conflict of interest.

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6.1.2 Duty to share profits

Unless varied by agreement, a partner must turn over to the partnership and to the co-partners any profits or advantages directly or indirectly derived from the partnership activities.

6.1.3 Duty to contribute capital

A partner has a duty to comply with the obligation to contribute to partnership capital and, while entitled to return of the contribution and any profits, the partner has no specific entitlement to remuneration for activities in the business enterprise, other than as spelled out in the partnership agreement.

6.1.4 Duty to share losses and liabilities

A partner has a duty to share in losses and liabilities of the partnership as well as not to incur unreasonable obligations binding the partnership or co-partners. General partners are jointly and severally liable for the obligations of the firm.

6.1.5 Management duty

A general partner has a duty to participate in the ongoing management activities of the partnership and not to withhold such consent as may be necessary to admit new partners or for other changes in the structure of the partnership unless prohibited by the partnership agreement. A partner must act for the benefit of the partnership in all the activities involving the enterprise and should not attain personal enrichment at the expense of partnership opportunities. A partner should not carry out an act that would make it impossible to perform the ordinary business of the partnership.

6.2 Remedies for Breach

6.2.1 Court action

Partners are entitled to an accounting of partnership assets, liabilities, income, or losses, to ascertain or protect their own interests in the entity, upon reasonable demand. A partner is also entitled to examine the books of record and accounts of the partnership. If refused, such accounting may be undertaken and enforced through a legal action. A partner, personally or on behalf of the partnership, may also bring an action for satisfaction of unjust enrichment made by a co-partner at the expense of the partnership.

6.2.2 Dissolution or withdrawal

A partner may petition to dissolve the partnership upon allegations of breach of trust (fiduciary duty) by one or more of the co-partners and may ask the court to terminate the business relationship and account for and distribute profits and assets.

A partner may declare a personal intention to withdraw from the partnership and, by withholding consent to substitute another partner or restructure the partnership, cause the business relationship to dissolve. The buy-sell agreement or a portion of the partnership agreement should specify the terms of the withdrawal.

7. DUTIES AND LIABILITIES TO THIRD PARTIES

7.1 Express Authority

7.1.1 Binding contracts

Each general partner is an agent of the partnership for transacting business. Each general partner can make contracts, written or verbal, and bind the other partners and the partnership to the extent allowed under the partnership agreement. A majority vote of the partners is required to grant a partner express authority not granted in the partnership agreement. Furthermore, some partnership decisions can only be made upon a unanimous vote (including decisions to go to arbitration, admit new members, and amend the partnership agreement) unless otherwise provided for in the agreement.

Statements made by a partner acting within the scope of authority as a partner may be attributed to and used against the partnership itself or the co-partners.

7.1.2 Liability for wrongful acts or omissions

The partnership and co-partners are liable for the wrongful act or omission of a partner that causes injury or loss to a third party when the act or omission takes place in the ordinary course of business or the act/omission is authorized by the co-partners.

An individual partner may be personally liable to a third party injured as a result of the partner's act or omission if the partner was acting outside the partner's authority as a member of the partnership.

7.1.3 Conveyance of real estate

A partner can convey title to real estate to third parties, but the conveyance may be voided if the partner was acting outside the scope of authority or the party taking the real estate was aware of the lack of authority. The transfer cannot be voided if the property is subsequently purchased from the original buyer by a person who was unaware that the partner lacked authority in the previous transfer.

Partners who misrepresent themselves are personally liable for credit or other benefits extended by third parties who erroneously believed that authority existed to bind the partnership.

7.2 Implied or Apparent Authority

Implied or apparent authority arises when express authority for a partner to act is not granted in the partnership agreement, but the partner represents to third parties that he or she has such authority, on which they rely. The binding of the partnership in this situation is based on general principles of agency law because of the principal-agent relationship between a partnership and its partners.

This binding of the partnership permits innocent third parties to rely on appearances and thus facilitates the normal course of business. Such liability of the partnership does *not* occur if

— The partner is not authorized to act, and

— The third party has knowledge of the lack of authority.

The partnership may also be bound to third parties for a partner's unauthorized actions when

— The partnership or co-partners allow an unauthorized person to misrepresent himself or herself as an authorized agent of the partnership to an innocent third party.

— The partnership ratifies, or approves after the fact, the act or omission by the partner affecting the rights or interests of a third party.

— The acts of the partnership or a partner imply to a third party that a partner is authorized to do something or execute some document on behalf of the partnership and the third party relies on it.

A partner's liability for misrepresentation depends on whether there has been a public or private holding out.

7.2.1 Public holding out

A "public holding out" is a representation that an unauthorized person is a partner in a public manner, in which case any third party who extends credit to the partnership can receive damages from that person even if the third party was unaware of the representation.

7.2.2 Private holding out

A "private holding out" will extend a person's liability only to the extent third parties actually relied on the misrepresentation.

7.3 Notice to Third Parties

As discussed above, third parties may rely upon a partner's appearance of authority. In order to relieve a departing partner from liability or obligation, notice must be given to third parties. Even though the authority of a partner to bind the partnership itself ceases on departure or on the dissolution of the partnership, liability of either the entity or the individual may result if the change is not communicated to the third party.

Dissolution of the partnership or filing of the partnership agreement or an amended partnership agreement in a public office may be insufficient to relieve the entity or its individual members from liability. Notice should be communicated directly to third parties.

General partners may be liable for a partnership's unpaid employment taxes even where the partners have filed bankruptcy. The U.S. Supreme Court held in *Galletti* that a proper tax assessment against a partnership extends the statute of limitations on collection against the general partners who are liable for the debts of the partnership under underlying state law.

A new partner assumes the liability or obligation of the partnership arising before admission, except that such liability extends only to partnership property which includes the partner's capital contribution. Similarly, a departing partner retains liability on the partnership's obligations beyond the time of departure.

For this reason, the most prudent course is to provide notice to third parties with whom the partnership has dealt in the past of any organizational changes occurring in the partnership or in the authority of any of its partners. Although the partner would still be liable for debts incurred before departure, the notice would limit the liability to the date of departure.

7.4 Notice From Third Parties

Notice is a communication by a third party to a partner concerning partnership business. In most circumstances, communication to a partner is also deemed to be notice to a partnership—thereby affecting all partners. Potential problems can arise when different partners actively participate in management but notice is not communicated to all partners.

8. ADVANTAGES AND DISADVANTAGES OF A PARTNERSHIP

In determining the most appropriate form of doing business, a comparison of various entity attributes, set forth in appendix 3 to this chapter,

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should be consulted. For information regarding incorporation of a partnership, detailed checklists are included in appendix 2 of the Sole Proprietorships chapter.

8.1 Advantages

Partnerships are easy to start: The required filing procedures for general partnerships are minimal. Limited partnerships, however, are more complex to establish. A partnership may be dissolved at any time simply by the agreement of the partners. However, additional requirements may exist for limited partnerships.

The partnership form provides greater flexibility in allocating income and deductions disproportionately. Guaranteed payments to partners or specially allocated items are ways in which income can be distributed.

A guaranteed payment allows a form of salary to be paid to a partner for services or use of capital. For example, when one partner contributes substantially more labor than another partner, a guaranteed payment can be used to compensate the partner for the additional hours worked, before the net income (loss) of the partnership is distributed according to the partnership agreement. The Internal Revenue Code (IRC) contains provisions requiring that allocations of income among partners have substantial economic effect. Nonetheless, income and loss may be allocated to partners in a ratio different from the ownership percentage.

Due to the pass-through nature of a partnership, double taxation of income does not occur as it may with a corporation.

A limited partnership affords some measure of asset protection. If a general partner were to contribute property to a properly structured and conducted limited partnership, the transferor would retain control of the assets. A general partner's creditors normally are not able to attach or force the sale of partnership assets.

8.2 Disadvantages

The chief disadvantage of a partnership lies in the general partner's lack of a shield from liability. While such liability may be mitigated by insurance coverage, a general partner will retain ultimate personal liability.

The disadvantage of unlimited general partner liability can be mitigated by using a corporate general partner (often an S corporation). This limits the exposure to the assets held by the corporation and effectively walls off the personal assets of all the ultimate owners. Limited partners, however, are able to avoid exposure to personal, nonbusiness assets for liabilities associated with a limited partnership, LLC, or LLP.

Unlike corporations, a partnership may be disadvantageous in the area of fringe benefits. Deductible medical benefits may not be available to partners to the same extent as shareholder-employees within a corporation. Nevertheless, medical insurance and medical reimbursement plans offered to employees of a partnership may be deducted by the partnership as legitimate fringe benefit expenses.

A partnership also lacks continuity. The death of a majority partner or the transfer of material ownership may cause the partnership to be terminated. In the case of a limited partnership, the death or incapacity of a general partner can cause dissolution of the partnership. (See section 14.1 herein.)

With the taxable earnings base continuing to rise, it is possible that more income may be subject to Social Security taxation than is available to be taken as draw, particularly when the partnership is in a capital-intensive business. Additionally, the purchase of fixed assets, paydown of debt principal, and buildup of inventory and accounts receivable may all result in the partners reporting more taxable income than cash available to be withdrawn from the business. Furthermore, wages paid to a partner's minor children, except in special situations, are subject to Social Security tax, unlike wages paid to the child (under age 18) of a sole proprietor.

Partnership interests are generally difficult to sell to third parties. Many small partnerships, particularly those with a partnership agreement specifying the terms and conditions of the sale of a partner's interest, provide liquidity to the partners. Overall, however, corporate stock is often more appropriate from a liquidity standpoint.

9. CREATING THE PARTNERSHIP

9.1 Partnership and Limited Partnership Documents

9.1.1 General partnerships

As a rule, there is no requirement that partnership agreements be filed. An optional filing of the agreement, amendments to the agreement, or articles of dissolution of the partnership in governmental offices (generally the recorder of deeds or its equivalent) in the jurisdiction of the partnership's principal place of business are normally allowed.

9.1.2 Limited partnerships

Limited partnerships are generally required to file a certificate of limited partnership in a local or state office, specifying a description of the character of its business, its financial structure, and the names and designations of general and limited partners. Amendments and certificates of dissolution must also be filed. A limited partnership must comply completely with the requirements of the limited partnership statute.

The rationale for the varying treatment lies in the limitation of liability inherent in the limited partnership and the need for third parties to have notice of the character of the individual and entity with which they are dealing.

If the agreement is not filed or is filed improperly, a general partnership will effectively be formed regardless of the partners' intentions to form a limited partnership. Furthermore, if there are misleading statements in the partnership agreement (for example, a misrepresentation of a partner's status), all partners who know of the misrepresentation are liable to reliant third parties for damages even if they are otherwise limited partners.

The partnership name should not include the name of any limited partner. It should include the words "limited partnership." Any violation of these rules could make the limited partner liable as if the partner were a general partner.

9.1.3 Advantages and disadvantages

The advantage of filing the partnership agreement is notice to third parties of the nature of the entity with which they are dealing. It also may be of some assistance if the authority of a partner is questioned or if someone falsely portrays himself or herself as a partner.

The disadvantage lies in the fact that the partners may not wish to reveal all the details of the internal functioning of the partnership to the world in general through the public record.

9.2 Certificate of Assumed Name

Many jurisdictions require that business enterprises file a certificate setting out any assumed name under which the enterprise will operate and specifying the names and addresses of one or more co-partners. The certificate may then be published in a newspaper in the immediate area of the principal place of business. (Limited partnerships are often required to publish the certificate of partnership as part of the filing requirement.)

Some states require certificates to be filed even if the names used are the actual names of all the partners. Certain professional partnerships may be exempt from this requirement.

Business names receive varying degrees of protection under state and federal law. Searches may be conducted to assure that no similarly named enterprise exists, which might result in confusion. Names may also be reserved prior to commencing business, with protection of names assured by filing in a central agency, generally the office of the secretary of state.

9.3 Federal Employer Identification Number

A federal employer identification number (FEIN) must be obtained by filing Form SS-4 with the Internal Revenue Service. The IRS provides a procedure to obtain the FEIN on-line. The service can be accessed at www.irs.gov and is used in connection with filing the SS-4. Further details may be obtained by accessing the Web sites. See also the Sole Proprietorship chapter for additional information on applying for an FEIN. Some states also require a state tax identification number. A new, unique FEIN may be required upon incorporation of the partnership or creation of a successor partnership.

9.4 Local and Professional Licensing and Permits

Partnerships, like any other business enterprise, are subject to local, state, and federal licensure or certification requirements, depending upon the nature of the business. There also may be specific local filing requirements for the actual commencement of business. Inquiry to the local agencies involved is always advisable prior to commencing business, since noncompliance could subject the business to penalties.

9.5 Sales Tax Permits

Most states require the payment of sales tax, and partnerships involved in the sale or exchange of goods or services may need to collect and pay this tax. Application should be made to the state revenue department and, in some cases, the municipality, to obtain the necessary permits.

9.6 Workers' Compensation

When the partnership has employees, arrangements should be made with the local authority administering workers' compensation statutes to determine if coverage is mandatory and to provide any necessary proof of compliance. (See also the chapter on Workers' Compensation, herein.)

9.7 Unemployment Compensation

Filings and deposits may need to be made with the agency administering unemployment compensation programs if the number and nature of employees of the business meet the requirements under federal and state laws. Accordingly, both state and federal unemployment taxes may be involved. Federal unemployment tax (FUTA) must be paid on a quarterly basis, using a federal tax deposit (FTD) coupon, if the liability exceeds $500, with annual reporting required on IRS Form 940. (See the chapter on Unemployment Compensation, herein, for further detail.)

9.8 Withholding Taxes

Periodic payments, filings, and informational filings will be required for employee withholding, income, and Social Security tax obligations. IRS Form 941 and Form 943 for agricultural partnerships are required to report federal income and Social Security taxes. The partner's Social Security tax liability is computed on the partner's U.S. individual income tax return.

The IRS EFTPS program allows taxpayers to make federal tax payment directly by phone or personal computer (PC), or through a financial institution. Taxpayers can initiate tax payment twenty-four hours a day, seven days a week. As an added convenience, EFTPS-Direct allows taxpayers to warehouse payment instruction up to 120 days in advance of a tax due date for businesses and up to 365 days in advance for individuals. Payments will be made on the tax due date or the date designated. No special equipment is required to use EFTPS, and if one wishes to use a PC, free Windows-based software is available at www.irs.gov. More information can be obtained at www.eftpssouth.com.

Many states also require state income tax withholding. Application filing procedures, deposit requirements, and so forth vary from state to state. Several states also allow automated tax payment procedures.

9.9 Other Employment Regulations

Proof of compliance with local and federal wage/hour, safe workplace, nondiscrimination, and other fair employment regulatory laws, such as the Americans With Disabilities Act, depends on the size and nature of the business and form of operation. These and other workplace regulations are described more thoroughly in the chapter on Employment Regulations, herein.

Liability for undeposited payroll withholding taxes or trust fund taxes may extend to each partner's personal assets if he or she is held to be a "responsible party." For this reason, it is imperative that federal and state withholding taxes be given the highest priority in periods of poor cash flow.

9.10 Amending Required Filings

Any filing requirement must be updated or amended when a significant change occurs in the condition of the partnership (with respect to membership, location, or nature of the business, for example), and additional filings are required upon termination of the partnership or of its business operation.

Limited partnerships are generally subject to stricter administrative scrutiny and stronger public filing requirements than other business forms.

10. FUNDING THE PARTNERSHIP

10.1 Contributions of Partners

Some or all partners may contribute to the capitalization of the partnership. Contributions may be made in the form of property other than money, or the partner may receive an interest in the partnership in exchange for the performance of immediate or future personal services to the partnership itself.

Contributions need not be tangible property. Intangible property, such as patents, plans, copyrights, or loan commitments, may have value and can be contributed in exchange for an ownership interest.

Appraisals may be advisable because contributed property often has a different fair market value and tax basis. Establishing the fair market value is important because, under IRC Section 704(c), special tax allocations of partnership gains, losses, depreciation, depletion, and amortization are necessary to reflect the differences between fair market value and tax basis as of the contribution date.

The timing of a contribution is not particularly significant, but the books and records of the partnership should clearly and accurately reflect the contributions of each partner and the corresponding interest in the partnership itself. Accounting for contributions becomes particularly important when the contribution changes the nature of the business entity itself (as when a sole proprietorship is transformed into a partnership).

10.2 Basis in Partnership Interest

The contributing partner receives tax basis in the partnership interest equal to his or her existing basis in the property. Typically the contribution has no income tax effects, although there are certain exceptions. For example, if property is contributed to a partnership and, within seven years before or after the exchange, (1) other property is distributed to the contributing partner or (2) the contributed property is distributed to another partner, the transaction is treated as an exchange on which taxable gain or loss may be recognized.

10.2.1 Sale of property

The contributing partner may legitimately sell property to the partnership entity. Any gain is recognized as income and increases the partner's basis in the partnership interest. Generally, property contributed to the partnership is not treated as a sale.

10.2.2 Interest in exchange for personal services

A partner who receives an interest in property contributed by another may be considered as receiving taxable compensation. The same result may occur when a finder's fee or promotion fee is exchanged for a partnership interest. Compensation results only where services are exchanged for capital interest. A right to share in future partnership profits may not produce income, even though the partnership interest was received in exchange for services.

10.2.3 Liabilities assumed by other partners

If a partner's personal liabilities are decreased because the other partners have assumed a portion of them, taxable income can result where the assumption exceeds the partner's basis.

10.2.4 Summary

Generally, a partner's basis in a partnership will

— *Increase by*
1. Contributions to the partnership.
2. The partner's share of taxable and nontaxable income.
3. Miscellaneous adjustments, such as excess depletion over the properties' basis.

— *Decrease by*

1. Money or property distributed.
2. Partner's share of losses.
3. Nondeductible partnership expenses.
4. Depletion allowances for oil and gas wells.

11. ACCOUNTING SYSTEMS AND ACCOUNTS

Any accounting system that accurately reflects the income of the partnership and is appropriate for the particular nature of the business may be used.

11.1 Accounting Methods and Consistency

The accounting method chosen should allow profit and loss to be determined under generally accepted accounting principles (GAAP) or an other comprehensive basis of accounting (OCBOA). The cash basis of accounting is generally the simplest and can be used by many small businesses. If inventories are involved, the regulations at IRC Sections 446 and 471 require that the accrual basis be used.

As described in Rev. Proc. 2002-28, the IRS has published a revenue procedure that provides relief for many small businesses with inventories to report under the cash method. Certain small businesses with average annual gross receipts up to $10 million may adopt, or change to, the cash method of accounting regardless of the presence of inventories.

IRC Section 448 specifies that tax shelters and partnerships with C corporations as partners cannot use the cash method of accounting. Such businesses may not use the cash method even if they are not otherwise required to keep inventories. Exceptions exist for businesses with average annual gross receipts of $5 million or less, farming businesses within the meaning of IRC Section 263A(e)(4), and qualifying personal service corporations.

The main advantage of the use of the cash method is deferral of income until payment is actually or constructively received instead of having to take income into account when billed. Deductions for inventory items or material items used in a business generally will have to be deferred until the later of payment or use of an item. Whatever method is employed, it must be followed consistently from period to period.

In filing the initial Form 1065, the partnership can choose the appropriate accounting methods without IRS consent. Subsequently, if the partnership wants to change an accounting method, it may get an automatic consent from the IRS, which is usually accomplished by filing Form 3115, Application for Change in Accounting Method. A user fee is not required to be paid at the time Form 3115 is filed, provided the business qualifies under Rev. Proc. 2002-9. Appendix 7 of this chapter, "Eligibility for Using the Cash Method of Accounting," found on the *Accountant's Business Manual Toolkit CD-ROM* contains a flowchart to help determine whether a business qualifies to use the cash method of accounting.

11.2 Minimum Requirements

The Internal Revenue Code (IRC) requires that the system used clearly show income and deductions. This normally includes the checkbook and some appropriate record of cash receipts and disbursements that categorizes them by type. The double-entry system of accounting greatly reduces the risk of errors in the recording of transactions and is a necessity when the accrual basis of accounting is used.

Whether computer-generated or manually prepared, it is essential that the records provide an audit trail from the basic transactions to the amounts used for financial reporting or income tax purposes.

11.3 Accounts

As a rule, separate income and capital accounts are set up for each member of the partnership. The partnership may also make provision for draws by any or all partners against the partner's share of the profits. Provision may also be made for paying interest on that portion of the partner's capital account in excess of the required contribution. Establishing and maintaining such accounts are generally at the sole discretion of the partners as specified in the partnership agreement.

A separate capital account should be kept for each partner. The amount in the capital account increases for a capital contribution on behalf of a partner and for the partner's pro rata share of income from partnership earnings. The capital account decreases when draw is taken

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by a partner and for the partner's pro rata share of losses arising from partnership operations.

Capital accounts measure the partners' equity in the partnership. Often, two sets of capital accounts, "book" and "tax basis," are maintained. The book capital accounts may be used for general financial purposes, while tax basis capital accounts are used in determining each partners' basis in his or her partnership interest.

12. DISTRIBUTION OF PROFITS AND LOSSES

12.1 Ongoing Distributions

As a rule, partners have the right to equal distribution of profits or, generally, of surplus beyond the amount of their contributions, in the same fashion as they are liable for partnership losses.

This general rule, however, may be varied by (1) specific arrangements set out in the partnership agreement or (2) according to the respective percentage of ownership (contribution) of each partner. Profits can also be allocated through guaranteed payments to partners which are treated as expenses of the partnership in determining the remaining distributable income. These guaranteed payments then constitute income to the recipient. The form and time of such distributions are at the discretion of the partnership but must meet the criteria of economic reality.

If provided by the partnership agreement, a partner may be entitled to repayment of contributions to the partnership (including interest on contributions in excess of an agreed-upon contribution obligation) and to indemnification by the other partners for payments made or liabilities incurred as an individual in furthering the partnership business.

12.2 Distribution on Retirement, Death, or Good-Faith Withdrawal

A retiring partner, unless there is a specific agreement to the contrary with the remaining partners, has the right to have the value of the interest in the partnership determined and paid, along with the profits of the partnership attributable to the use of the partner's rights in the partnership property.

Payment of such amounts is a debt of the partnership but is subordinate to the claims of third-party creditors on the individual property of the remaining partners.

The estate or personal representative of a deceased partner has the same rights, except that the estate or the heir of a deceased partner may elect to continue as a partner in a newly created partnership upon dissolution of the original partnership.

12.3 Liquidating Distributions

Terminating the partnership enterprise and liquidating its assets takes place under the rules and priorities described in section 14 of this chapter.

13. TAXATION OF PARTNERSHIPS

13.1 Conduit Nature of Partnership

Although a partnership is legally viewed as a tax entity (as well as a legal entity) separate and apart from its individual members, the partnership is not itself an income tax paying entity. It must, however, file an annual information return, IRS Form 1065.

Profits and losses pass through to the individual partners, as do certain other tax incidents.

As a result of the "conduit" or pass-through nature of the partnership for tax purposes, there is no double taxation of partnership earnings, and partnership losses can usually be applied against other personal ordinary income of the partners. However, for partners who do not materially participate in the partnership, the limitations on passive activities, as described in section 13.2 of this chapter, may apply, thus disallowing partnership losses to be applied against other ordinary income of the partner.

Each partner must individually take into account on his or her own personal income tax return the partner's distributive share of the following items, which retain their character when passing through to the level of the individual partner:

— Ordinary income (loss) from trade or business activities

— Net income (loss) from rental real estate activities

— Net income (loss) from other rental activities

— Guaranteed payments to partners

— Net gain (loss) under IRC Section 1231

— IRC Section 179 depreciation expense deduction

— Net short-term capital gain (loss)

— Net long-term capital gain (loss)
— Other net capital gain (loss)
— Dividends
— Interest
— Royalties
— Charitable contributions
— Investment interest expense
— Tax credits
— Other items separately allocated
— Tax preferences

An individual partner who wants to treat a partnership item differently on the partner's individual return must file Form 8082, Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR), along with the individual return identifying the different treatment.

The partnership agreement is very significant in showing the intent of the partners to form a partnership, which is important if a taxing authority decides that the enterprise is an association other than a partnership and, for example, taxes the partnership as a corporation.

In December 1996, Treasury issued the so-called check-the-box entity classification regulations (Regs. 301.7701-1 through -3). These regulations implement an extremely simple approach to classifying most unincorporated entities. After that date, it is no longer necessary to consider the four corporate characteristics (continuity, management, liability, and transferability) in deciding how a newly formed entity will be treated for federal income tax purposes. Also, an existing entity is allowed to change its classification, but such a change could trigger adverse tax consequences.

Under these rules, most unincorporated entities will be treated as partnerships. (They can also elect to be treated as corporations, which will be attractive in only limited circumstances.)

13.1.1 Advantages of partnership taxation over S corporation taxation

The taxation of partnerships and S corporations is often compared because of the conduit nature of both types of entities. Following are some advantages that partnership taxation may have over S corporation taxation:

- *Basis from entity-level debt.* Partners are able to receive additional tax basis from entity-level debt. This is not available to S corporation shareholders, even if they guarantee the corporate debt.

- *Tax-free contribution of assets with debt in excess of basis.* Partners generally have the ability to contribute assets to the partnership along with debt in excess of the tax basis in a tax-free transaction. S corporation shareholders would have to recognize gain on a similar transaction.
- *Section 754 optional basis adjustment.* May result in ability to step up basis, resulting in larger depreciation deductions or decreased taxable gains (see section 13.8). No similar basis adjustments are allowed for S corporations.
- *Tax-free distribution of appreciated assets.* Partnerships generally have the ability to distribute appreciated assets to the partners tax-free, while similar distributions from an S corporation would result in taxable gain.

13.1.2 Large partnership simplified pass-through election

Most large partnerships are eligible to elect to treat pass-through items in a simplied manner for tax purposes, starting with partnership tax years beginning after December 31, 1997. A large partnership is considered to be one which has at least one hundred partners in the preceding taxable year.

An electing large partnership computes taxable income in a similar manner as individuals, with some modifications. The deductions for net operating losses, personal exemptions, and many itemized deductions are disallowed. The computation of other itemized deduction items is modified. All of these items are passed through to the partners as a net amount.

Several items are separately stated and are passed through to the partners, such as passive loss limitation items and various credits. Many other items are not stated separately, such as short-term capital gains and losses, charitable contributions, and alternative minimum tax preference items. Most limitations and elections apply at the partnership level.

13.2 Limitations on Passive Activities

A partnership may be deemed passive when the partner does not materially participate (as described in Reg. 1.469-5 and Temp. Reg. 1.469-5T)

(Text continued on page 31)

in the conduct of a trade or business or if the partnership has rental activities. Rental activities and limited partners are always considered passive whether the partner materially participates or not.

IRC Section 469 limits losses, deductions, and credits from a partnership's passive activities. A partner can use these losses only to the following extent:

— To offset other passive income, excluding portfolio income.

— If from rental real estate activities, to offset up to $25,000 of a partner's nonpassive income, assuming the taxpayer has at least a 10 percent ownership in the rental real estate activity and "actively participates" (within the meaning of IRC Sec. 469(i) and the rules contained in Reg. 1.469-9) in the activity. However, the $25,000 rental real estate privilege phases out for taxpayers with adjusted gross income exceeding $100,000.

— Unused losses and credits are carried forward indefinitely and used to offset passive income in succeeding years.

— Suspended losses are deductible in full upon a taxable disposition of the activity.

— Suspended losses are at least partially allowed in the case of a transfer by reason of death.

Special rules apply to oil and gas "working interest" partnerships.

13.3 Limitation on Losses to Amount at Risk

For tax purposes, the at-risk rules limit the losses partners may deduct to the amount they had invested in the activity, including borrowed amounts, if the partners are personally liable to repay (recourse).

Nonrecourse financing that is secured by the real property may be considered at risk if—

— The loan is not convertible debt.

— The loan is from or guaranteed by any federal, state, or local government.

— The loan is from a qualified person (such as an independent bank or financial institution) as defined in IRC Section 465.

A general partnership, by reason of its full-recourse nature, is less subject to "at-risk" than a limited partnership (though still subject to the limitation of loss to the amount of basis).

13.4 Interest Expense to Carry Partnership Interests

Interest expense to purchase a partnership interest is fully deductible as business interest expense if the individual materially participates in the partnership business and the assets of the partnership are used in an active trade or business.

Interest expense to carry an investment in a passive activity must be included with the results of the passive activity. Passive interest includes interest as a limited partner or interest in other activities in which the partner does not materially participate.

However, other unreimbursed partnership expenses may not be deductible by a partner unless the partnership agreement specifically provides that partners are to personally incur certain partnership expenses. Allowable unreimbursed partnership expenses from non-passive activities are reported on Form 1040, Schedule E.

13.5 Transfers to the Partnership

When property is contributed by a partner to a partnership, generally no gain or loss is recognized to either the partnership or the partner so long as the contribution involves cash or property. If the partner makes a contribution of services to the partnership, gain may be recognized to the extent of the fair market value of a capital interest in the partnership received in return for services.

As a rule, a partner receives basis in the partnership interest equal to the basis of the property he or she has contributed. For this reason, it is important to delineate in the partnership agreement the exact nature and quantity of interest in the enterprise the partner receives.

Gain may also result to the contributing partner if debt is transferred and assumed by the other partners (see section 10.2.3, above).

If property is transfered, or sold, to a partnership by a partner who, directly or indirectly, owns more than 50 percent of the capital or profits—

— Any gain recognized would be ordinary income.

— Any loss would not be allowed on the partners' tax return. (The partnership may use this disallowed loss against any future gain on the sale of the property.)

13.6 Distributions and Liquidating Distributions

Partners are taxed on their distributive share of partnership income items, whether or not any distributions are actually made. Flow through of loss from the partnership interest is normally limited to the partner's adjusted basis in the partnership interest in the year the loss occurs. See section 13.3 for the limitation on losses to the amount the partner has at risk.

A liquidating distribution disposes of the entire interest of a partner in the partnership. A partner receiving a liquidating distribution from a partnership generally realizes income only if the moneys received exceed the adjusted basis of the partnership interest. Loss is recognized only if the partner's basis in the partnership interest exceeds cash received plus the basis received in inventory, accounts receivable, and certain other assets.

Other payments made in liquidating a retired partner's interest are generally subject to self-employment tax under IRC Section 1402(a). However, payments made under a written partner retirement plan may be exempt from self-employment tax where the following requirements are met:

- The plan provides for periodic payments to retired partners until death.
- Payments are made postretirement and based on years of service/ compensation criteria.
- Eligibility is based on age and years of service.
- The retired partner provides no services to the partnership during the year.
- No other partnership obligations to the retired partner exist.
- The retired partner must have been fully paid for his or her partnership capital.

13.7 Sale of Partnership Interest

A partnership interest is a capital asset and thus subject to treatment as a capital gain or loss. If sold at a loss, the deduction may be limited in any year to other capital gains plus $3,000 on a joint tax return.

The portion of a sale price attributable to unrealized receivables or to substantially appreciated inventory items is considered to be realized from the sale of noncapital assets. For exchanges of partnership interests involving unrealized receivables or substantially appreciated inventory items, the partnership must file Form 8308, Report of a Sale or Exchange of Certain Partnership Interests, with its Form 1065 for the tax year in which the exchange takes place. An arm's-length sale agreement should specify the portion of the sale price that is attributable to such items based on fair market values according to IRS regulations.

13.8 Partnership Can Elect to Adjust the Basis of Partnership Property

Generally a partnership may not adjust the basis of its property as a result of property distributions to a partner or as the result of a transfer of an interest in the partnership, either by sale or exchange or because of a partner's death, unless the partnership chooses in writing to make an optional adjustment, pursuant to IRC Section 754, to the basis of its property upon the transfer. Appendix 8 on the *Accountant's Business Manual Toolkit CD-ROM* contains a "Sample Election Under IRC Section 754" to adjust the basis of partnership property.

13.8.1 Example: Adjustment to basis of property upon sale of partnership interest

Pete is a member of Changes Partnership in which the three partners have equal interests in capital gains and profits. The partnership has made the election under IRC Section 754, relating to the optional adjustment to the basis of partnership property. Pete sells his interest to Julie for $44,000. The balance sheet of the partnership at the date of sale shows the following:

Assets	*Tax Basis*	*Market Value*
Cash	$ 10,000	$ 10,000
Accounts receivable	20,000	20,000
Inventory	40,000	42,000
Depreciable assets	40,000	80,000
Total Assets	$110,000	$152,000
Liabilities and Capital		
Liabilities	$ 20,000	$ 20,000
Capital		
Pete	30,000	44,000
Ellen	30,000	44,000
Frank	30,000	44,000
Total Capital	$ 90,000	$132,000
Total Liabilities and Capital	$110,000	$152,000

Because of the IRC Section 754 election in effect, the amount of the adjustment under IRC Section 743(b) is the difference between the basis of Julie's interest in the partnership and her share of the adjusted basis of partnership property. The basis of Julie's interest is $50,667 (the cash paid for Pete's interest, $44,000, plus Julie's share of partnership liabilities, $6,667). Julie's share of the adjusted basis of partnership property is $36,667 ($30,000 plus $6,667). The amount to be added to the basis of partnership property is therefore $14,000 (the difference between $50,667 and $36,667). This amount will be allocated to partnership properties in accordance with the rules set forth in IRC Section 755 and Reg. 1.755-1.

The $14,000 basis increase constitutes an adjustment affecting the basis of partnership property with respect to Julie (the transferee partner) only. Thus, for purposes of depreciation, depletion, gain or loss, and distributions, Julie will have a special basis for those partnership properties that are adjusted under IRC Section 743(b).

Note: Basis adjustments resulting from a distribution of partnership assets under IRC Section 734(b) affect all partners, not just the transferee partner.

13.9 Termination of a Partnership

For taxable years beginning after December 31, 1997, a partnership terminates for tax purposes by death of a partner, substitution of a new partner, or by the liquidation of a partner's interest.

Termination also occurs when:

— No part of the partnership operation is carried on by *any* of the partners; or

— Within a twelve-month period, there is the sale or exchange of 50 percent or more of the total interest in both partnership capital and profits.

A termination that occurred before May 9, 1997 is deemed a pro rata distribution of partnership assets, causing recognition of gain or loss to the departing partner and a new basis to the remaining partners. This is still true for terminations occurring after May 8, 1997 if the termination takes place because no part of the partnership operation is carried on by any of the partners. (See section 14.2, below.)

The regulations have been revised regarding termination of partnerships caused by a sale or exchange of 50 percent or more of the total interest in partnership capital and profits within twelve months, effective May 9, 1997 (Reg. 1.708-1). After May 8, 1997, such a "technical termination" no longer results in a deemed distribution of partnership assets. As a result, such a termination no longer causes recognition of gain or loss to the departing partner and new basis to the remaining partners. The new regulations still require a closing of the tax year, and the tax elections of the terminated partnership are invalidated.

However, the new partnership does retain the taxpayer identification number of the terminated partnership.

13.10 Conversion to a Limited Liability Company or Limited Liability Partnership

The conversion of an existing partnership into a limited liability company (LLC) can generally be accomplished without federal income tax consequences, even though the partners become members upon conversion. (See the Limited Liability Companies chapter.)

Conversion to a limited liability partnership (LLP) can also generally be accomplished without federal income tax consequences. Conversion to LLP status can be quite painless from a legal standpoint. Depending on the state statutes, all that may be required is filing a form to register as an LLP, paying a fee to the state (sometimes annually), and changing the name of the entity to include "LLP" at the end.

13.11 Conversion to a Corporation

A partnership may be converted to a corporation by the following:

— Exchange of partnership assets for shares of the corporation.

— A liquidating distribution of partnership assets in which individual partners exchange assets for shares.

— Exchange of partnership interests for shares followed by termination of the partnership.

— A "formless conversion," where an unincorporated entity treated as a partnership for federal tax purposes under the "check-the-box" rules effectively changes the entity's status under state law to the corporate form, will be treated as a transfer to a corporation. A state formless conversion statute is one that does not require the actual transfer of assets or interests.

13.11.1 S Election by Partnership

Partnerships and LLCs may elect to be taxed as S corporations without changing their legal structure. Under the "check-the-box" IRS regulations, the election is made by filing Form 2553, Election By A Small Business Corporation. It is not necessary for a partnership to also file Form 8832, Entity Classification Election, to be taxed as a corporation as the S election is also deemed to be an election to be treated as an association taxable as a corporation.

For tax purposes, an electing partnership or LLC is deemed to be dissolved and reformed as a corporation. To be eligible, the partnership units or LLC member interests must convey the same rights for distribution and liquidation as differing rights would violate the "one-class-of-stock" requirement for S corporations. Differences in voting rights are ignored.

Caution: Form 2553 is not currently designed to accommodate an S election by a partnership or LLC and the instructions do not give guidance on handling questions such as date incorporated, number of shares issued and dates acquired. Presumably, one would indicate the date the S election is effective and indicate the number of partnership units or percentage ownership.

Electing S status while retaining the partnership/LLC legal status may be more advantageous than formally incorporating the partnership. Among the business reasons for retaining its legal status as a partnership, the business retains its organizational legal documents, federal and state ID numbers, legal title to vehicles and real estate and bank accounts.

All such transactions would be viewed as the sale of partnership assets and liquidating distributions in return for the partnership interests. For tax purposes, however, the incorporation may be a tax-free transfer under IRC Section 351.

13.12 Merger of Partnerships

Under IRC Section 708, the merger of two or more partnerships may result in one partnership continuing while the others terminate, or formation of a new partnership with all merging partnerships terminating.

In a merger, the partnership whose members own more than 50 percent interest in both the capital and the profits after the merger will be deemed the continuing partnership. The other partnerships cease to exist.

When more than one partnership qualifies as the successor under this test (for example, partnerships with identical partners), the partnership with the greatest dollar value of assets contributed is the successor.

If all the merging partnerships fail the 50-percent test, all the merged partnerships cease and a new partnership results.

13.13 Death of a Partner

A partnership is deemed to terminate, for purposes of state law, at the death of a general partner (but not limited partner), and a new partnership deemed to come into existence at the same time.

For tax years beginning before January 1, 1998, the partnership is not deemed to terminate for federal income tax purposes. In the event that a partner's death causes termination, the partnership's taxable year terminates upon liquidation of the partner's interest. If there is no termination, the partnership income of the deceased partner and any liquidating distributions that are attributable to the period ending with the date of the partner's death, would be income in respect of a decedent. This rule applies even though part of the distributive share for the period, withdrawn by the decedent before death, is not included in the value of the decedent's partnership interest for estate tax purposes.

For taxable years beginning after December 31, 1997, the tax year of the partnership closes with respect to a partner whose entire interest in the partnership terminates, whether by death, liquidation, or otherwise. However, the law did not change with respect to the effect upon the partnership tax year of a transfer of a partnership interest by a debtor to the debtor's estate under Chapter 7 or 11 of Title 11, relating to bankruptcy. Provisions within partnership agreements providing for the sale or exchange of partnership interests upon death to close the partnership tax year are no longer necessary. Subsequent sale of the partnership interest would be a separate taxable event with respect to the estate or to the deceased partner's heirs. (See the Estate Planning chapter, herein, for additional information.)

13.14 Tax Year

In general, all partnerships must have the same taxable year as that of the majority of partners, normally the calendar year. If the majority of partners do not have the same taxable year, the partnership must adopt the calendar year.

Under a very narrow set of circumstances, a partnership may apply to the IRS for permission to use a different fiscal year-end for specific business reasons, such as when at least 25 percent of gross receipts occur in the last two months of the fiscal period.

If specific IRS permission has not been obtained, a partnership may still elect to retain a different fiscal year-end. This election is provided through IRC Section 444. However, electing entities must make a required tax payment by April 15 each year.

13.15 Examination Procedures

Unless the partnership has no more than ten partners who are individuals or estates, the treatment of any partnership item is determined at the partnership level, with the individual returns adjusted accordingly. Small partnerships may also elect this procedure.

A large partnership that elects the simplified pass-through provisions described in section 13.1.2, above, is an "electing large partnership." Such partnerships are subject to special IRS audit rules. Only the partnership receives notice of adjustments or has the right to appeal adjustments. The partnership can pass the adjustments through to the partners in the year the adjustments take place, and the adjustments will not affect the partners' prior-year returns. Alternatively, the partnership can elect to pay tax on any adjustments at the highest individual or corporate rate, plus penalties and interest. Partners are not allowed to report any partnership items inconsistently with the partnership return, even if the partner notifies the IRS of the inconsistency. (See the IRS Practice and Procedure chapter.)

13.16 Self-Employment Tax

General partners are generally subject to self-employment tax on their share of ordinary net earnings plus any guaranteed payments they received regardless whether they are active or passive in the partnership activities.

For general partners, net earnings do not include

— Dividends (paid on stock) and interest income, unless the dividends or interest were earned as a dealer.

— Rents, unless earned in the course of a trade or business in which services are provided.

— Royalties, unless earned as part of a trade or business.

— Gains or losses recognized under IRC Section 1231.

— Capital gains or losses.

Limited partners are not subject to self-employment tax on partnership earnings unless from guaranteed payments for services rendered to the partnership. Under proposed IRS regulations [Prop. Reg. 1.1402(a)-2(h)(2)], a limited partner or LLC member will be treated as limited (and thus, exempt from self-employment tax) unless that partner/member:

— Is liable for partnership/LLC debts,

— Has management authority,

— Participates for more than 500 hours, or

— Performs more than de minimis services for a personal service partnership.

The proposed regulations also indicate that service entity partners are always subject to self-employment tax. While the first two criteria are supported by statute and case law, the 500 hour test appears to lack any precedent as authority. Management authority must be segregated to particular units by the member agreement. It is irrelevant whether a member actually performs management functions.

One-half of the self-employment tax paid by a partner is deductible by the partner as an adjustment to income on Form 1040.

13.17 Self-Employed Health Insurance Deduction

A partner cannot deduct as a business expense his or her health insurance premiums. If the partner or spouse is not eligible to participate in a subsidized health plan, 100 percent of the amount paid for health insurance and eligible long-term care insurance for themselves and their families can be deducted as an adjustment to income on Form 1040. Prior to 2003, a portion of premiums paid was not deductible in arriving at adjusted gross income.

13.18 Retirement Plans

The partners and any employees of the partnership may be eligible for a retirement plan. There are a number of options available as well as a number of rules that must be followed, such as those involving nondiscrimination. For additional information, see the chapter on Employee Retirement and Deferred Compensation Plans.

14. TERMINATING A PARTNERSHIP

This section discusses various aspects of a legal dissolution or termination, which might not result in a termination for tax purposes. (See section 13.9, above, for a termination for tax purposes.)

14.1 Dissolution

Dissolution is the change in relationships that occurs when a partner ceases to be associated with the business. Following dissolution, the partnership may continue in changed form. Whenever a partnership terminates, competent professional counsel should be consulted.

Section 801 of the Uniform Partnership Act was amended in 1997 regarding events causing dissolution of a partnership. Partnerships may dissolve when any of the following events occur:

- When the business of the partnership or the carrying on of the particular business in the form of a partnership becomes illegal
- When the partnership acts for an illegal purpose
- Upon the expulsion of a partner
- Upon the withdrawal or addition of a partner
- Upon the expiration of the term of the partnership agreement and the mutual agreement of the partners to dissolve the business
- Upon fulfillment of the partnership purpose as stated in the partnership agreement
- When any partner or partners declare that they no longer wish to continue the partnership arrangement
- Upon the death of any partner if over half the remaining partners agree
- Upon the bankruptcy of any partner or of the partnership itself
- When a partner acts to defraud the partnership or otherwise breaks a partner's fiduciary duty
- When a court grants the petition of a partner (or someone acting in the partner's behalf) or of a local or state regulatory authority to dissolve the partnership. Such petition may be granted if—
  - A partner cannot perform his obligations to the partnership.
  - A partner has been judicially declared mentally incompetent.
  - A partner has prejudiced the carrying on of the partnership business or prejudiced the continuing partnership form of the business.
  - The business of the partnership can only be carried on at a loss.
  - The court finds other circumstances that make dissolution a fair or equitable result.

Assigning a partner's interest to a third party does not in and of itself result in a dissolution if the assignment or substitution of a new partner for a former partner is consented to by all the remaining partners.

A partnership may be dissolved by operation of law if, for example, a family partnership is dissolved in the course of a marriage dissolution, or if divestment of a partnership interest occurs as part of a marital property settlement under either community property or common law statutory schemes.

14.2 Termination

Dissolution and termination of partnerships are distinguished by the fact that dissolution occurs on one of the above-named events but termination does not take place until the full winding-up of all the business affairs of the partnership is completed. (This winding-up occurs in a much narrower category of situations when the partnership business is to be liquidated.)

Winding-up is a period allotted for the purpose of providing notice of the impending termination to third parties; settling obligations of the partnership to third parties; and adjusting rights, liabilities, and distributions among the partners and their heirs or assigns. Winding-up may take place informally or may be under the supervision of a court that has decreed dissolution. Except as necessary to complete the

(Text continued on page 37)

winding-up of the enterprise's affairs, dissolution removes the authority of any partner to act on behalf of the partnership. (See section 13.9 regarding termination for tax purposes.)

Appendix 6 on the *Accountant's Business Manual Toolkit CD-ROM* contains a checklist of actions typically completed during the termination of a partnership.

14.3 Termination Not Ending Liability to Third Parties

In line with the purpose of protecting third parties dealing with it, the partnership will be bound by the act of a partner after dissolution by a transaction that would have bound the partnership if dissolution had not occurred, as long as

— The third party had previously extended credit to the partnership and lacked knowledge or notice of the dissolution.

— The third party had knowledge of the partnership prior to dissolution and the fact of dissolution was not made as a public notice in a newspaper in the immediate area of the principal place of business.

In other circumstances subsequent to dissolution, partners misrepresenting themselves as authorized representatives of a continuing partnership are personally liable but do not bind the partnership.

Mere dissolution does not terminate the existing liability of any partner unless there is an agreement to the contrary among the other partners, the partner whose liability is in question, and the party to whom the obligation is owed. Barring such agreement, the individual assets of a deceased partner will be subject to partnership obligations that arose while the partner was a member of the functioning partnership.

14.4 Disposition of Assets and Liabilities

Valuation of existing partnership assets may be an issue either in distribution among the partners or in application of those assets to the partnership's obligations to third parties, ordinarily creditors.

At dissolution, partnership assets are disposed of in the following order:

1. Obligations owed to creditors other than partners (secured creditors have priority over unsecured creditors with respect to the property

secured; unsecured creditors share equally in any unsecured property)
2. Obligations owed to partners other than for their capital contributions or profits
3. Obligations to partners for their capital contributions
4. Obligations to partners for profits

If assets of the partnership are not sufficient to pay these obligations, payment is made on a pro rata basis. All obligations of one level must be satisfied before distribution may be made on the next level. Each partner (or representative, if deceased) retains the obligation of contribution to make up deficiencies based on the partnership's debts.

If dissolution has been caused by the wrongful act of a partner, resulting in expulsion, the partner may forfeit the right to any surplus accrued by the partnership to the extent offset by damages and may also be subject to a lawsuit brought by the other partners, based on the breach of the partnership agreement.

When the enterprise has generated losses, obligations arising therefrom are paid first from any surplus, then from the capital accounts of the partners (pro rata), and finally from the individual property of the partners in proportion to their interest in the general partnership.

A limited partnership distributes its assets in a slightly different order than a general partnership does (as discussed above). The limited partnership assets are distributed in the following order:

1. Secured creditors (including a secured limited partner but not a secured general partner)
2. Unsecured creditors (including unsecured limited partners)
3. Limited partners—first, to the extent of their profits, and second, to the extent of their capital contributions
4. General partners—first, to the extent of their loans, then, to the extent of their profits, and finally to the extent of their capital contributions

14.5 Dissolution Where Business Continues

When a partner assigns a partnership interest to a third party, that assignee becomes entitled to the profits owed to the original partner but does not become a full partner with the resultant rights of a coproprietor.

Dissolution does not automatically require termination. The business may continue in altered form under a new partnership arrangement.

When a partnership continues its business enterprise in a new form upon withdrawal or expulsion of one or more partners, creditors of the partnership continue to have the identical rights against the re-created enterprise. If that enterprise is not a partnership but has agreed to assume the debts of the partnership, the creditors will retain such rights against the new entity.

If creditors have not received notice of the change and have acted in reliance on their prior knowledge of the makeup of the partnership, the creditors may retain rights against the individual property of the departing partner or legal representative.

When a partnership continues to transact business beyond the fixed term of its duration or beyond the scope of the business specified in the partnership agreement, third parties without notice may continue to treat the partnership as such, and obligations incurred will be viewed as those of a "partnership at will."

Appendix 5 on the *Accountant's Business Manual Toolkit CD-ROM* contains a sample notification to creditors of a change in the partnership business form.

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APPENDIX 1: Partnership Agreement Checklist

The following issues should be addressed when preparing a partnership agreement.

1. Designation of accountant/attorney
2. Names of partners/Name of partnership
3. Date of agreement
4. Start-up date of partnership
5. Nature of business
6. Duration of partnership
7. Partnership purpose
8. Principal place of business
9. Capital contributions
10. Contributions in excess of capital
11. Schedule of contributions to be made in the future
12. List of initial property contributions by each partner
13. Partners' property to be used in business (not the same as partnership property)
14. Noncapital contributions permitted
15. Licensure requirements
16. Designation of banks
17. Specific authority to borrow/incur indebtedness
18. Specific authority of partners to lend to the partnership or a third party
19. Contribution or indemnification to co-partners for liabilities
20. Requirement for notices to third parties (creditors) in case of dissolution or departing partner
21. Accounting system
22. Types of accounts
23. Place for keeping partnership records
24. Understanding as to access of books and records
25. Fiscal year
26. Insurance provisions
27. Salaries
28. Vacation
29. Sick leave
30. Work hours
31. Devotion of full- or part-time efforts and best efforts
32. Assignment of particular functions among partners
33. Restrictions on management prerogatives for any partner
34. Specific management authority of each partner
35. Provision for majority rule, tie-breaking and quorum for voting purposes
36. Periodic partnership meetings

37. Restrictions (if any) on a partner's authority to bind the partnership
38. Recitation of capacity to contract
39. Admission of new partners
40. Optional adjustment to basis of partnership property (election under IRC Section 754)
41. Profit and loss sharing allocation among partners
42. Rights with respect to drawing accounts
43. Provision for expulsion of partners
44. Provision for withdrawal of partners
45. Agreement not to compete upon withdrawal
46. Arbitration provision
47. Manner of handling partnership affairs if a partner dies or becomes incompetent or bankrupt
48. Manner of terminating the partnership
49. Manner of selecting partner to handle a dissolution
50. Assignability of partnership interest
51. Retirement of partners
52. Proposed sale of interest/buy-sell agreements
53. Provision for continuing partnership, if desired, in the event a partner leaves, dies, etc.
54. Severability clause
55. Choice of law
56. Amendments to partnership agreement
57. Filing of agreement and amendments
58. Life insurance coverage to fund buy-sell agreement

APPENDIX 2: Partnership Creation Checklist

	Date Required	To Be Done By Atty.	CPA	Company	Date Finished
1. Select attorney					
2. Select accountant					
3. Target date (date partnership is to commence business)					
4. Drafting partnership agreement					
5. Meeting of partners to sign agreement					
6. Assets and liabilities (determine what assets and liabilities are to be turned over to the partnership and partnership interest issued in exchange therefor)					
7. Identification number (Form SS-4)					
8. Workers' compensation (file for coverage)					
9. Unemployment compensation (file for coverage; check on transfer of credit from preexisting business)					
10. Sales tax (if required)					
11. Accounting methods (year-end, accrual or cash basis, depreciation method, inventory valuation)					
12. Select accounting software					
13. Prepare mission statement					
14. Prepare business plan					
15. Prepare a current year budget					
16. Prepare tax projection and consider need for quarterly estimates					
17 Banks (select bank or banks and furnish authorizing persons to sign checks and negotiate loans)					
18. Negotiate financing arrangements					
19. Notify utilities					

	Date Required	To Be Done By Atty.	CPA	Company	Date Finished
20. Insurance (secure necessary insurance, i.e., fire, liability, etc. Notify all agents if partnership was formed from a preexisting business)					
21. Special licenses and permits (secure, if necessary)					
22. Retirement plans					
23. Determine what, if any, fringe benefits will be offered to employees					
24. Vehicle requirements (if employee is to furnish vehicle, formally require him or her to do so in written agreement)					
25. Determine employment requirements (wage & hour) and hiring					
26. Employment agreement (prepare an employment agreement for key employees)					
27. Buy-sell agreements					
28. Consider life insurance coverage (on partner to fund replacement or buy-sell)					
29. Lease:					
a) personal property					
b) real estate					

APPENDIX 3: Comparison of Entity Attributes—Proprietorships, Partnerships, C Corporations, S Corporations, and LLCs

Attribute	Proprietorship	General, Limited, or LLP Partnerships	C Corporation	S Corporation	Limited Liability Company
Life of Entity	Terminated at will or death of proprietor	Terminated at will or death of a major partner or transfer of material ownership	Indefinite	Indefinite	Stated limit
Maximum Number of Owners	One	Unlimited	Unlimited	One hundred	Unlimited
Transferability of Interests	Freely transferable	Typically, subject to partners' approval	Typically, freely transferable; can be restricted through buy-sell agreements	Typically, freely transferable; can be restricted through buy-sell agreements	Same as S corporation

Attribute	Proprietorship	General, Limited, or LLP Partnerships	C Corporation	S Corporation	Limited Liability Company
Liability of Owners	Unlimited	General partners unlimited; limited partners limited to investment in partnership; LLP partners unlimited for own actions, limited to investment for actions of other partners	Generally limited to assets in corporation	Generally limited to assets in corporation	Generally limited to investment in company
Contribution of Property	Nontaxable transaction	Generally, a nontaxable transaction; assumption of liabilities may trigger recognition of gain by partnership	Nontaxable only if transaction meets IRC Section 351 requirements; however, liabilities in excess of asset basis may trigger gain per IRC Section 357	Nontaxable only if transaction meets IRC Section 351 requirements; however, liabilities in excess of asset basis may trigger gain—IRC Section 357	Generally a nontaxable transaction

Taxability of Income	Taxable to proprietor	Taxable to partner; special allocations possible	Taxable at corporate level	Taxable at shareholder level based on shares held; no special allocations	Taxable to member; special allocations possible
Deductibility of Losses	Deductible by proprietor	Generally, deductible by partner; special allocations possible; partnership liabilities increase loss deduction basis	Deductible by corporation	Generally deductible by shareholder; loss limited to basis in stock and direct loans from shareholders; no special allocations allowed	Generally deductible by member; special allocations possible; company liabilities increase loss deduction basis
Passive Losses	May not offset active or portfolio income	May not offset active or portfolio income at partner level	May offset active but not portfolio income if corporation is closely held; may not offset active or portfolio income of personal service corporation	May not offset active or portfolio income at shareholder level	May not offset active or portfolio income at member level

Attribute	Proprietorship	General, Limited, or LLP Partnerships	C Corporation	S Corporation	Limited Liability Company
Required Tax Year	Must use tax year of proprietor	Generally, must use fiscal year of partners or calendar year unless IRC Section 444 election is made	May select any fiscal year if not a personal service corporation	Generally, must use calendar year unless natural business year test is met or IRC Section 444 election is made	Same as S corporation
Medical Insurance Premium	100 percent of premium cost deductible above-the-line; if a spouse is an employee and a spousal insurance plan is in place, 100 percent of premium cost deductible as a business expense	100 percent of premium cost deductible above-the-line; if a partner's spouse is an employee of the partnership and an insurance plan is in place, 100 percent of the premium cost is deductible	100 percent of premium cost is deductible	100 percent of premium cost deductible above-the-line by more than 2 percent shareholders	Same as partnership

Life Insurance for Employee/Owner	Nondeductible	Nondeductible	Premiums for up to $50,000 of group term life are deductible and not taxable to employee	Nondeductible	Nondeductible
Distribution to Owner	Nontaxable	Nontaxable to extent of basis in partnership; property nontaxable until sold	Not deductible by corporation; generally, ordinary income to shareholder; appreciated property results in recognition of gain to corporation	Nontaxable to extent of basis in stock and loans to corporation; distribution of appreciated property results in gain recognition to corporation	Nontaxable to extent of basis in membership interest; property nontaxable until sold
Sale of Interest: Gain	Capital and/or ordinary	Capital and/or ordinary	Capital	Capital	Capital and/or ordinary
Loss	Capital and/or ordinary	Generally, capital	Ordinary to extent of IRC Section 1244 stock; otherwise, capital loss	Ordinary to extent of IRC Section 1244 stock; otherwise, capital loss	Capital and/or ordinary

Attribute	Proprietorship	General, Limited, or LLP Partnerships	C Corporation	S Corporation	Limited Liability Company
Liquidating Distribution	Nontaxable	Generally, nontaxable; cash distribution in excess of basis or non-pro rata distribution of IRC Section 751 assets will trigger gain	At corporation level, treated as a sale of property; gain to shareholder if FMV exceeds stock basis	At corporation level, treated as a sale of property; gain passes through and increases shareholder basis; could trigger built-in gains tax	Same as partnership
Social Security (FICA), Self-Employment Tax (SE Tax)	Self-employment tax paid on net earnings	Self-employment tax paid on partnership earnings for general and LLP partners	FICA tax paid on wages paid to employee	FICA taxes paid on wages paid to employee	Self-employment tax paid on member share of earnings

Corporations

CORPORATIONS

1. INTRODUCTION

1.1 Definition

A corporation is a formal legal entity established by detailed compliance with a governing statute. A corporation can be thought of as an artificial person, created for the purpose of conducting a business, that can enter into contracts, hire employees, and acquire assets. Corporations are also liable for debts incurred and can sue or be sued.

The characteristics of corporations, as set forth in *Morrisey v. Commissioner,* 296 U.S. 344 (1931), are these:

— Title to property is held by the entity.

— Management is centralized.

— Continuity of operation is uninterrupted by death of beneficial owners.

— Transfer of interest can occur without affecting the continuity of the enterprise.

— Liability is limited to corporate assets.

For tax purposes, additional definitions are required:

— *Regular C corporation.* An income tax is imposed on the taxable income of the corporation. A personal service corporation (PSC) is a segment of this type of classification to which certain special tax rules apply.

— *Subchapter S corporation.* With some exceptions, income is not taxed at the corporate level, but is passed through and taxed to its shareholders (that is, similar to a partnership).

1.2 Corporations in the United States

The modern concept of incorporation can be traced back at least to the Roman Empire. The laws that govern modern corporations in the United States emerged primarily during the late nineteenth and early twentieth centuries. Initially, individual state laws, designed to regulate the behavior of corporations within their borders, varied widely. Today, however, many states have adopted similar bodies of corporation law primarily as a result of the Model Business Corporation Act (MBCA) developed by the American Bar Association. Based on the Illinois statute, the earlier versions of the MBCA have been adopted by many states, though not in their entirety. In 1984, the MBCA was completely revised on the basis of a revision of the Virginia corporation law, and numerous states are in the process of considering adoption of the revised MBCA. (Reference here will be to the revised MBCA.) Several of the most important corporate jurisdictions (Delaware, New York, New Jersey, California, and Michigan) have not modeled their corporation laws on MBCA, and there are still significant differences from state to state. The federal government has also influenced corporation law with the passage of the Securities Act of 1933 and the Securities Exchange Act of 1934. Note, however, that there is no federal incorporation statute except for certain corporations such as savings and loan associations.

1.3 Three Important Terms

Relevant terms will be defined as they are introduced, but at the outset of any discussion of the corporation as a business entity it is necessary to understand these three:

1. *Publicly held corporation.* The shares are traded on securities exchanges or price quotations are published.
2. *Closely held corporation.* There is no outside market for shares, and free transferability of shares may be restricted. Closely held corporations have relatively few shareholders: any corporation with fewer than fifteen shareholders is generally considered closely held. Several states have special provisions or statutes that apply only to closely held corporations.
3. *Personal service corporation.* The principal business activity is the performance of personal services, which are substantially performed by employee-owners. Employee-owners are employees who own, on any day of the tax year, more than 10 percent of the personal service corporation's stock (IRC Sec. 269A(b)).

1.4 Reasons to Incorporate

The corporate form offers many advantages over other forms of business operation, but there are disadvantages as well. Legal and accounting professionals must, therefore, thoroughly understand the pros and cons of operating a corporate enterprise and also know the business owners' specific commercial and personal needs. The major advantages of operating a business as a corporation include

Tax benefits. The corporate form provides great flexibility for income tax planning. Corporations have a wide choice in selecting a taxable year.

Capital gains exclusion for certain investors in small business stock. To help small companies attract investors, IRC Section 1202 permits noncorporate investors to exclude from income 50 percent of the gains realized on the disposition of "qualified small business" stock. The stock must be acquired as an original issue after August 10, 1993, and must be held for more than five years. The definition of a *qualified small business* is a domestic C corporation (S corporations are not eligible) other than a domestic international sales corporation (DISC), a regulated investment company, a real estate investment trust (REIT), and certain other excluded classes. The corporation must use at least 80 percent (by value) of its assets in the active conduct of qualified trades or businesses, such as manufacturing or biotechnology. Specialized small business investment companies licensed by the Small Business Administration (SBA) are exempt from the active business requirement. The amount of gain excluded is limited to the greater of $10 million ($5 million for married taxpayers filing separately) or ten times the investor's adjusted basis in the stock.

At the time the stock is issued, the corporation's gross assets (cash plus the total basis of all other assets) cannot exceed $50 million. If the corporation's assets exceed the $50 million limit at any time after August 10, 1993, the corporation may never again issue qualifying stock.

Gain on qualified stock held by pass-through entities, that is, S corporations, partnerships, regulated investment companies, or common trust funds, is excluded if the entity held the stock for more than five years and if the shareholder, partner, or participant to whom the gain passes through held an interest in the entity when the entity acquired the stock and at all times thereafter.

If the investor is subject to the alternative minimum tax, 42 percent of the amount of capital gains excluded would be treated as a tax preference item. In the case of qualified small business stock acquired after December 31, 2000, only 28 percent of the amount of capital gains excluded is treated as a tax preference item.

Rollover of capital gain for certain investors in small business stock. In the case of a sale by an individual taxpayer after August 5, 1997, of qualified small business stock held for more than six months, IRC Section 1045 (which was added by the Taxpayer Relief Act of 1997) allows the taxpayer to elect to exclude the gain realized on the sale to the extent that the taxpayer uses the sale proceeds to purchase other qualified small business stock within sixty days after the sale. The Internal Revenue Service Restructuring and Reform Act of 1998 amended IRC Section 1045 to allow any taxpayer other than a regular C corporation owning qualified small business stock to receive the benefit of IRC Section 1045. In the case of qualified small business stock held by a pass-through entity, rules similar to those discussed above under IRC Section 1202 apply.

Maximum tax rates. In prior years, the top tax rate for individuals had been higher than the top corporate rate. As a result of tax rate reductions introduced by the Economic Growth and Tax Relief Reconciliation Act of 2001, as accelerated by the Jobs and Growth Tax Relief Reconciliation Act of 2003, however, the top individual rate is now 35 percent, which is equal to the top corporate rate. The corporate rates, which include net capital gains, are

Taxable Income	Rate
0–$50,000	15%
$50,001–$75,000	25%
$75,001–$10 million	34%*
Over $10 million	35%**

*A phaseout imposes an additional 5 percent tax on taxable corporate income between $100,000 and $335,000. Corporations with taxable income of $335,000 or more pay tax at a flat 34 percent rate.

**A corporation with taxable income over $15 million must increase its tax by the lesser of 3 percent of the excess, or $100,000. The surtax results in a marginal tax rate of 38 percent for corporate taxable income between $15 million and $18.3 million.

In addition, Social Security taxes can be saved if owners of closely held corporations can implement legitimate ways to extract funds from the corporation that are not subject to payroll taxes (for example, rent, interest, commodity salary payments, and so forth).

The following example illustrates the potential income tax savings available through the corporate low tiers. It assumes the individual to be in a 28 percent tax bracket.

> *Example:* Corporation A has $50,000 of net profits that need to be retained in the business for future new equipment. The federal income tax will amount to $7,500 ($50,000 × 15%). If the income was earned through a proprietorship, the individual would pay $14,000 in federal income taxes. The corporate entity was saved $6,500 in federal income tax during the year. This example ignores other potential problems involved with the corporate structure, such as the accumulated earnings tax and possible double taxation if the corporation needs to liquidate.

Dividends-received deduction. The dividends-received deduction allows for a favorable tax treatment in the corporate taxation of dividends from another domestic corporation.

The benefits of incorporating also include group term insurance, accident and health insurance, keyman insurance, major medical insurance, split-dollar insurance, salary continuation plans, employee meals and lodging programs, ESOPs, and so forth. In 1982, The Tax Equity and Fiscal Responsibility Act (TEFRA) made it essentially unnecessary for professionals to be C corporations in order to obtain beneficial retirement benefits. This law created virtual parity between Keogh plans for self-employed individuals and corporate retirement plans.

Limited liability. Because a corporation is a legal entity in itself, the owners of the corporation are not personally liable for debts incurred by the corporation provided that the corporation's creditors realized they were doing business with a corporation. (Many creditors now seek a personal guarantee from shareholders of closely held corporations, thereby eliminating much of the protection of limited corporate liability.) See section 3.3, herein, for a description of how creditors can pierce the corporate veil.

A corporation will generally *not* shield a shareholder/employee from liabilities related to his or her own tortious acts (such as causing personal injury or property damage by careless or negligent actions) or professional errors or omissions or from certain liabilities for payroll taxes.

Perpetual life. Since a corporation is an entity separate from the persons who own it, its existence is not threatened by transfer of ownership or the death of an owner.

Ease of transferring ownership. Transferring the ownership of a corporation merely involves transferring ownership of the corporation's stock.

1.5 Disadvantages of Operating as a Corporation

The legal and the accounting professional should review with the small business owner the following tax advantages of using a sole proprietorship, an S corporation, a limited liability company, or a partnership instead of a regular corporation structure.

Taxation of dividends. One of the historical disadvantages of operating as a corporation is the potential for double taxation. Earnings of a C corporation are taxed to the corporation, and are taxed again when distributed to the shareholders as dividends. Prior to 2003, dividends were taxed to individual shareholders at regular individual income tax rates, which in recent years were as high as 39.6 percent. Under the Jobs and Growth Tax Relief Reconciliation Act of 2003, however, dividends received by individual shareholders from domestic and certain foreign corporations are generally taxed at the same rates as capital gains. These rules apply to dividends received after December 31, 2002, and before January 1, 2011.

Alternative minimum tax on corporations. The alternative minimum tax generally applies to corporations. A corporation subject to the alternative minimum tax will pay a flat tax rate of 20 percent on the excess of its "alternative minimum taxable income" over an exemption amount. Note that the Taxpayer Relief Act of 1997 (as modified by the Internal Revenue Service Restructuring and Reform Act of 1998) repealed the alternative minimum tax, effective for tax years beginning after 1997, on certain C corporations with (x) average annual gross receipts of $5 million or less for the first three-year taxable period of the corporation beginning after December 31, 1993, and ending before the tax year for which the exemption is claimed and (y) average annual gross receipts of $7.5 million or less for all succeeding three-year taxable periods ending after December 31, 1993, and ending before the tax year for which the exemption is claimed. If the corporation fails to meet the average annual gross receipts test for any year, it cannot qualify for the exemption for any later year.

For tax years beginning after 1989, alternative minimum taxable income is increased by 75 percent of the amount by which adjusted current earnings (ACE) exceed what otherwise would be alternative minimum income. ACE is alternative minimum income plus those items of earnings and profit that are not included in the calculation of regular or alternative minimum income. This adjustment potentially subjects to tax all municipal bond interest, intercorporate dividends (before 70 percent deduction or 80 percent deduction if the corporate shareholder owns 20 percent or more of the stock of the dividend-paying corporation), and life insurance proceeds. For ACE purposes, depreciation is computed using the stright-line method. Therefore, C corporations can have four methods for depreciation: book, tax, AMT, and ACE. The earnings and profit adjustment is one of the most controversial aspects of the corporate AMT.

Maximum tax on noncorporate capital gains. Under the Jobs and Growth Tax Reconciliation Act of 2003, the maximum rate on net long-term capital gains for individuals was lowered to 15 percent (and, in some cases, to 5 percent or zero) for sales and exchanges (and payments received) on or after May 6, 2003, and before January 1, 2011. In contrast, the maximum tax rate on corporate income (including net long-term capital gains) is 35 percent.

Distribution following liquidation. Corporations (including S corporations) must recognize gain or loss on a sale or distribution of appreciated assets under a plan of complete liquidation.

Elimination of the cash method of accounting. Corporations other than farming corporations, qualified personal service corporations (those with substantially all activities in the fields of health, law, engineering, architecture, accounting, and so forth), and partnerships with a C corporation as a partner are not permitted to use the cash method of accounting if the entity has three-year average gross receipts of more than 5 million dollars. For taxable years beginning after December 31, 2001, a "qualifying small business taxpayer" (generally a taxpayer with three-year average gross receipts of between $1 million and $10 million that is not principally engaged in an excluded industry) is permitted to use the cash method of accounting. See Notice 2001-76, I.R.B. 2001-52.

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Practice Tip. If a decision is made to liquidate a corporation, the accountant must analyze any potential double taxation. Taxation may occur at the corporate level when there are gains from an actual or a deemed sale of corporate assets *and* may occur at the individual level if the fair market value of the distributed cash and property exceeds the shareholder's basis in his or her stock. The costs of liquidation, therefore, might be so high that the client should keep the existing structure.

2. INCORPORATION PROCEDURES

2.1 Selection of State of Incorporation

When corporations became popular in the United States, the individual states passed laws to regulate corporate behavior within their borders—laws often designed to make interstate corporation operation difficult. As a result, entities were forced to incorporate in the states in which they planned to do business. Eventually the U.S. Supreme Court struck down many of the state laws, allowing corporations to conduct interstate business with relative ease; corporations can now elect to incorporate in the state that will offer them the greatest benefits. Remember, however, that there are costs involved in operating a corporation in a state other than its state of incorporation (see section 2.6, below). If the business of a proposed corporation will be primarily intrastate it is usually advisable to incorporate in the state where the corporation's business is to be conducted. Corporations that conduct business in many states may want to incorporate in a state (for example, Delaware) that has a liberal statute governing incorporation and other matters. Nevada is becoming a popular state for incorporation based on the perception that Nevada law favors majority shareholders. Whatever incorporation locale is chosen, people who plan to establish a corporate entity should retain legal counsel for overall pre-incorporation advice and aid in preparing and filing the necessary corporate documents.

2.2 Documents Needed to Incorporate

The incorporation procedure varies from state to state, but every state requires that a document be filed with a state official (usually the secretary of state). This document is called by such names as *articles of incorporation, certificate of incorporation* or *charter* (we will refer to it as *articles of incorporation*), but in all cases it is reviewed by the state officer's staff. Pending approval of the document, the corporation's existence is usually deemed to begin on the date and at the time the articles of incorporation were filed and the filing fees paid.

2.2.1 Name reservation

A major item in the articles of incorporation is the corporate name. The rules vary among states, but typically the name must not be "the same or deceptively similar" to the name of any other corporation. To ensure that the desired corporate name is available at the time of incorporation, planners may want to reserve the name before incorporation. Not all states allow the reservation of corporate names, but most allow them to be reserved for a limited time by payment of a nominal fee. In most states, the secretary of state maintains a list of corporate names that are not available. Certain names are not permitted in some states—for example, the name of a governmental body if the corporation is not connected with it. It is important to remember that, just because a name is available for use within a state, it does not mean that the use of that name will not violate the trademark or common law rights of another business (for example, even if the name "Burger King" is available to use in a state, a corporation could not use that name to sell hamburgers without violating the trademark and common law rights of the nationally known Burger King Corporation). If the use of a specific name is important to the proposed business of the client, the client should consult with trademark counsel before selecting the name of the corporation.

2.2.2 The articles of incorporation

The information provided in the articles of incorporation normally includes the following:

(Text continued on page 11)

— The name of the corporation
— The number of shares the corporation has authority to issue
— A clause stating the purposes of the corporation (most contemporary statutes permit a corporation to pursue any legal purpose)
— The name and address of each incorporator
— The period of duration of the corporation (now almost always perpetual)
— The address of the initial office of the corporation
— The voting rights of the stock
— The name and address of the corporation's registered agent

Appendix 3 on the *Accountant's Business Manual Toolkit CD-ROM* contains sample articles of incorporation.

2.3 Preliminary Procedures

A practitioner assisting a business owner in setting up a corporation should see to it that the following items are obtained:

— A corporate minute book
— Blank stock certificates
— An employee identification number (EIN)
— A corporate bank account
— A corporate seal

See the incorporation checklist in appendix 1 of this chapter, and on the *Accountant's Business Manual Toolkit CD-ROM.*

In addition, if the shareholders desire that the corporation be treated as an S corporation, the practitioner should see to it that the shareholders and the corporation file a timely S election on Form 2553. See section 3.1 of the chapter on S Corporations.

Note that the IRS now permits taxpayers and their authorized representatives to apply for an EIN online and receive the EIN instantly. This is a great convenience when the taxpayer needs an EIN promptly to open a bank account or apply for a loan, for example.

2.4 The Corporate Bylaws

Any business planning to incorporate must have a set of bylaws to govern the corporation, generally drawn up with the help of an attorney and binding on the members of the corporation. The function of the bylaws is to supplement the articles of incorporation. There are no specific legal matters that must be included in the bylaws, but most have provisions concerning election of directors and officers, quorum requirements, board size, board meetings, and duties of the officers and directors. Bylaws can be changed more readily than the articles of incorporation, often merely by action of the board of directors, because bylaws do not have to be filed with the secretary of state as do the articles of incorporation.

Appendix 4 on the *Accountant's Business Manual Toolkit CD-ROM* contains sample bylaws.

2.5 Doing Business Under a Fictitious Name

Any time a corporation does business under a name other than the name on the corporation's incorporation certificate, it is doing business under a fictitious name (some states use the term *trade name* or *assumed name*). Most states require corporations to file a public notice when using a fictitious name. See the discussion in section 2.2.1 regarding potential restrictions on the use of names.

2.6 Foreign Corporations

Corporations are considered "domestic" in the state in which they were incorporated and "foreign" elsewhere. Corporations doing business in states other than their state of incorporation need to register in those states (failure to register usually triggers penalties). It is often difficult to determine what constitutes "doing business" in a particular state, although most follow the approach of the MBCA, which provides a nonexclusive list of activities a corporation may engage in without being considered to have transacted business in a state, including the following:

— Maintaining or defending any action, suit, administrative proceeding, or arbitration proceeding, or effecting the settlement thereof or the settlement of claims or disputes.

— Holding meetings of its directors or shareholders or carrying on other activities concerning its internal affairs.

— Maintaining bank accounts.

— Maintaining offices or agencies for the transfer, exchange, and registration of its securities, or appointing and maintaining trustee depositories with relation to its securities.

— Effecting sales through independent contractors.

— Soliciting or procuring orders, whether by mail or through employees or agents or otherwise, if the orders require acceptance outside the state before becoming binding contracts.

- — Creating evidences of debt, mortgages, or liens on real or personal property.
- — Securing or collecting debts or enforcing any right in property in securing the same.
- — Transacting any business in interstate commerce.
- — Conducting an isolated transaction completed within a period of thirty days and not in the course of a number of repeated transactions of a like nature.

All states issue certificates permitting foreign corporations to do business within their borders. A certificate of authority to do business in the state is extremely important to the successful operation of a business and the preservation of its legal rights within the jurisdiction. The nature of business the corporation may do in a foreign state is, however, subject to the laws of, and the rights granted by, that foreign state. Some state statutes provide that no foreign corporation transacting business in the state without authority to do so will be permitted to maintain any action or proceeding in any court of the state until the corporation obtains the necessary authorization.

2.7 Deduction of Organization Expenses

Although the costs of organizing a corporation (such as legal fees incident to the organization) are not immediately deductible, IRC Section 248 permits a corporation to elect to amortize organizational costs over a period of not less than sixty months. If the corporation fails to make such an election, the organizational expenses will probably not be deductible until final dissolution of the corporation.

3. CORPORATE DIRECTORS AND OFFICERS

3.1 Directors

Corporate bylaws normally specify the number of directors the corporation must have. Certain states may specify a minimum number of directors in relation to the number of shareholders. The MBCA states that there are no qualifications for a director and a director need not be a shareholder, but a corporation can specify qualifications for directors in its articles of incorporation. The directors are elected annually by shareholders. Many states require that "the business and affairs of the corporation shall be managed by the board of directors." While *business and affairs* does not specify particular duties for the directors, the directors' powers generally include

— Overseeing the daily activity of the officers of the corporation.

— Declaring dividends.

— Formulating corporate policy.

— Authorizing contracts involving the corporation.

Directors need not be compensated financially for their services as directors, although many corporations do so and the trend is toward compensation of outside directors.

The MBCA permits directors to fix their own compensation. Directors can be sued in their capacity as directors, and the directors of a corporation should ask the corporation to carry malpractice (officer and directors' liability) insurance for them. Recently, in an effort to assist corporations facing the prohibitive expense of carrying malpractice insurance, many states have allowed limits to be placed on the personal liability of outside directors charged with negligence. The laws apply only to directors, not to officers. It does not apply to breaches of so-called duty-of-loyalty situations in which, for example, a director might have a conflict of interest; nor does it apply to intentional misconduct or illegal activity. In addition, in Delaware, shareholders of several large corporations have overwhelmingly complied with requests to forfeit their right to sue directors for some forms of negligence.

3.1.1 Directors' meetings

State statutes may require at least one meeting per year. The frequency and location of directors' meetings are customarily set forth in the corporation's bylaws, but they may be left to the discretion of the directors. Directors' meetings are classified as regular and special:

— *Regular meetings,* the regularly scheduled directors' meetings, may be held without first issuing a notice.

— *Special meetings,* any directors' meetings other than regular meetings, may not be held without first issuing a notice as specified in the bylaws.

The bylaws of a corporation typically set the requirement for a quorum, which is the minimum number of directors who must be present for the board of directors to act. State statutes may *set* a quorum requirement. If a quorum is not present, the directors cannot act unless they are in the process of filling a vacancy, in which case fewer than a quorum may be permitted to act. With the advent of telecommunications, many corporations now hold their directors' meetings by teleconference (not all states permit this). In addition, some corporations hold directors' meetings via an Internet "chat" site, which has the advantage of producing a simultaneous written record of the proceedings (again, not all states permit this). Many states allow directors to act by unanimous written consent without a meeting unless the bylaws of the corporation prohibit such action.

3.1.2 Director's right of dissent

If a director of a corporation feels that the majority of board members are acting in a questionable or risky manner, he or she may choose to file a written dissent. Such a dissent generally eliminates any personal liability the director might incur as a result of the action by the other directors, provided that the dissent is recorded in the minutes of a meeting or sent by registered mail to the secretary of the corporation immediately following the meeting.

3.2 Officers

The officers of a corporation are elected by its directors. The officers and their duties are set forth in the corporate bylaws and vary from corporation to corporation. In general, however, the four major officers are president, vice president, secretary, and treasurer.

The president is the primary executive officer of the corporation and usually controls the corporation's day-to-day business affairs. The president has the prerogative to hire and fire employees. In the event of the president's absence or death, the vice president is authorized to perform the duties of the president. Customarily, both the president and the vice president have the authority to execute share certificates and other corporate instruments.

The duties of secretary vary among corporations but generally involve keeping the corporate records and seeing that all corporate notices are timely given to all persons specified in the bylaws. The treasurer is responsible for keeping accurate records of all accounting transactions that affect the corporation, and is responsible for the administration of federal and local withholding, sales, and income taxes and payments to appropriate jurisdictions.

3.3 Piercing the Corporate Veil

The term *piercing the corporate veil* refers to the equitable doctrine by which courts can ignore the fact that a corporation is a separate legal entity and hold the shareholders of the corporation personally liable for the actions of a corporation. Generally, in order to accomplish this, the party seeking to pierce the veil must show that the corporation was used for an improper purpose. Acts of fraud, bad faith, or failure to observe corporate formalities can also often lead to piercing of the veil. Additionally, courts can pierce the corporate veil when necessary to accomplish substantial justice.

The corporate veil can also be pierced if the corporation and its shareholders do not go to the trouble of conducting themselves as separate legal persons. For example, if directors' meetings are not held, minutes are not kept, funds are commingled, loans are made without approval of corporate officers or documentation, and the like, the existence of the corporation may be ignored for legal and tax purposes even though the corporation was properly formed and was *not* used for any improper purpose. The point is the corporate veil is pierced if the corporation and shareholders do not transact with each other in substantially the same manner as they would with unrelated parties. The "form over substance" concept definitely applies in this context. (See section 4.5, below.) See the *Accountant's Business Manual Toolkit CD-ROM,* Appendix 9, for a "Sample Policy on Conflicts of Interest and Disclosure of Certain Interests," that may help protect a corporation from a "piercing the veil" attack.

4. MINUTES, MEETINGS, AND SEAL

4.1 Minutes

Every corporation should keep a volume called a minute book (some states require it), which should include the articles of incorporation in their entirety and any subsequent amendments. In addition, these items should be added to or noted in the minute book: minutes of all directors' meetings, including the time and place of any directors' meetings, the names of all persons present at any directors' meetings, and the text of any resolutions adopted by the directors at the meeting; minutes of any shareholders' meetings, including the number of shares represented at any shareholders' meeting; an indication of whether the meetings were regular or special, and the text of any resolutions adopted by the shareholders at the meeting; and an indication of how any special meetings were authorized and a record of any notice given.

See the *Accountant's Business Manual Toolkit CD-ROM,* Appendix 5, for sample minutes of first meeting of board of directors, Appendix 6, for sample minutes of first meeting of shareholders, and Appendix 10 for a "Worksheet for Preparing Annual Minutes."

Shareholders and directors can generally take action without a meeting if the shareholders or directors sign written consent. Copies of the signed written consents should be filed in the minute book. Typically the secretary of the corporation maintains the minute book.

4.2 Meetings

4.2.1 Shareholders' meetings

A corporation's bylaws should include a section containing the rules governing shareholders' meetings. If the bylaws are silent, state statute may control. However, the bylaws should cover the following:

(Text continued on page 17)

— A specified location for holding meetings, often left to the discretion of the directors (some states require that shareholders' meetings be held in their state if that is the state of incorporation)
— A specified date and time for the annual meeting of shareholders (including a provision for adjustment when the annual meeting falls on a legal holiday and a clause stating what should be transacted at such meetings)
— Specification of who is authorized to call for special meetings of shareholders and under what circumstances they may call them
— Policy for notice to be given before holding a meeting, including a specified method of giving notice
— The number of shareholders that constitutes a quorum
— Requirements for meeting adjournment and the procedure for giving notice thereof
— Specification of the voting rights of the shareholders at the meeting
— Policy regarding shareholder action without a meeting
— Policy regarding proxies representing shareholders at meetings

4.2.2 Directors' and committee meetings

The corporate bylaws should include sections governing meetings of directors and of any special committees. For most corporations these sections will be very similar to the section governing shareholders' meetings and will cover the items discussed in section 4.2.1.

4.3 The Corporate Seal

While a formal corporate seal is no longer required in all states, most corporations choose to have a die-cast seal. Use of a corporate seal helps distinguish between corporate transactions and personal transactions. Examples of items to which the corporation should affix its seal include corporate resolutions to open bank accounts, share certificates, debentures, bonds, and important contracts (such as real estate deeds, mortgages, and the like).

4.4 Corporation's Bank Accounts

One of the first things a corporation should do is open a corporate bank account. Often, the first time a corporate officer uses the corporate seal is on the bank's resolution form designating depository of funds.

The bylaws of the corporation should limit the individuals authorized to sign checks drawn on the account.

4.5 Corporation Formalities

The failure to follow corporate formalities can endanger recognition of the corporation's separate existence (see section 3.3). The following are some of the corporate formalities that should be observed:

— Shareholder approval of the actions of officers and directors should be reflected in the minutes of annual meetings of shareholders.

— Director approval of the actions of officers should be reflected in the minutes of periodic meetings of directors.

— Officer action should be pursuant to resolutions and policy enunciated in the minutes of meetings of directors and shareholders.

— Complete corporate and financial records should be maintained.

5. SHARES

5.1 Definitions

5.1.1 Equity securities

Equity securities represent equity in a corporation, and persons holding equity securities of a corporation are considered to have an ownership interest in that corporation. Three common classes of equity securities are:

— *Common shares.* Holders of common shares have a residual ownership interest in the corporation that issued the shares. The common shareholders elect the directors of the corporation and are entitled to dividends out of the corporation's earnings as declared by the directors. Upon dissolution of the corporation, holders of common shares are entitled to a per-share (normally pro rata) distribution of the corporate assets remaining after creditors and holders of senior securities have been satisfied.

— *Nonvoting common shares.* Some shares of common stock specifically exclude the power to vote. Not all states permit the issue of nonvoting common shares; some allow holders of nonvoting common shares to vote as a class on issues that affect them as a class.

— *Preferred shares.* Preferred shares are securities senior to common shares, and holders of preferred shares therefore have preferential rights to dividends and the assets of the corporation upon liquidation as compared to the rights of common shareholders. However, preferred shareholders are only entitled to a specified amount of dividends or assets upon liquidation, most commonly do not vote for the directors of the corporation, and generally do not participate in the management of the corporation unless their dividends have been omitted. Preferred shares may be convertible into common stock, thereby giving preferred shareholders the ability to participate in any increases in the value of the corporation.

5.1.2 Par value

The *par value* of a stock is the dollar value of that stock as stated on the stock certificate. (Stock can be issued with no par value.) The par value of a stock is of very little importance; the actual price paid for the stock will vary depending on market value. The par value may be relevant, however, for purposes of calculating state franchise taxes (or other similar taxes) imposed on the stock. The price for a stock with a stated par value must, however, be set at or above par value. In most states, a person who buys stock for less than par value (see section 5.1.5) is liable to the corporation that issued the stock for the difference between the price paid for the stock and its par value.

5.1.3 Debt securities

A corporation may raise capital by issuing *debt securities.* Bonds payable are generally secured by assets (if any) and by the general credit of the corporation, which assumes the responsibility for repaying the investor the amount of the investment at a maturity date plus interest. In contrast to equity securities, debt securities usually provide investors a fixed return that is not dependent upon the success of the company. Bondholders do not have voting rights and do not participate in corporate earnings. Almost all bonds are *callable* so that corporations can pay off the debt prior to the maturity date. Debt securities may be convertible into common stock thereby giving the debt holder the ability to participate in any increases in the value of the corporation.

5.1.4 Treasury shares

Shares of capital stock a corporation has issued and subsequently reacquired are referred to as *treasury shares.* Treasury shares are counted by the corporation as shares fully paid and issued but not as shares outstanding. Treasury shares do not vote or receive dividends, cash, or other assets upon dissolution of the company. The MBCA eliminated the concept of treasury shares. It provides that repurchased shares are restored to unissued status and may be reissued unless the articles of incorporation prohibit reissue of acquired shares. Many states follow the MBCA approach.

5.1.5 Watered stock

The term *watered stock* refers to three types of stock that are issued by a corporation as fully paid in, when, in fact, they are not fully paid in. The three classes of such shares are as follows:

- *Bonus shares.* Par value shares issued without further payment when a shareholder has fully paid for shares of another class.
- *Discount shares.* Par value shares paid for by cash issued at less than par value.
- *Watered shares.* Par value shares issued for property valued at less than par value. Watered shares usually occur when the promoters of the corporation convey property to the corporation at an inflated value in payment for the shares of the corporation. The issuance of watered shares may impose a liability on the recipient equal to the amount of the shortfall from par value.

5.2 Authorized Shares

The number of shares a corporation is authorized to issue must be stated in the corporation's articles of incorporation. There are no limitations to the number of shares a corporation may authorize and there is no minimum number of shares that actually must be issued. Remember, however, that some states base franchise and stock taxes on the number of shares authorized. Even so, it is still advisable for corporations to authorize more shares than they plan to issue, so that the corporation can raise additional capital without amending its articles of incorporation.

5.3 Shares Issued

The capitalization of a corporation is based on the shares of stock the corporation issues and the capital it receives in return. The capital the investors provide in return for shares of stock is referred to as *contributed capital.* In addition, some states allow shares of stock to be issued in return for property or services provided to the corporation.

Another popular method of incorporating is the transfer of an entire business (including substantially all of its assets and liabilities) to a newly formed corporation. In exchange, the transferor (that is, the business owner) receives stock in the corporation. Such a transfer can usually be accomplished tax-free under Internal Revenue Code Section 351.

5.4 Consideration for Shares

People often wish to acquire shares of stock by promising future services to the issuing corporation or by giving the corporation a promissory note. (Many states do not allow such transactions or allow them only if the promise or promissory note is backed by collateral other than the shares of stock issued in exchange for them.) The MBCA allows stock to be issued in exchange for promissory notes and contracts for services to be performed. Shares issued for services are generally taxable upon receipt unless they are not transferrable and are subject to a substantial risk of forfeiture.

An employee who receives shares in exchange for the performance of past or future services is generally taxed at ordinary income rates, at the time of receipt, on the fair market value of the shares received (in which case the corporation generally receives a corresponding compensation deduction). Note that the corporation will be responsible for collecting and remitting employment withholding taxes upon the issuance of its shares in exchange for services rendered, even though the employee will not be receiving any cash consideration.

5.5 Preemptive Rights

Shares of stock can give shareholders specific preemptive rights if such rights are set forth in the corporate articles of incorporation. Typically the article creating preemptive rights reads: "Every shareholder upon sale for cash of any new stock of this corporation of the same kind, class, or series as that which he already holds, shall have the right to purchase his pro rata share thereof at the price at which it is offered to others." Preemptive rights are often used to prevent dilution of a shareholder's voting strength.

6. SHAREHOLDER AGREEMENTS

6.1 Pooling Agreements

A pooling agreement is an agreement among a group of shareholders of a corporation to vote in a certain manner on certain matters. The method of voting can be specified in the agreement or can be discussed and decided on before the vote on the matter in question. For example, a group of minority shareholders can agree to vote collectively against a proposed change detrimental to them as a group. Some states have statutes that regulate pooling agreements, but most do not. If disputes arise among shareholders in a pooling agreement, an outside arbiter usually resolves the disagreement. Appendix 7, "Sample Shareholder's Agreement" is found on the *Accountant's Business Manual Toolkit CD-ROM*.

6.2 Voting Trusts

The major difference between voting trusts and pooling agreements is that in a voting trust legal title to the shares involved is vested in the trustee. When the corporation records the names of its shareholders, the shares vested in the trustee are recorded in the name of the trustee. This does not prevent the equitable owners from receiving dividends on their shares, but the voting rights of the stock are given to the trustee. Voting trusts ensure that all shares of stock held by the trustee will be voted in the same manner. In certain states, if the trustee does not properly exercise fiduciary duty according to the trust agreement, the courts could entertain an action against the trustee. All states recognize the validity of voting trusts, but many states regulate them as follows:

— The agreement may not extend beyond ten years.

— The agreement must be in writing.

— A counterpart of the agreement must be deposited with the corporation at its registered office, to be subject to the same right of inspection by shareholders or holders of a beneficial interest in the trust that is provided a shareholder to inspect books and records of the corporation.

— The shares subject to the trust must be transferred to the trustee or trustees.

Voting trusts that do not comply with all statutory requirements are considered invalid by the majority of states. Appendix 8, "Sample Voting Trust Agreement," can be found on the *Accountant's Business Manual Toolkit CD-ROM.*

6.3 Share Transfer Restrictions

Many closely held corporations place share transfer restrictions on their stock to prevent shares from falling into unfriendly hands. Typical restrictions include

— *Options.* The corporation must be given the option to buy the shares at a specified price before the shareholder sells them to an outside party.

— *Buy-sell agreements.* The corporation or its shareholders must purchase the shares of any shareholder wanting to sell them. In the case of the death of a shareholder, the corporation must buy the decedent's shares (usually funded by a life insurance policy).

— *Right of first refusal.* The corporation or its shareholders must be given the option to match the best bona fide offer that a shareholder wanting to sell shares has been able to obtain from outside parties.

Corporations that impose share transfer restrictions must state that fact conspicuously on the shares themselves. If this is not done, the share transfer restrictions may be unenforceable against a transferee that is unaware of such restrictions.

7. SHAREHOLDER REMEDIES

7.1 Definitions

Shareholder action against a corporation generally falls into one of three categories:

1. *Direct action.* A suit filed by a shareholder against the corporation. Direct action can be taken by a shareholder with a claim based on an ownership share in the corporation. For example, the shareholder may claim entitlement to dividends that have not been paid to him or her.
2. *Class action.* A direct action in which a class of shareholders acts to cure or prevent a wrong from befalling that class of shareholders.
3. *Derivative action.* An action taken by one or more shareholders as an effort to cure or prevent a wrong from befalling the corporation. Derivative actions by shareholders are subject to various restrictions discussed in section 7.2.

7.2 Restrictions Governing Derivative Suits

Certain prerequisites typically must be met before shareholders can take derivative action against a corporation:

— The shareholders must make an effort in good faith to resolve the problem by negotiating with the corporation's directors.

— The shareholders must make an effort in good faith to resolve the problem first by getting the directors of the corporation to remedy the situation, a requirement that does not apply to shareholders who can show existence of an adequate reason for not making such an effort. (For a complete description of reasons that are considered adequate consult Rule 23.1 of the *Federal Rules of Civil Procedure.*)

— Most states require that the shareholders taking the action must all have been shareholders in the corporation at the time the action causing the wrong took place.

— The plaintiff shareholders may be required to post a security bond for reasonable expenses incurred by the corporation or other defendants involved in the suit. (The MBCA has eliminated the security requirement.)

The recovery, if any, in a derivative suit is usually paid to the corporation, not to the individual shareholders.

8. CORPORATE DISTRIBUTIONS

8.1 Definitions

One crucial decision facing the directors of a corporation is whether to distribute any or all of the corporation's profits to the shareholders in the form of dividends. The more common forms of dividends provided by corporations include

— *Cash dividends.* Cash distributions paid to shareholders out of the profits of the corporation, usually expressed in terms of dollars and cents per share or as a percentage of the stated value of the share.

— *Property dividends.* Distributions of the corporation's assets other than cash or stock to the shareholders of the corporation. Dividend distributions of appreciated property will cause gain recognition at the corporate level.

— *Stock dividends or share dividends.* Distributions of additional shares of stock in the corporation issuing the dividend, usually expressed as a ratio.

Example: If a corporation declares a 25 percent stock dividend, the shareholders of the corporation are entitled to a 25 percent increase in stock: one additional share for each four shares owned. A shareholder who owns fewer than four shares or a number of shares not divisible by four will receive a cash payment equal to the fair market value of the shares, a fractional share, or scrip (a fractional share with no voting or distributional rights).

All of the above distributions are normally nondeductible to the corporation and are taxable as ordinary income to the shareholder. A stock dividend that does not increase the interest of any shareholder in the corporation (that is, a private stock dividend) is generally not taxable to the shareholders.

8.2 Shareholders' Rights to Dividends

As a general rule, dividends declared by a corporation are a debt of the corporation and may not be revoked by its directors. Dividends are normally payable to the shareholders of the corporation as of a specified date (known as the "record date"). If shares are transferred after the record date, the purchaser and seller must agree on who is entitled to receive the dividends; the corporation will simply pay the dividends to the owner of record on the record date.

To ensure that corporations are paying dividends out of the earnings instead of capital, states have placed certain restrictions on the declaration of dividends. The specific restrictions required by the various states differ greatly, but all states require that any corporation declaring dividends be solvent (and must not be rendered insolvent by the payment of the dividend), so that the transfer of corporate assets to the shareholders does not harm the corporation's creditors. Directors of a corporation may be held personally liable for repayment of a dividend that causes the corporation to be insolvent.

8.3 Dividend Strategies: Publicly Held vs. Closely Held

8.3.1 Publicly held corporations

Publicly held corporations, especially large ones, generally pay dividends on a periodic basis. Payments made by these corporations tend to be stable from period to period, often geared to a percentage of earnings over some period of time.

8.3.2 Closely held corporations

Reinvestment of earnings can be used to finance the internal growth of a corporation. This will be reflected in the increasing growth of a corporation's retained earnings account. Closely held corporations often prefer not to pay dividends for tax reasons because dividends are not deductible to the corporation. They often distribute earnings as salaries or interest which would be deductible. However, if the goal of the owners is to sell the corporation, earnings are generally allowed to accumulate. IRC Section 531 imposes an accumulated earnings tax on corporations that expressly avoid paying dividends to shareholders. The penalty tax is imposed on the portion of retained earnings that exceeds any sensibly predicted corporate expenses or capital investment. There is a benefit of accumulating excess earnings in a corporation because of the preferential treatment of capital gains. If income is distributed, a dividend will be taxed at a higher rate than the gain on the sale of the corporation's stock. Other taxes may also apply to a corporation that is closely held, such as personal holding company tax if the corporation is a personal holding corporation and does not distribute all of its personal holding income.

8.4 Stock Redemptions

When a corporation reacquires its own shares (see section 5.1.4), the financial effect on the corporation is basically the same as if the corporation had paid dividends; in both cases the corporation makes a payment and receives nothing of value in return. The shareholders benefit from the acquisition of these shares because their proportional interest in the corporation is increased. The statutory restrictions on the right of a corporation to purchase its own shares differ from state to state. Reacquisition, however, must be made only by solvent corporations that will continue to be solvent after the transaction.

When a corporation purchases shares of its stock from one of its shareholders, the question arises whether the shareholder should be treated as if he or she received a dividend or sold the stock. IRC Section 302 answers the question in these terms: A redemption of stock by a corporation is treated as a sale or exchange of the stock if the redemption falls into one of the following four categories:

1. The redemption is not substantially equivalent to a dividend under IRC Section 302(b)(1);
2. The redemption is substantially disproportionate with respect to the shareholder under IRC Section 302(b)(2);
3. The redemption terminates the shareholder's entire interest in the corporation under IRC Section 302(b)(3); or
4. The redemption is of stock held by a noncorporate shareholder and is made in partial liquidation of the redeeming corporation (IRC Sections 302(b)(4), 302(e)).

Prior to 2003, the determination of whether a redemption payment was taxable as dividend versus a sale or exchange had significant tax implications because the tax rate on dividends (recently as high as 39.6 percent) was higher than the tax rate on sale or exchange transactions (generally 20 percent). As a result of the Jobs and Growth Tax Relief Reconciliation Act of 2003, however, there is generally no difference to a shareholder who is an individual in the tax rate on dividends versus sale or exchange transactions (now both are generally taxed at 15 percent). IRC Section 302 is still relevant, however, because a redeemed shareholder is entitled to recover his or her tax basis in the stock redeemed in a sale or exchange transaction, but not in a dividend transaction. In addition, the 15 percent maximum tax rate on capital gains recognized by individual taxpayers, and the 15 percent tax rate on qualified dividends paid to individual shareholders, are currently set to expire on January 1, 2010.

To ensure that corporations are paying dividends out of the earnings instead of capital, states have placed certain restrictions on the declaration of dividends. The specific restrictions required by the various states differ greatly, but all states require that any corporation declaring dividends be solvent (and must not be rendered insolvent by the payment of the dividend), so that the transfer of corporate assets to the shareholders does not harm the corporation's creditors. Directors of a corporation may be held personally liable for repayment of a dividend that causes the corporation to be insolvent.

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1. The redemption is not substantially equivalent to a dividend under IRC Section 302(b)(1);
2. The redemption is substantially disproportionate with respect to the shareholder under IRC Section 302(b)(2);
3. The redemption terminates the shareholder's entire interest in the corporation under IRC Section 302(b)(3); or
4. The redemption is of stock held by a noncorporate shareholder and is made in partial liquidation of the redeeming corporation (IRC Sections 302(b)(4), 302(e)).

Prior to 2003, the determination of whether a redemption payment was taxable as dividend versus a sale or exchange had significant tax implications because the tax rate on dividends (recently as high as 39.6 percent) was higher than the tax rate on sale or exchange transactions (generally 20 percent). As a result of the Jobs and Growth Tax Relief Reconciliation Act of 2003, however, there is generally no difference in the tax rate on dividends versus sale or exchange transactions (now both are generally taxed at 15 percent). IRC Section 302 is still relevant, however, because a redeemed shareholder is entitled to recover his or her tax basis in the stock redeemed in a sale or exchange transaction, but not in a dividend transaction.

9. AMENDMENTS, MERGERS, AND DISSOLUTIONS

9.1 Amending the Articles of Incorporation

9.1.1 Right to amend

Most states allow amendments to a corporation's articles of incorporation at any time.

9. AMENDMENTS, MERGERS, AND DISSOLUTIONS

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9.1.2 Procedure for amending

Generally, if the board of directors of a corporation wants to amend its articles of incorporation, the directors must adopt a resolution stating the proposed amendment and submit it to a shareholder vote. The directors must give the shareholders notice of the proposed changes along with the date and location of a meeting during which the shareholders can vote on the proposed changes. If the holders of a majority of shares in the corporation vote to accept the proposed changes, the articles of incorporation can then be amended accordingly.

9.1.3 Filing the amended articles

The customary procedure for filing amended articles is as follows. Duplicate originals of the articles, as amended, should be filed with the secretary of state. If the secretary of state finds that the amended articles of incorporation conform to the law, he or she will—

— Endorse each duplicate original *Filed* and date it.

— File one of the duplicate originals in his or her office.

— Issue a certificate of amendment to which he or she will affix the other duplicate original.

9.2 Mergers

Most state statutes allow for a corporation to merge freely into another business entity, with proposed mergers subject to approval by the shareholders of the corporations involved. In addition, the board of directors for each corporation involved in the merger must formulate and state a plan for the exchange of stock that will take place at the time of the merger. There are many complexities in the Internal Revenue Code regarding mergers, some of which allow for tax-free treatment on the exchange of assets involved in these types of reorganizations. Many states now also allow cross-entity mergers (for example, a merger of a corporation into a partnership or limited liability company). A transaction that is treated as a merger under a cross-entity merger statute will generally not qualify as a reorganization for federal income tax purposes. For detailed analysis of the tax ramifications of mergers, practitioners should consult other reference materials (see References at the end of this chapter).

9.3 Voluntary Dissolution

Statutory regulations governing voluntary dissolution of a corporation vary greatly from state to state. Generally, state regulations provide for a simple dissolution procedure for business entities that have not yet begun to do business as a corporation. Corporations that have done business as a corporation can usually dissolve by having the holders of a majority of the corporation's stock vote to dissolve the corporation. Directors who want to dissolve the corporation can adopt a resolution to dissolve but must have this resolution voted on by the shareholders. States normally require that a corporation must have paid all its franchise taxes before the corporation can dissolve. The dissolution of a corporation includes the liquidation of assets and liabilities. A corporation is required to file IRS Form 966 within thirty days after adopting a plan of voluntary dissolution.

9.4 Involuntary Dissolution

The state, the shareholders, or the creditors of a corporation can take judicial action to dissolve a corporation. Judicial action can be taken to dissolve a corporation when:

- — The corporation has failed to fulfill a state requirement (for example, failed to file its annual report with the secretary of state).
- — The directors of the corporation are deadlocked and the deadlock is doing irreparable damage to the corporation.
- — The shareholders of the corporation are deadlocked and cannot elect directors.
- — Those in control of the corporation are acting illegally.
- — The assets of the corporation are being misused.
- — A creditor can show that the corporation is unable to pay its debts.

See the chapter on Bankruptcy/Insolvency, herein.

10. PLANNING HINTS FOR CLOSELY HELD CORPORATIONS

10.1 Who Should Own the Real Estate?

Until passage of the Tax Reform Act of 1986 it was nearly always beneficial to separate real estate from the rest of the business by placing it in a separate S corporation, individual ownership, or a partnership—thereby providing a possible moderate tax shelter for the owner. If the rent received from the real estate is sufficient to cover the real estate taxes and other related expenses, the tax benefit of depreciation deductions will have been shifted from the corporation to an individual.

The Tax Reform Act of 1986 placed limitations on losses from passive activities, which the reader must review before doing all planning.

If the real estate owner personally does not have passive income to offset the passive losses generated or cannot effectively use the $25,000 rental realty loss privilege, the real estate could be put into an operating corporation. The passive tax losses of real estate can then be offset by operating income of the corporation, since the limitations on passive losses do not apply to closely held corporations that have active income. However, because a corporation is subject to gain on a sale of its assets, holding appreciating real estate in a corporation could be undesirable if it is held for a long period of time. If the real estate is sold, the depreciation taken and any appreciation would be subject to federal income tax of up to 35 percent plus state tax (versus 15 percent if held directly or via a pass-through entity). Then, if the resulting cash is distributed as dividends, the tax at the shareholder level can be an additional 15 percent.

> ***Practice Tip.*** A limited liability company (LLC) is generally an ideal entity for owning real estate because it offers limited liability protection, but permits the distribution of appreciated real estate without a resulting entity-level tax. See the chapter on Limited Liability Companies herein.

These days it often makes sense to own intangibles (e.g., patents, copyrights, and secret processes) outside of the C corporation when possible. Knowledge- or technology-based intangibles have great potential for appreciation, and it is obviously desirable to avoid double taxation on such appreciation.

10.2 Giving Nonvoting Stock to Family Members

The owner of a corporation who wants to transfer some of the wealth of the corporation to family members should consider creating two classes of stock, voting and nonvoting, which will allow allocation of the wealth among family members by the transfer of nonvoting shares. Since the transferred shares have no voting rights, the family members receiving them normally will have no say in the management of the corporation. (Some states allow holders of nonvoting shares to vote on certain major issues, but this is rare.)

10.3 Avoiding Special Penalty Taxes

Corporations usually avoid paying accumulated earnings tax by paying dividends to shareholders. If shares of stock have been issued to family members, it will be desirable to pay dividends only to children over age fourteen who are in a low tax bracket. This can be accomplished by creating a preferred series of stock that gives certain shareholders special rights to dividends. The owner of the corporation would then distribute the preferred shares only to those children he or she wants to receive the dividends. Note, however, that S corporations cannot issue preferred stock. See section 2.2.3 of the chapter on S Corporations.

10.4 Choosing a Fiscal Year

New corporations other than certain S corporations or personal service corporations (see section 1.4 herein) can choose a taxable year ending in any month. For tax purposes, a corporation should adopt a fiscal year that ends just before the corporation's busy season begins. In this way, the corporation will not pay the tax on the income it earns during its busy season until the following fiscal year. There are benefits for the officers and employees of a closely held corporation that chooses an early calendar-year month as its fiscal year-end. In this way any fiscal year-end bonuses or dividends will be paid to the individuals in the beginning of their taxable year when they can still plan to minimize their taxes for the calendar year.

For financial statement purposes, a fiscal year should end with the close of a cycle of business activity. Theoretically, this would be when inventories and accounts receivable are at a minimum and before new inventory is acquired for another cycle of sales.

10.5 Tax Interview Checklist

Because of the complexity of corporate income tax laws and regulations, it is recommended that an annual checklist approach be used when completing the corporate income tax returns. This approach will help ensure that no significant items are overlooked when completing the return. Appendix 2, also on the *Accountant's Business Manual Toolkit CD-ROM*, includes a sample interview checklist that can be adapted and expanded upon.

10.6 Deduction for Qualified Production Activities Income

Several provisions of the Internal Revenue Code were intended to encourage exports by providing partial relief for the double tax often faced by exporters (that is, U.S. tax and foreign tax). Before 2000, foreign sales corporations (FSCs) were granted an exemption from U.S. tax on certain revenues from exporting. The FSC laws were repealed in 2000 and replaced with an exclusion for extraterritorial income (ETI) under Code Section 114. In 2004, however, the World Trade Organization ruled that the ETI exclusion was a prohibited export subsidy. As a result, Congress was required to find an alternative method of encouraging exports.

As part of the American Jobs Creation Act of 2004, Congress enacted new Code Section 199, which provides a deduction for "qualified production activities income" (QPAI) from domestic production activity. While the QPAI deduction was intended to replace the ETI exclusion, the QPAI deduction is available to a domestic producer regardless of whether the items are exported, provided that the items are "manufactured, produced, grown or extracted by the taxpayer in whole or significant part in the U.S." In addition, while the QPAI deduction is discussed in this chapter on Corporations, the deduction is available to producers regardless of the form entity that they use to conduct their business (for example, the deduction is also available to a producer that operates as a partnership, limited liability company, or sole proprietorship).

Treasury regulations issued under Code Section 199 in 2006, provide guidance on the calculation of the QPAI deduction. The steps for calculating the QPAI deduction appears as Appendix 11 on the *Accountant's Business Manual Toolkit CD-ROM.*

11. THE SARBANES-OXLEY ACT OF 2002

11.1 Introduction

The Sarbanes-Oxley Act of 2002 (commonly referred to as SOX) was signed into law on July 30, 2002, in an attempt to restore public confidence with respect to the financial practices and financial statements

(Text continued on page 31)

of public companies. The stated purposes of SOX are to "protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws, and for other purposes." Currently, the provisions of SOX summarized in the following sections apply only to public companies. There have been efforts, however, to make some or all of the provisions of SOX applicable to closely held corporations. In addition, many public companies subject to SOX expect their vendors and other service providers to comply with SOX. Finally, some closely held corporations may want to comply with SOX if they anticipate going public or being acquired by a public company.

11.2 Establishment of Public Company Accounting Oversight Board

SOX establishes a five-member board known as the Public Company Accounting Oversight Board, under the supervision of the Securities and Exchange Commission (SEC), for the purpose of adopting auditing, quality control, ethics, independence, and other standards applicable to public accounting firms. Public accounting firms are required to register with, and submit periodic reports to, the Public Company Accounting Oversight Board.

11.3 Requirement of Auditor Independence

SOX prohibits a public accounting firm that performs an audit for a company to provide any of the following services contemporaneously with the audit:

- Bookkeeping or other services relating to the accounting records or financial statements of the company.
- Design and/or implementation of financial information systems.
- Appraisal or valuation services.
- Issuance of fairness opinions.
- Actuarial services.
- Internal audit outsourcing services.
- Management or human resources services.
- Broker-dealer, investment adviser, or investment banking services.
- Legal services.
- Expert services unrelated to the audit.

- Other services as designated by the Public Company Accounting Oversight Board.

In addition, a public accounting firm may not provide other non-audit services to a company, including tax services, unless the performance of such services is preapproved by the company's audit committee.

11.4 Audit Committees

SOX requires the SEC to adopt rules designed to enhance the independence of audit committees of public companies. Those rules require that:

- Each member of the audit committee must satisfy an independence standard established by the SEC, including requirements that such member not receive fees from the company other than fees for service to the board or audit committee, and rules that such member not be an "affiliated person of the issuer."
- The audit committee must be responsible for the appointment, compensation, and oversight of the company's outside auditors.
- The audit committee is required to establish procedures for complaints relating to accounting matters.

11.5 Certification Requirements

SOX generally requires that the chief executive officer (CEO) and chief financial officer (CFO) of public companies certify the accuracy of the companies' statements filed with the Securities and Exchange Commission (SEC). The following are examples of the types of certifications that the CEO and CFO must make with respect to a report filed with the SEC:

- He or she has reviewed the report being filed.
- To his or her knowledge, the report does not contain any untrue statement of material fact or omit to state a material fact necessary to make such statements, in light of the circumstances under which they were made, not misleading.
- To his or her knowledge, the financial statements and other financial information included in the report fairly present in all material respects the financial condition, results, or operations and cash flows of the company for the periods presented in the report.
- Certifications with respect to the "disclosure controls and procedures" implemented and maintained by the company.

- Certification that he or she has disclosed all relevant items to the auditors and audit committee of the company.

11.6 Potential Forfeiture of Bonuses and Profits

In the event that a public company is required to restate its financial reports as a result of corporate misconduct, the CEO and CFO of the company must reimburse the company for all bonuses and equity-based incentive compensation they received during the 12 months following the first public disclosure of the incorrect financial statements, and any profits they realized from the sale of stock of the company during the same period.

11.7 Blackout Periods for Insider Trading

SOX generally prohibits the directors and executive officers of a public company from purchasing or selling company stock during certain blackout periods with respect to the company stock if the director or executive officer of the company acquired company stock in connection with his or her performance of services for the company.

11.8 Disclosure Requirements

Pursuant to SOX, the SEC is required to adopt rules relating to disclosures to be contained in a company's period reports to the SEC. The following are examples of the type of disclosures to be included in a public company's periodic reports:

- All material off-balance sheet transactions, arrangements, and obligations.
- Whether the company has adopted a code of ethics for senior financial advisers.
- Whether the company's audit committee has at least one "financial expert."
- Certain disclosures regarding the effectiveness of the company's internal control structure and procedures for financial reporting.

11.9 Prohibition on Loans to Executives

SOX generally prohibits a public company from directly or indirectly making or arranging for "personal loans" to any director or executive officer of the company. This prohibition may adversely affect public companies' ability to offer certain types of executive compensation programs that contain a loan element. For example, the recently finalized regulations governing split-dollar life insurance treat certain split-dollar arrangements as loans by sponsoring corporation to the participating employees.

11.10 Disclosure of Certain Transactions in Company Stock

SOX generally requires officers, directors, and owners of 10 percent or more of the stock of a publicly traded company to report purchases and sales of the company's stock within two days after the transaction. Such reports must be posted on both the SEC's and company's Web sites.

12. SECURITIES REGULATION

12.1 Introduction

The scope and purpose of this section are twofold: The accountant should be familiar with the various laws regulating the issuance and sales of securities, and he or she should have an understanding of what those laws regulate, in order to identify securities issues that may arise (for example, seeking securities counsel). The need for the accountant to be conversant in securities matters is doubly important in the event a client or company wants to go public.

Even though this section appears in the chapter on corporations, it is important to note that interests in all forms of entities, including S corporations, partnerships, and limited liability companies, may be treated as "securities" for purposes of state and federal rules governing the sale of securities.

12.2 Scope

In the United States, far-reaching power to regulate issuance of and trading in securities is given to a federal agency, the SEC, which not only administers the statutory provisions of the federal securities acts but also wields considerable power through the rule-making prerogatives delegated to it. The federal securities acts are these:

- The Securities Act of 1933, which requires publicly offered securities to be registered with the SEC. The act contains antifraud provisions that apply to accountants and other persons involved with the process of registration.
- The Securities Exchange Act of 1934, which requires registration of securities before their trading on an exchange as well as of certain over-the-counter securities in which there is a significant trading interest. The act also regulates broker-dealers, the national securities exchanges, and associations of securities dealers. Its antifraud provisions apply to persons, such as accountants, involved in securities transactions carried out by use of the mail, telephones, or any instrumentality of interstate commerce.
- The Trust Indenture Act of 1939, which requires appointment of an independent trustee for publicly offered debt securities.
- The Investment Company Act of 1940, which requires the registration of investment companies. Their financial statements must be audited by independent accountants.
- The Investment Advisers Act of 1940, which requires registration with the SEC of persons deemed to be investment advisers, including accountants in some cases.

All state jurisdictions and Puerto Rico (but not the District of Columbia) require in some form the registration of securities. An official, whose title varies among the jurisdictions, is designated to administer these laws. Some uniformity in state law has been achieved through the adoption of major portions of the Uniform Securities Act by 31 jurisdictions.

12.3 Federal Securities Regulation: Overview

The SEC administers the five federal securities acts. The commission's principal office is in Washington, D.C., and there are five regional and six district offices. The SEC has considerable rule-making authority, which it has frequently exercised to expand upon or clarify the securities acts. Generally, the SEC staff has taken an expansive posture toward its role in the administration of securities law.

Distribution to the public of securities not previously traded is regulated by the Securities Act of 1933. This act and the SEC rules together specify the disclosures necessary to register a proposed new issue of securities. Unless exempted, registration is necessary to avoid penalties provided by the act. This act also regulates both the use of prospectuses and fraud in connection with public offerings of securities.

The Securities Exchange Act of 1934 requires the registration of both securities before listing and trading on a stock exchange and over-the-counter securities in which there is significant trading interest. Under this act there are continuing requirements to disclose significant corporate developments. This act also requires broker-dealers, national securities exchanges, and associations of securities dealers such as the National Association of Securities Dealers (NASD) to register with the SEC. It also regulates fraud in connection with the purchase and sale of securities and generally provides the mechanism with which the SEC oversees trading in securities.

The Trust Indenture Act of 1939 concerns public offerings of debt securities, for which it requires the establishment of independent trustees pursuant to trust agreements called indentures.

The Investment Company Act of 1940 requires registration of investment companies such as mutual funds and imposes conditions relating to their operation.

The Investment Advisers Act of 1940 requires registration of investment advisers who have more than 14 clients unless their activities are exclusively intrastate.

Of particular interest to accountants will be the 1933 and 1934 securities acts and the Investment Advisers Act. These are discussed in detail in the following sections.

12.4 The Securities Act of 1933

12.4.1 The purpose of registration under the 1933 act

Registration of a new issue of securities with the SEC provides potential investors with a source of information about their investment. The 1933 act provides for civil and criminal penalties to discourage misrepresentation in connection with offerings of securities. The SEC's role is to oversee the registration process, essentially to determine if the registration documents are complete, without passing in any way upon the suitability or safety of the investment. Securities purchasers who have scrutinized the mandated registration documents may be foolish in their investment, but they will not have been misinformed—at least, that is the intent of the 1933 act.

12.4.2 The process of registration

When securities are offered to the public by the issuer, registration is ordinarily required, which means the federal securities acts and the SEC rules and regulations must be complied with. It is unlawful to use the instrumentalities of interstate commerce (including telephone and mail) to sell unregistered securities. State securities laws must also be consulted. The decision by a closely held corporation to go public is not one to be undertaken without detailed consideration of the pros and cons. Expansion of the sources of capital and national, or at least regional, recognition are partially offset by the expense of the registration process and the ongoing complexity of continuous reporting, coupled with the partial relinquishment of control to outsiders. Clients considering the desirability of going public can consult for advice:

- Commercial bankers
- Certified public accountants
- Stockbrokers
- Investment bankers
- Registered investment advisers
- Attorneys, particularly those experienced in securities law
- Entrepreneurs who have recently gone public
- Books cited in the references section of this chapter

Ordinarily, publicly offered securities are marketed through an underwriter. Underwriters are usually stockbroker-dealer firms with investment-banking departments. Commercial banks cannot function as underwriters. A group of underwriters, headed by one or more lead underwriters, handle big issues; the team may be supplemented by broker-dealers who act solely as sales agents. Underwriter compensation packages typically include, but are not limited to:

- Commissions
- Discounts on the securities they underwrite
- Expense allowances
- Stock purchase warrants
- Rights of first refusal on future securities issues

The reasonableness of compensation received by its members acting as underwriters is regulated by the National Association of Securities Dealers (NASD) and by state regulations. Stated as a percentage, compensation is slightly higher for smaller offerings and for best-effort underwriting, slightly lower for larger offerings.

Assuming that no exemptions from registration can be found and the abbreviated procedures of Regulation A are not applicable, the process of a firm underwriting can be visualized like this:

- The firm desiring to raise capital meets with an investment banker.
- The banker gives oral assurance (or a letter of intent) expressing interest.
- Banker, issuer, legal counsel, and independent public accountants work together to prepare a registration statement and prospectus. (Preparation of these materials is time-consuming and, because of the expertise required of many of the participants and the liability to which they expose themselves, expensive.)
- The registration statement is filed with the SEC.
- The SEC's Division of Corporation Finance may review the filings and may issue a deficiency letter, a comment letter, or a stop order, or it may find the filing acceptable as it is. If the filing is not reviewed, a "no-review letter" will be issued.
- A preliminary prospectus is issued, and expressions of investors' interest are sought by the underwriter.
- After the filing of any necessary amendments, the registration statement becomes effective. (Theoretically, this occurs 20 days after the original filing; however, amendments required by the SEC staff may extend the date or the issuer may take advantage of procedures to delay the effective date.)
- Underwriter and issuer sign a firm agreement for a closing date and price. The underwriter begins to accept customers' offers to buy.
- The issuer receives a check from the underwriter and sale of the securities to the public is begun by the underwriter at the effective date of the registration.

Registration is an expensive process. The issuer, the underwriter, and sometimes the independent accountant are each represented by his or her own legal counsel. Masses of information must be accumulated concerning the issuing company, including its history, current operations, accounting policies, major customers, labor relations, affiliated companies, management background, qualification, and compensation, as well as its financial arrangements, contracts, patents, and existing or potential litigation. Requirements to be considered are those of the SEC, of the NASD, and of state blue-sky laws. Only legal counsel experienced in securities matters should be relied upon for guidance through this process.

12.4.3 Contents of the registration statement

The four basic registration forms are SEC Forms S-1, S-2, S-3, and for small business issuers, Form SB-2. They differ in the amount of detail required, because the S-2 and S-3 allow other filings with the SEC to be included by reference (that is, referred to but not attached to the S-2 or S-3 filing) and the SB forms follow rule S-B, which provides for simplified disclosures. Registration statements contain:

- A facing page appropriate to the particular SEC form being used, ordinarily displaying the names of the issuer and its legal counsel and the calculation of the registration fee.
- A prospectus containing financial data and making up the bulk of the registration. (See Section 4.4, herein.)
- A cross-reference sheet coordinating registration form and prospectus.
- Selected information not required in the prospectus, including expenses of the distribution and data about unregistered securities sold within three years.
- "Undertakings" appropriate to the filing form being used, as prescribed by Item 512 of Regulation S-K. (In effect, undertakings consist of promises on the part of the registrant, introduced with the clause "The undersigned registrant hereby undertakes," for example, "to deliver . . . the latest annual report that is incorporated by reference in the prospectus.")
- A signature page.
- Exhibits, including consent documents from experts named in the filings.

The following table lists commonly used 1933 Act forms.

Form	*For Registration of Securities*
S-1	Used when no other form is applicable. Used primarily by first-time registrants. Requires inclusion of all specified information in the prospectus.
S-2	Available to companies subject to 1934 Act reporting requirements for at least three years but do not meet the float requirements to use Form S-3. Requires incorporating by reference registrant's 1934 Act reports. Must furnish to investors certain registrant-related information either by including it in the prospectus or by delivering with the prospectus the annual shareholder report and subsequent interim reports.
S-3	Available to companies subject to the 1934 Act reporting requirements for one year and meet the float test. Requires incorporating by reference the registrant-related information from the 1934 Act reports. Disclosure generally is limited to information about the offering.

Form	*For Registration of Securities*
S-4	Registration of securities to be issued in a business combination. Permits, in certain cases, incorporating by reference information included in 1934 Act filings of the issuer and the target company.
S-8	Securities offered to employees under various employee stock plans.
S-11	For certain real estate companies.

Form	*For Exemptions From Registration*
1-A (Reg A)	Available for an offering under the "small issues" exemption (Reg A). Maximum offering is $5 million (including up to $1.5 million for selling shareholders) during any 12-month period. Offering statement to be filed with regional office containing an Offering Circular that includes financial statements, risk factors, and other information. Financial statements must comply with generally accepted accounting principles (GAAP) but not Regulation S-X. Balance sheet as of 90 days before filing; statements of income, cash flows, and stockholder's equity for two fiscal years. Need not be audited unless issuer filed (or was required to file) audited financial statements with the SEC during the year. There are many advantages to this type of offering.
D (Reg D)	For offerings under Regulation D (Rules 501–508). Due 15 days *after* the first sale of securities.

- Rule 504—may offer up to $1 million during any 12-month period. Cannot be used by investment companies, by development stage companies, or by issuers subject to section 13 or 15(d) of the 1934 Act. Registration and disclosures generally are not required.
- Rule 505—may offer up to $5 million during any 12-month period. Offer limited to 35 non-"accredited" investors and to unlimited "accredited" investors (see definition following).
- Rule 506—allows the "private placement" of securities with an unlimited number of accredited investors and up to 35 nonaccredited persons. However, under this rule, each nonaccredited purchaser of the issuer must reasonably believe he or she is "sophisticated" (can evaluate merits and risks of offered securities). No limit is set to the amount that may be offered.

(Form D is also used for offerings pursuant to Rule 4(6).)

Financial Statement Requirements for Regulation D Offerings

- Nonreporting companies:
  - — Offerings up to $2 million—GAAP financial statements for the last two years.
  - — Offerings up to $7.5 million—GAAP financial statements for the last two years.

— Offerings over \$7.5 million—GAAP financial statements for the last two or three years (depending on whether company follows Regulation S-B or S-X).

Note: Regardless of offering amount, if audited financial statements cannot be obtained without unreasonable effort or expense, only the balance sheet dated within 120 days of the start of the offering must be audited.

- Reporting companies: Irrespective of offering size, present either (1) proxy statement and annual shareholders' report, or (2) Form 10-K or 10, or Part I of Form S-1 or S-11.

Distribution of Prospectus

- Offerings up to \$1 million—No prospectus required for nonreporting companies and offerings to accredited investors only.
- Offerings over \$1 million—If purchasers include nonaccredited investers, specific disclosures are required in an offering circular.

Definition of Accredited Investor

Includes banks; investment and insurance companies and small business investment companies; certain employee benefit plans; large tax-exempt organizations; broker-dealers; large corporations, partnerships, and trusts; directors, general partners, and executive officers of the issuer; persons with a net worth over \$1 million or annual income over \$200,000.

12.4.4 Contents of the prospectus

The amount of detail required in a prospectus differs somewhat, depending on the SEC form on which the filing is made. For instance, Form S-2 allows the incorporation of financial statements by reference to those statements included in a recent Form 10-K filing (the annual filing required under the 1934 Act). This list of matters to be included in a prospectus is taken from Regulation S-K (available from the publication section of the SEC) and assumes the most detailed filing (Form S-1) is to be used. Disclosures or descriptions that must be provided include

- Audited balance sheets for two years and statements of income and changes in cash flow for three years.
- Description of the business, its markets, sources of supply, and its competitive conditions and risk factors related to the company and the offering.
- A plan of operations.
- A statement of whether it will be necessary to raise additional funds within six months.
- Use of the proceeds of the present offering.

- Plan of distribution, including names of selling security holders and information about the underwriters.
- Revenue, operating income or loss, and identifiable assets attributable to different operating segments (as defined in Financial Accounting Standards Board Statement of Financial Accounting Standards No. 131, *Disclosures about Segments of an Enterprise and Related Information*).
- Nature of dependence on a few customers.
- Amounts spent on research and development.
- Segment information by geographic area.
- Descriptions of properties.
- Legal proceedings.
- History of market prices and dividends for most recent two years.
- Number of holders of each class of equity securities.
- Description of securities to be registered.
- Selected financial data for the last five fiscal years.
- Selected quarterly financial data for quarters within last two fiscal years.
- Management's discussion and analysis of financial condition and results of operations.
- Disagreements with and changes in independent accountants.
- Quantitative and qualitative disclosures about market risk.
- Identification of directors, executive officers, significant employees and their business experience, and involvement in bankruptcy and certain other legal proceedings.
- Executive compensation, stock options, and bonuses.
- Ownership by any group of more than 5 percent of any securities.
- Transactions with or indebtedness exceeding $60,000 with directors, executive officers, and other related or selected persons.

In 1998, the SEC adopted plain English rules that require issuers to write the cover page, summary, and risk factors section of prospectuses in plain English. These requirements became effective for registration statements and post-effective amendments filed on or after October 1, 1998. The SEC published *A Plain English Handbook: How to Create Clear SEC Disclosure Documents,* which includes techniques for writing in plain English, a summary of the plain English rules (and an excerpt from the rules), as well as examples of "before" and "after" filings.

These rules do not reduce or eliminate any substantive disclosures but provide for more easily understood language. Sections written in plain English should use the active voice, short sentences, everyday language, tabular presentation or bullet lists for complex materials if possible, no multiple negatives, and no "legalese." The specific language and format, related to certain legal warnings previously made in all capital letters and the "red herring" legend, has been replaced with a plain English format.

12.4.5 Exemptions from registration

Numerous provisions eliminate, modify, or reduce the full registration filings otherwise required; a choice of exemptions may also be available. In some cases exemption applies to the securities to be issued, in other cases to a particular transaction, type of transaction, or type of buyer to whom the distribution will be targeted. Fully exempted are securities issued by religious, educational, charitable, and governmental organizations, as well as interests in railroad equipment trusts. Generally, a transaction exemption conveys no exemption from the registration procedures that might be required in the case of subsequent nonexempt resale of the same securities. The choice of exemption must be integrated with the marketing plan for distribution of the securities. The ramifications of state law must be considered. The choice of exemptions under which to qualify will be made by the underwriter and legal counsel experienced in securities laws.

12.4.6 Secondary transactions and Rule 144

Section 4(1) of the 1933 act exempts from registration transactions by "any person other than an issuer, underwriter, or dealer." The term *issuer* includes any person who directly or indirectly controls or is controlled by the issuer. An underwriter is any person who purchases from an issuer "with a view to, or offers or sells for an issuer in connection with, the distribution of any security." Thus nonissuers and nonunderwriters can distribute securities in transactions deemed exempt under this section.

Advisers should warn their clients that institutions or individuals who purchase securities in exempt transactions and then resell the securities can unintentionally become underwriters. This outcome can ordinarily be avoided by adherence to Rule 144, which provides an exemption from registration for certain transactions. The purpose of the rule is to permit the public sale of limited quantities of securities—without prior registration—by affiliated persons and by persons who bought restricted stock from the issuer. (An affiliate is a person controlling, controlled by, or under common control of the issuer.) Six conditions are required for an exempt transaction under SEC Rule 144:

1. *Adequate public information.* This condition is ordinarily satisfied if the issuer is a reporting company under the 1934 act.
2. *Holding period.* The securities must have been beneficially owned and fully paid for by the seller for at least one year before this sale.
3. *Limited amount.* In any three-month period, the amount of securities sold is limited to the greater of (a) 1 percent of the outstanding shares or (b) the average weekly reported volume of trading.
4. *Manner of sale.* Sales must be made in "brokers' transactions" or in transactions with a market maker. (Brokers' transactions are those in which the broker executes orders while acting as the seller's agent.)
5. *Notice of offering.* In any three-month period, if more than 500 shares, or $10,000 of sales price, will be offered, the seller must file with the SEC a notice on Form 144.
6. *Intent to sell.* The person filing the notice on Form 144 must have a bona fide intention to sell within a reasonable time.

If the sale is made by a nonaffiliated person who has been a beneficial holder for three years, the conditions regarding amount, manner of sale, and notice are waived. Sales on behalf of a controlling person, however, can cause the seller to be deemed an underwriter, thus canceling the exemption. Rule 405 defines *control* as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise." This undoubtedly confers "controlling person" status on top level management of a corporation even if their stock ownership is minimal. The two-year holding period referred to in Rule 144 does not create a safe harbor for a controlling person.

Rule 144A provides a safe harbor from registration requirements for the resale of unregistered securities to a qualified institutional investor acting for its own account. A qualified institutional investor is one that has $100 million in securities under its discretionary management or, subject to certain conditions, is a registered securities dealer, investment company, or bank.

Considerable litigation has resulted regarding Rule 144, and at least one book of substantial length has been devoted entirely to it. Because of varying judicial interpretation, clients must be advised not to place their reliance for an exemption entirely upon the two-year holding period, particularly if they are controlling persons within the context of the SEC rules. If the exemption of a resale transaction is challenged by the SEC, it is a question of fact to be decided by the courts whether a seller of securities originally purchased them with the intent to distribute them. Despite these possible pitfalls, however, most registered broker-dealers will have worked out procedures for safely handling Rule 144 securities and clients may be counseled to rely on these procedures.

12.4.7 Simplified registration

Regulation S-B provides two forms for a simplified registration. Financial statements must conform to generally accepted accounting principles but need not comply with the SEC's more stringent requirements stated in Regulation S-X.

Form SB-1 is available for most small business issuers (SBI) that have not previously registered with the SEC. The limit is $10 million of securities issued for cash in any continuous 12-month period. SB-2 can be used for an unlimited cash issuance by an SBI. A small business issuer is a U.S. or Canadian company, other than an investment company, that has revenue of less than $25 million and a public float of securities less than $25 million. In late 1998, the SEC proposed a change to the small business issuer criteria. The proposed change eliminates the public float test and increases the revenue level to $50 million.

Regulation A provides another type of simplified registration—in effect, a miniregistration. Its features are these:

- It allows aggregate offerings, within a 12-month period, to $5 million by the issuer, its affiliates that became such within the last two years, and its predecessors. Additionally, included in the $5 million limitation are certain secondary distributions by affiliates and other exempt securities sold under Section 3(b) of the 1933 act (Rule 504 or 505).
- It provides for lower limits for securities offered on behalf of nonaffiliated persons other than the issuer. These are:
  a. $100,000 on behalf of any person; $300,000 for all such persons.
  b. $500,000 limit if offering person is an estate.
- Solicitation of investor interest allowed before filing of an offering statement containing the offering circular used to sell the securities.
- Filings are made with and reviewed by regional SEC offices.
- State registration will ordinarily be required.
- Financial statements need not be certified but must conform to generally accepted accounting principles.
- Financial statements must include a balance sheet prepared within 90 days of the filing and profit and loss statements for the two preceding fiscal years.

- Financial statement specifications can be found in SEC Form 1-A.
- An offering circular must be provided to prospective purchasers.

Many attorneys believe the costs of filing and the necessity for approval by the SEC, when compared to the small size of the allowed offering, argue against the use of Regulation A registration in cases where an exemption can be found within Regulation D.

12.5 The Securities and Exchange Act of 1934

12.5.1 Overview

The Securities Exchange Act of 1934, cited hereafter as the 1934 act, prescribes registration and reporting requirements for issuers of certain securities by securities dealers, securities exchanges, and self-regulatory organizations (the only one to date being the NASD). The act in addition concerns itself with proxy solicitation, tender offers, insider profits, and manipulative and fraudulent practices. The 1934 act established the SEC.

12.5.2 Securities and Exchange Commission (SEC)

The SEC was established by the Securities Exchange Act of 1934 to administer and enforce the securities acts, and therefore has extensive rule-making authority. Documents required to be filed by the securities acts are filed with the SEC. Regional and district offices of the SEC initiate investigations and enforcement proceedings and can be queried for informal advice about matters of securities regulation.

12.5.3 Registration of brokers and exchanges

The SEC oversees operation of the two national stock exchanges, the New York Stock Exchange, the National Association of Securities Dealers Automated Quotation System (NASDAQ), and the American Stock Exchange (AMEX), as well as regional exchanges.

The largest number of stock issues are not listed for trading on an exchange but are traded over-the-counter, in direct exchange between brokers. The NASDAQ facilitates such trades. Possible advantages of listing on an exchange include

- Exemption from registration under some state blue-sky laws.
- Increased attention from securities analysts, which increases investors' interest.
- Increased visibility and prestige in the business community.

- Price stability of shares because of readily available market quotations.
- Greater acceptance of shares as collateral by lending institutions.

Disadvantages include

- Necessity for providing more information to the SEC, the stock exchange, and shareholders.
- Initiation fees and annual charges.
- Restrictions imposed by the exchange.

12.5.4 Registration of securities: general issues

All securities traded on a national exchange must be registered with the SEC. The SEC may suspend trading in any improperly registered security. Over-the-counter securities must also be registered by issuers who have a class of equity securities with 500 or more shareholders and more than $10 million in total assets. The data required is similar to that required for securities act registration; recent SEC policy has been to bring the two registration procedures into closer agreement. Following registration, reports must be filed to keep the information up-to-date.

This information is available for inspection at the SEC's Public Reference Room at 450 Fifth Street, N.W., Washington, DC 20549 (call (800) SEC-0330 for information on the operation of the room). The SEC also maintains an Internet site that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC (at http://www.sec.gov).

Exemptions from exchange act registration are provided for the security issues of savings and loan, not-for-profit, and cooperative associations, certain insurance companies, and certain employee stock bonus, pension, or profit-sharing plans.

The process of registration is being facilitated through a system called integrated disclosure. Integrated disclosure is designed to reduce the incidence of duplicative and overlapping filings required by the various securities acts. Registration statements and prospectuses will still be required to provide transaction-specific information (unless an exemption is available) for the issuance of securities. Information focusing on the registrant/issuer, however, will in most cases already be available under the periodic and continuous reporting requirements of the 1934 act (through such Forms as 10-K, 10-Q, and 8-K).

The workings of the integrated disclosure system can be observed in the alternative use of these three different registration forms:

1. Form S-1 requires the most detail and is used by first-time registrants.

2. Form S-2 demands less detail and is available for use by issuers who have reported for three or more years under the 1934 act.
3. Form S-3, exacting the least detail, is available for issuers who have reported for 12 months under the 1934 act and who have an aggregate market value of voting and nonvoting common stock held by nonaffiliates of $75 million or more but also requires as a precondition a "market following" test that assures the securities are widely held.

If a registrant qualifies for S-3 registration, no registrant-specific information is required. Instead, data about the registrant/issuer are incorporated by reference in other exchange act filings (such as 10-Ks, for example).

12.6 Other Federal Securities-Related Acts

12.6.1 Foreign Corrupt Practices Act of 1977

The accounting provisions of the Foreign Corrupt Practices Act specify that all securities issuers who report to the SEC are required under Section 13(b)(2) of this act to:

1. Make and keep books, records, and accounts that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer; and
2. Devise and maintain a system of internal accounting controls sufficient to provide reasonable assurance that:
   a. Transactions are executed in accordance with management's general or specific authorization;
   b. Transactions are recorded as necessary (1) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (2) to maintain accountability for assets;
   c. Access to assets is permitted only in accordance with management's general or specific authorization; and
   d. The recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any difference.

This Act was intended to subject to audit payments that heretofore had been disguised and that were being used by U.S. corporations to bribe foreign officials.

12.6.2 Investment Advisers Act of 1940

This act, according to a 1981 SEC staff report, may require registration as an "investment adviser" by "financial planners" and others who provide investment advice to their clients for compensation. Three exceptions from registration are provided under the act:

1. *Intrastate exception.* Section 203(b)(1) provides an exception for an investment adviser whose clients are all residents of the state within which the adviser maintains the principal office and place of business, as long as he or she does not furnish advice or issue analyses or reports about securities listed or admitted to unlisted trading privileges on any national securities exchange. (There may still be certain state registration and reporting requirements.) An investment adviser is also subject to the act's antifraud provision. A person who is not an investment adviser (which includes the accountant's exception) is not subject to the act at all.
2. *Insurance company adviser.* This exception is for those advisers whose only clients are insurance companies. Section 203(b)(2) applies.
3. *Private investment advisers.* Section 203(b)(3) offers an exception for investment advisers who, during the course of the preceding 12 months, had fewer than 15 clients and who neither hold themselves out generally to the public as investment advisers nor act as investment advisers to an investment company registered under the 1940 act or to a "business development company."

Accountants rendering investment advisory services may be required to register in certain circumstances. Persons or firms who engage for compensation in the business of advising others concerning securities transactions must register with the SEC. This includes advising directly or through publications or writings as to the value or advisability of purchasing or selling any security. Any "accountant whose performance of such services is solely incidental to the practice of his profession" is exempted (Section 202(a)(11)). Any form of recommendation to a client concerning a specific security made by a public account potentially could cross the "solely incidental" threshold.

Certain activities follow upon registration under the Investment Advisers Act.

Reporting. Reporting is done on Form ADV, which requires the adviser to give information about various practice aspects:

- The nature of the business
- Background, education, and experience of the principals and employees
- Whether there are grounds for disqualification from registration
- Amount of assets under management
- Type of clients advised
- Kinds of investment advisory services provided
- Methods of securities analysis

An annual report, Form ADV-S, is required within 90 days after the close of the adviser's fiscal year.

Recordkeeping. Certain records are required of registered advisers and may be inspected by the SEC:

- Journals and ledger accounts
- Memoranda or orders and instructions for purchase, sale, receipt, or delivery of securities
- Copies of certain communications received or sent
- Listings and records relating to discretionary accounts
- Copies of all written agreements
- Copies of publications and recommendations distributed to 10 or more persons and information indicating the factual basis for the recommendations
- Records of certain securities transactions entered into

Disclosure. The so-called "brochure rule" requires the adviser to furnish to prospective clients certain kinds of information. Generally, it is data of the sort included in Form ADV:

- Services provided
- Types of client served
- Methods of security analysis used by the adviser
- Standards of education and business background required of the adviser's principals and employees
- Descriptions of the specific backgrounds of its principals and employees

Performance fees. Although the act itself prohibits a registered investment adviser from receiving compensation based on a share of the capital appreciation in a client's account, under certain conditions this will be acceptable under a new SEC rule (SEC Investment Advisers Act Release No. 996 (November 14, 1985)).

Antifraud provisions. It is unlawful for an investment adviser to "employ any device, scheme, or artifice to defraud any client or prospective client" or to engage in any activity that operates as a fraud upon a client. Even persons excused from registration by one of the three exceptions from registration are subject to these antifraud provisions. Persons who rely on the exceptions from the definition of investment adviser, including the accountant's exception, however, are not subject to these provisions.

12.6.3 Investment Company Act of 1940

An investment company is one engaged primarily in the business of investing, reinvesting, or trading in securities. The most commonly encountered example of an investment company is a mutual fund. The 1940 act requires registration of investment companies and spells out such safeguards over operations as ratification by shareholders of the selection of the independent public accountant (Sec. 32 of the act) and changes in investment policy. Unexpected consequences may derive from operation of the act: For example, an investment company that fails in its duty to register will find itself denied access to the courts if it should attempt to enforce a contract with another party. The act contains provisions for the independence of the board of directors and for separate investment advisers. Criminal penalties are set out for willful violations of the act. There are also antifraud provisions and private remedies, both of which supplement similar provisions in the 1933 and 1934 acts, which are also operative regarding investment companies.

12.6.4 Trust Indenture Act of 1939

The Trust Indenture Act of 1939 provides that evidences of indebtedness such as bonds may not be offered to the public unless they are issued under an agreement (called a trust indenture) that has been passed on by the SEC. Among its other provisions, this act specifies the requirements for persons who serve as trustees for the bondholders. Accountants ordinarily have no direct role in the preparation of the registration documents or the annual filings required under this act. It may be desirable, however, for the issuing debtor's public accountant to review the trust indenture to provide advice concerning covenants that affect the financial statements or operations of the issuer.

12.6.5 Public Utility Holding Company Act of 1935

The Public Utility Holding Company Act of 1935 requires registration of holding companies operating electric utility or retail gas businesses. Financial statements required with the registration documents and with annual reports to the SEC must be audited by independent public accountants.

12.6.6 Securities Investor Protection Act of 1970

The Securities Investor Protection Act of 1970 requires almost all broker-dealers to be members of the Securities Investor Protection Corporation (SIPC). Through assessments of its members to create a fund of $150 million, the possibility of levying a charge on stock exchange and over-the-counter transactions, and authority to borrow up to $1 billion from the U.S. Treasury, the SIPC can advance funds to satisfy claims by customers of failed broker-dealers. SIPC coverage extends to a maximum of $500,000 for each customer, but not more than $100,000 for claims for cash held by a failed broker.

Notification to the SIPC originates with the broker-dealer, the SEC, or a self-regulatory organization such as the NASD. Customers of an SIPC member in financial difficulty have no rights, by themselves, to require the SIPC to act. Customers who suspect they may be damaged by a broker-dealer's financial difficulties should contact an attorney or the SEC. Once the SIPC determines the financial status of a broker-dealer it may apply to the courts for customers' protection under the act. The court then appoints a trustee and an attorney for the trustee who go about returning specifically identifiable property to customers, completing any open contractual commitments of the firm, selling the assets of the firm, and paying off customers and other creditors. It is a process similar to that of Chapter 10 of the bankruptcy act.

12.6.7 Small Business Incentive Act of 1980

The thrust of the Small Business Incentive Act of 1980 is to exempt companies that elect to qualify as business development companies from certain burdensome provisions of the Investment Company Act of 1940. Business development companies provide assistance in the form of capital and managerial expertise to small businesses, both those that are financially sound and those that are trying to regain their liquidity. Sections 54 through 65 of the Investment Company Act provide the details of qualification. Accountants who need a detailed analysis of this act should refer to Reginald L. Thomas and Paul F. Roye, "Regulation of Business Development Companies," 55 S. Cal. L. Rev. 895 (1981), an article that should be available through any law school library.

12.7 State Securities Regulations

Nearly all states register securities and broker-dealers. The wisest preliminary assumption, therefore, is that state registration will be required whenever securities are issued, although a majority allow for registration by coordination. In these states full registration may consist only of paying the fees, naming an agent, and filing with the state the same documents that are required at the federal level. When the federal registration becomes effective, so does the state's. States' antifraud statutes continue to be operative despite SEC registration (or exemption from registration). Additionally, most states' commissioners or administrators of securities (whatever the title) will retain power to suspend distribution in their states upon suspicion of fraud.

Despite the adoption of the Uniform Securities Act, or a portion of it, in a majority of states, considerable variation in detail still exists, particularly in the 15 or so states that either have not adopted the act or have passed highly individualized versions of it. A few relatively common features can be cited. Except for the District of Columbia, all of the states and Puerto Rico require registration of securities in some circumstances. Securities already listed on the New York and American stock exchanges are exempt from further registration in most jurisdictions. Also, issuers of securities benefiting from a Regulation D exemption from SEC registration under Rule 505 or 506 will often find an equivalent exemption at the state level.

12.8 Going Public

"Going public" means offering stock for sale to the public. The Securities Act of 1933 requires that a registration statement be filed with the SEC before a public offering of securities is made in interstate commerce or through the mails, unless the offering qualifies for an exemption. The registration statement is available to the public from the SEC. Somewhat similar requirements are imposed by the Securities Exchange Act of 1934 for certain companies—those seeking to have their securities listed and registered for public trading on an exchange and those whose equity securities are traded over the counter, having at least $10 million in assets and at least 500 shareholders.

12.8.1 Registration statement

The registration statement is a document presented in narrative form, similar to a brochure. Registration serves to provide investors with a source of information and does not constitute approval of the investment by the SEC.

The registration statement does not become effective immediately upon its filing. No sales of securities may be made until it becomes effective, although expressions of interest can be solicited from investors by showing them a preliminary prospectus called a "red herring." Only the securities subjected to the filing process are considered registered; previously issued and outstanding securities must comply with SEC regulations before being resold.

A registration statement consists of two principal parts:

1. A prospectus, or selling document, that must be furnished to all purchasers of the securities.

2. A supplemental part containing information that will be available subsequently at the SEC, on the SEC's Web site, or by mail upon request and the payment of a small fee.

Each of several forms tailored to the type of issuing company specifies the information required for registration. Form S-1 is the basic and most commonly used form for full registration of an initial public offering (IPO). Instructions for the financial statement portions of the forms are found in Regulation S-X. Regulation S-K gives instructions for the nonfinancial aspects of a registration. These regulations and forms are available from the publications section of the SEC. Registration statement requirements are discussed in Sections 12.4.4 and 12.5.5 of this chapter.

The company must provide whatever information is necessary to make the statement complete and not misleading. The SEC will not pass judgment on the value of the offering as an investment, but will frequently require amendments to the registration documents to improve disclosure.

12.8.2 Selling securities without registration

Exempt transactions relate to securities sales that are technically not public offerings in that they are private or otherwise limited. As with all securities sales, antifraud laws apply and disclosures made to investors must be truthful. Despite federal exemption from registration, a "notification" must be filed with the SEC, and state securities laws may similarly require a filing. Issuing securities without registration and under an exemption may not fulfill company goals in that subsequent sales of the securities will be restricted by SEC rules.

12.8.3 State securities laws

The term *blue sky laws* refers to laws governing securities sales in each of the 50 states. In some states, an effective federal registration fulfills all state requirements. In others, the registration statement or other disclosure document must be submitted to the state commissioner of securities. Most states have a system of merit review through which offerings are scrutinized for compliance with criteria such as the size of the underwriters' commissions and fees. Most states require that sales reports be filed after the offering is complete because fees are based on sales within the state. State securities administrators can provide information.

12.8.4 Advantages and disadvantages of going public

12.8.4.1 Advantages of going public

A company's prestige and image are usually enhanced by public sale of stock. Often greater respect will be accorded to the company and its management by customers, competitors, and associates.

CEOs report that employee morale significantly increases. Going public is an immediate wealth builder for present owners, who could see a hundred-fold increase in documented personal wealth. Establishing a market valuation on stock makes stock options a more attractive benefit to executives and managers and is a less costly incentive than salary increases. Enhanced liquidity rewards company founders with a market for their stock. Pledging publicly offered stock makes personal borrowing easier. Liquidity of publicly held stock aids in estate planning.

A growing company needs a strong source of capital. A higher price per share can be commanded in a public offering than in a venture capital arrangement or private placement because the promised rate of return can be lower. Alternatively, a necessary amount of capital can be raised with less ownership dilution.

Good market performance of stock issued now will make it easier to raise capital in the future. An IPO improves the debt-to-equity ratio; future borrowings can be made on more favorable terms. Finally, a company's growth through acquisitions of other companies is facilitated by exchange of publicly traded stock.

12.8.4.2 Disadvantages of going public

If significant percentages of stock are sold, loss of effective control of the company could result. Entrepreneurs accustomed to running their own show may find it difficult to work with a board of directors. Management flexibility will be lost; many desirable corporate maneuvers such as mergers and acquisitions must first gain shareholder approval.

Only shares registered and issued in an offering are freely tradable. Controlling shareholders may not freely sell their shares in the market without registration except under specified conditions. Shares previously issued, for example as management compensation, or issued to accredited investors in reliance on an exemption, are "restricted" and may be resold only in conformity with SEC regulations (SEC Rule 144).

Registration of even the smallest IPO may cost several hundred thousand dollars out-of-pocket. Much of this expense will be incurred even if the public issuance is not completed, for example, as a result of adverse market conditions. Further, ongoing operating expenses will increase as a result of statutorily mandated filings with the SEC, more complex legal and auditing requirements, and the recordkeeping and public relations costs of dealing with public shareholders.

Public disclosures must be made of the identity, business connections, and compensation of directors, officers, and major shareholders. Major customers and products, as well as their profitability, may have to be revealed. A spotlight will be turned on decisions and actions the company founders will have become accustomed to keeping private. No longer can the company serve as a tax shelter for the owners.

The company's apparent worth—its market value—will be made visible, yet will vary subject to market conditions outside the control of management. "Bottom-line-itis" will focus pressure on short-range operating results. Long-term planning and prudent decision making may be more difficult to sustain. Lack of steady improvement in operating results may cause public stockholders to lose confidence and to sell their stock. Depressed stock prices cancel many of the advantages of going public.

12.8.5 Costs of going public

Because costs vary so widely from offering to offering, it is difficult to estimate typical fees. Excluding the underwriter's commission, which ranges from $700,000 to $1.2 million and is deducted from the sales proceeds, a $10 million offering might incur these representative out-of-pocket costs:

Legal fees	$50,000–$200,000
Accounting and auditing	$50,000–$200,000
Printing	$50,000–$200,000
Filing fees (SEC, NASD, state)	$25,000
Transfer agent, registrar fees, other costs	$25,000

Accounting and auditing costs can be lower for the company with good internal control, well-kept records, and a several-year history of physical inventory counts observed by an independent CPA. Legal fees vary widely and must be closely monitored. Printing costs depend upon the number of and the length of the prospectus(es); the necessity for corrections, use of drawings, photos, or maps; and the number of stock certificates. Ongoing costs for stock transfers, SEC filings, and added accounting and legal work can be estimated at $50,000 to $100,000 annually. Additionally, CEOs report that the process of registration consumes management time, significantly diverting attention from operations for six months to a year. Afterwards, many companies find they must staff an ongoing "department of stockholder relations" to act as a communications buffer between shareholders and officers.

Costs are considerably less for nonpublic sales under an exemption from registration. However, against this must be balanced the likely restrictions on subsequent public trading of the issued shares.

12.8.6 Deciding to go public

The decision to go public is best made by balancing the benefits of market valuation and liquidity against the loss of privacy in management. Underwriters report, unless a particular industry is of unusual interest to the market, that the equities market seems most receptive to IPOs having these parameters:

- An operating history of five years or more
- Annual sales of at least $20 million
- Net income of $1 million or more
- A demonstrated annual growth rate of at least 25 percent
- A justified need for at least $5 million in capital, since many of the costs of the offering itself are fixed
- Promise of a "niche" position in their industry as a result of a unique product or technological process, the value of which can be readily perceived by the investment community
- A management team having breadth and credibility, preferably with one or two executives who have been successful in taking a company public

If a public offering is made prematurely and the stock flounders because growth is not sustained, permanent damage may be done to the issuer's credibility among employees, investors, and customers. Raising capital in the public market afterward may be nearly impossible; "too public, too soon" is a refrain heard often from CEOs.

12.8.7 Planning and assistance

Much work must be done before going public. Assistance to the company by several kinds of business advisers, including CPAs, will be needed to evaluate and carry out numerous steps:

- Prepare a business plan.
- Prepare a capital forecast of needs for several years.
- Calculate the effect that alternative offerings of various sizes and prices would have on earnings per share and book value.
- Improve internal accounting control to allow for efficient auditing.

- Begin audits of financial statements in anticipation of SEC requirements, keeping in mind that auditor independence is defined by SEC rules that are more stringent in one respect than those of the AICPA; independence is lost for the CPA firm when it, its partners, or its employees perform any general accounting or bookkeeping functions for the client. Advise changes to generally accepted accounting principles. (One-time changes for the purpose of going public are presented as retroactive restatements.)
- Review present shareholder records for accuracy.
- Discuss implications of related party transactions and arrangements.
- Call in loans to management and other insiders.
- Restructure contracts, particularly with insiders or other related parties, to conform to good business practices.
- Determine that significant contracts and employment agreements have been reduced to writing.
- Reevaluate existing plans or implement stock option plans that may be easier to pass before going public.
- Authorize additional shares for the public offering and future acquisitions or sales.
- Formalize recordkeeping of minutes of stockholders' and directors' meetings.
- Consider desirability of splitting stock, adjusting par value, retiring preferred or special classes of stock, eliminating the preemptive right, or otherwise adjusting capital accounts to create a simple and understandable capital structure.
- Combine affiliated companies to consolidate interrelated entities.
- Amend articles of incorporation and bylaws to be consistent with needs of a public company.
- Restructure the board of directors to replace family members with persons having widely recognized business credentials, such as bankers, retired executives, attorneys, and certified public accountants.
- Consider election of an outside director who has experienced the process of going public.
- Establish an audit committee of the board of directors.
- Evaluate the need for a more experienced management team.
- Begin providing information to the financial community before entering the registration pipeline, because to begin doing so during registration will violate SEC rules.

- Compromise or otherwise settle litigation, because investors will avoid "buying a lawsuit."

The assistance of a variety of professionals will be required in the course of a public offering of securities. Some of the more prominent participants in the process are discussed in the following sections.

12.8.7.1 Underwriters and investment bankers

There are three types of underwriting:

- Firm
- Best-efforts
- Standby

In a firm underwriting, the lead or managing underwriter puts together a syndicate of underwriters and a selling group of brokers and dealers. When the registration becomes effective, the lead underwriter, backed by the members of the syndicate, presents a check to the issuing company for the securities and then undertakes to sell them to the public.

When the investment banker promises only to use his or her best efforts to sell the securities, the issuing company bears the risk that the securities may not sell. The issuer and the best-efforts underwriter may agree that no shares will be issued unless a minimum number or, perhaps, "all or none" are sold. This arrangement avoids the danger that too few shares will be sold for the company to benefit while being saddled with the chores and costs of public ownership. As underwriting agreements are not finalized until the day before a registration statement goes effective, even a "firm" underwriting is not "firm" until it is signed.

For large offerings, syndicates of underwriters and broker-dealers are formed by the lead underwriter to limit individual firms' risk and to assure a broad distribution of the securities. The managing underwriter determines the allocation of shares to members of the syndicate and selling group.

In a standby underwriting, the underwriter stands ready to purchase securities that have been the subject of a rights offering to existing shareholders who choose not to buy them.

Choosing an investment banker is a critical decision. Investment bankers are recommended and introductions are arranged by accountants, attorneys, officers of public companies, or commercial bankers. Several should be interviewed before the lead underwriter is chosen. The firm should be chosen for its professional reputation, its client base, and its success with similar underwritings.

The business relationship between the issuer and the banker will be a continuing one. After the successful underwriting, the investment banker will make a market in the company's securities, provide investment analysis to the financial community, and contribute ongoing advice to the company. Surveys show CEOs' dissatisfaction with an underwriter is frequently related to a lack of continuing service after the underwriting. A company planning an IPO should check out the experiences of others who have used the same underwriter.

Compensation to the underwriter is in the form of sales commissions and, sometimes, warrants for the purchase of securities and expense allowances for which no accounting is required. State securities commissioners and the NASD have guidelines for reasonableness of the compensation.

12.8.7.2 Law firms

Preparing the legal documents for filing with the SEC and state authorities is a highly specialized task. It should be entrusted only to a law firm having SEC experience or able to acquire it by association. Some state bar associations establish criteria for specialization in securities law. The company's present legal counsel may give recommendations, as may the underwriter, but the final choice is the company's.

12.8.7.3 Financial public relations firms

The company going public must have its story put before the public, but the SEC restricts publicity that may be issued during the crucial "quiet period" beginning when a preliminary understanding has been reached with the underwriter and ending 90 days after the effective date of the registration. A financial public relations firm that is knowledgeable about the registration process can create a plan to develop public recognition. Mailing lists will be used to get the story to business analysts and journalists. Business magazines and major newspapers in the closest metropolitan area will be solicited for interviews. Presentations will be scheduled and publicized for delivery at appropriate trade shows; for example, at COMDEX for companies in computer-related fields.

12.8.7.4 Certified public accountants

Certified public accountants occupy a unique position. According to a recent small business survey, most CEOs reported their first advice regarding going public came from their CPAs.

Audits such as those required for S-1 and S-18 filings must be performed by an independent public or independent certified public accountant. Many disciplinary proceedings have been brought by the SEC against accountants who were not in fact independent. Instances of violation of independence have been reported in these SEC releases: Financial Reporting Release (FRR) No. 1, Section 600, FRR No. 4, and in

Accounting and Auditing Enforcement Releases (AAER). Accountants involved in SEC filings must familiarize themselves with the FRRs, AAERs, Regulation S-X, and the SEC's Staff Accounting Bulletins and Staff Legal Bulletins, as well as be knowledgeable concerning generally accepted accounting principles.

Major investment bankers underwriting an IPO of national scope will insist upon a CPA firm that has a national reputation.

The form and content for the auditor's opinion letter (or report) is set forth in Rule 2-02 of the SEC's Regulation S-X. Generally accepted auditing standards must be adhered to. The report contained in a Securities (1933) Act filing must not be qualified as to scope or fairness of presentation.

Opinions that contain an explanatory paragraph that addresses the uncertainty of the company's ability to recover its investment in specific assets—for example, a significant receivable, an investment, or certain deferred costs—are prohibited. Because generally accepted accounting principles generally require such assets to be stated not in excess of their net recoverable amount, such modifications are indicative of a scope limitation (that is, the auditor was unable to determine that the asset was stated at or below net recoverable value). However, the SEC will accept a standard "going concern" explanatory paragraph if prepared in conformity with Statement on Auditing Standards No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern,* as amended, and if the filing contains full and fair disclosure of the company's financial difficulties and the plans to overcome them. The independent accountant's written consent for its use must accompany the registration statement.

Any filings made via EDGAR include a typed signature of the accountant. The registrant is required to keep a manually signed copy of the accountant's report in its files for five years after the filing of the document.

The accountant may assist in preparing tabular and other data contained in the registration statement aside from the audited statements but must make it clear he or she does not assume responsibility for any matters not within his or her expertise as an accountant.

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APPENDIX 1: Incorporation Checklist

	Date Required	To Be Done By Atty.	CPA	Company	Date Finished
1. Target Date (date corporation is to commence business).					
2. Incorporators (names and addresses).					
3. Directors and Officers (names and addresses).					
4. Statutory Agent (name and address).					
5. Drafting Articles of Incorporation.					
6. Meeting of Incorporators (elect officers, transfer assets for stock, adoption of bylaws, adoption of seal, designation of depository, etc.).					
7. Assets and Liabilities (determine what assets and liabilities are to be turned over to the corporation and shares issued in exchange therefor).					
8. Identification Number (Form SS-4).					
9. Workmen's Compensation (file for coverage).					
10. Unemployment Compensation (file for coverage).					
11. Transfer of Credit from Unemployment Compensation (if incorporating existing business).					
12. Federal Unemployment (determine if final Form 940 is to be filed on old business).					
13. Final Returns (if incorporating existing business).					
14. Thin Corporation (debt structure and ratio of debts to equity in view of current and future financing requirements).					
15. Election under Subchapter S (if going to elect, prepare and file Form 2553).					

	Date Required	To Be Done By Atty.	CPA	Company	Date Finished
16. Multiple Corporations (determine if a problem).					
17. Accounting Methods (year-end accrual or cash basis, bad debt election, depreciation method, inventory valuation).					
18. Select accounting software.					
19. Prepare mission statement.					
20. Prepare business plan.					
21. Prepare first year financial budget.					
22. Officers' Salaries (establish officers' salaries and fill out Form W-4 authorizing corporation to withhold wages).					
23. Banks (select bank or banks and furnish resolution authorizing persons to sign checks and negotiate loans).					
24. Notify Utilities.					
25. Insurance (notify all pertinent insurance agents so that insurance policies may be transferred to the corporation if incorporating existing business; if new business, secure necessary insurance, i.e., fire, liability, etc.).					
26. Special Licenses and Permits (secure, if necessary).					
27. Accident and Health (formally adopt a plan under §105(c) and §106, if desired).					
28. Wage Continuation (formally adopt a plan under §105(d)).					
29. Medical Reimbursement Plan (formally adopt a §105(b) medical reimbursement plan, if desired).					

APPENDIX 2: Tax Interview Checklist

Form 1120 Interview Worksheet Client: ______________________

DONE BY: Interviewer____________; Preparer____________; Reviewer____________
(initials & date) (initials & date) (initials & date)

	Done	N/A	Comments or Explanations
A. For Interviewer			
1. Do we have the engagement letter in file?			
2. Thoroughly compare prior year return to current data; scan prior file notes, prior year points, correspondence.			
3. Have there been any notices/correspondence from IRS or state?			
4. Has there been any corporate-owned life insurance to Schedule M-1?			
5. Were W-2s/1099s done? Who's to do?			
6. Has there been a claim §179? Fast or slow depr?			
7. Has there been a change in stock ownership during year?			
8. Do we need to do Form 5500—fringes?			
9. Any changes for current year est.?			
10. Complete worksheet re: vehicle & mileage.			
11. Does Unicap apply? Identify §263A current yr. costs.			
12. Does LIFO apply? Calculate change in reserve.			
13. Obtain State apportionment info. (sales, payroll, & property).			
14. Were there new business elections? Start-up, org. costs?			
15. Update corporate minute book?			
16. Any data back to client to be copied for our file?			
17. Has there been a discussion w/client re: exp. outcome?			
18. Perform complete follow-up for business development engagement.			
B. For Preparer			
1. Read and clear *all* interviewer points.			
2. Review file thoroughly for any prior notes/carryovers into this TR.			

	Done	N/A	Comments or Explanations
3. After reaching net amount, consider any adjustments up or down or other elective items to improve results.			
C. For Reviewer:			
1. Are all interviewer & prep. pts. cleared?			
2. Are there any follow-ups re: add. work/CB's?			
3. Are there any carryforward points for next year?			
4. Are there any T/letter advice points for client?			

	Vehicle 1	Vehicle 2	Vehicle 3	Vehicle 4	Vehicle 5	Vehicle 6
29 Total business miles driven during the year (DO NOT include commuting miles) . .						
30 Total commuting miles driven during the year						
31 Total other personal (noncommuting) miles driven						
32 Total miles driven during the year (Add lines 29 through 31)						

	Vehicle 1		Vehicle 2		Vehicle 3		Vehicle 4		Vehicle 5		Vehicle 6	
	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No	Yes	No
33 Was the vehicle available for personal use during off-duty hours?												
34 Was the vehicle used primarily by a more than 5% owner or related person?												
35 Is another vehicle available for personal use?												

Section C.—Questions for Employers Who Provide Vehicles for Use by Their Employees

(Answer these questions to determine if you meet an exception to completing Section B. **Note:** *Section B must always be completed for vehicles used by sole proprietors, partners, or other more than 5% owners or related persons.)*

	Yes	No
36 Do you maintain a written policy statement that prohibits all personal use of vehicles, including commuting, by your employees?		
37 Do you maintain a written policy statement that prohibits personal use of vehicles, except commuting, by your employees? (See instructions for vehicles used by corporate officers, directors, or 1% or more owners.)		
38 Do you treat all use of vehicles by employees as personal use?		
39 Do you provide more than five vehicles to your employees and retain the information received from your employees concerning the use of the vehicles?		
40 Do you meet the requirements concerning qualified automobile demonstration use (see instructions)?		
Note: *If your answer to 36, 37, 38, 39, or 40 is "Yes," you need not complete Section B for the covered vehicles.*		

S Corporations

S CORPORATIONS

APPENDIX 4: Sample Attachment to S Election for Additional Shareholders (*see Toolkit CD-ROM*)

APPENDIX 5: Sample QSST Election (*see Toolkit CD-ROM*)

APPENDIX 6: Sample ESBT Election (*see Toolkit CD-ROM*)

APPENDIX 7: Sample Election to Close the Books of an S Corporation (*see Toolkit CD-ROM*)

APPENDIX 8: Chart—Subchapter S Elections by Trust (*see Toolkit CD-ROM*)

APPENDIX 9: Flowchart—Operation of Rev. Proc. 2003-43 (*see Toolkit CD-ROM*)

APPENDIX 10: Sample Election to Distribute Earnings and Profits (*see Toolkit CD-ROM*)

APPENDIX 11: Sample Election to Forego Previously Taxed Income (*see Toolkit CD-ROM*)

1. BACKGROUND

1.1 History of the S Corporation

In 1958, Subchapter S of the Internal Revenue Code of 1954, as amended, was enacted. Under that law, corporations electing Subchapter S status (then called Subchapter S corporations) were not subject to the corporate income tax, but were treated as passthrough entities somewhat like partnerships. In order to elect and maintain Subchapter S status, corporations had to meet certain requirements, such as a maximum number of shareholders and limitations on the classes of stock issued.

Despite the restrictions imposed by the status and notwithstanding the regulations and rulings added since 1958, increasing numbers of corporations chose to elect Subchapter S status as time went by. As the popularity of Subchapter S continued to increase, and as even further regulations were added to an already complex set, the need to simplify matters relating to Subchapter S became increasingly clear. Eventually, Congress made major revisions and changes to Subchapter S. The 1982 Subchapter S Revision Act (SSRA) was the product of a collegial group (including the American Institute of Certified Public Accountants [AICPA]) similar to the one formed to prepare the 1980 Installment Sale Revision Act. This group's work was embodied in the April 30, 1980 joint committee pamphlet, which would have provided an even simpler system than that contained in the 1982 act. SSRA officially designated the name S corporation for corporations that qualified under Subchapter S and designated all other corporations C corporations. The Subchapter S rules were again liberalized by the enactment of the Small Business Job Protection Act of 1996, which significantly revised the rules of Subchapter S to:

- Increase the maximum number of shareholders from 35 to 75 (increased to 100 in 2004; see below),
- Permit "electing small business trusts" to own S stock, and
- Permit the creation of "qualified subchapter S subsidiaries."

Note: The Subchapter S rules were further liberalized by the American Jobs Creation Act of 2004, which increased the maximum number of shareholders from 75 to 100 and provided rules treating members of the same family as one shareholder for purposes of applying the 100-shareholder limitation.

1.2 Advantages of Operating as an S Corporation

One of the most attractive features of an S corporation is that its shareholders limit their personal liability to trade creditors while generally avoiding double taxation—taxation at both the corporate and the shareholder levels. Bank lenders and landlords typically require shareholder guarantees of corporate borrowings or leases, at least in the early stages of the business enterprise. The guarantee removes insulation of personal liability to the extent of the loan or lease. However, shareholders would still, in most instances, be shielded from personal liability for acts arising in the ordinary course of the corporation's business (other than certain professional corporations, for which state statutes extend personal liability to the physician, attorney, etc.). In addition, losses experienced during the first few years of a developing corporation's existence can be passed through to the shareholders, who may be able to use the losses to offset other income. While general partnerships and sole proprietorships offer these same advantages, they cannot offer the limited liability of the S corporation.

An S corporation has these tax advantages over a C corporation:

— Avoids the accumulated earnings tax under IRC Section 531.

— Avoids the unreasonable compensation problems that occur when officers' salaries are high enough to run the risk of being reclassified as dividends.

— Affords flexibility in the use of accounting methods. An S corporation that is not required to account for inventories can use the cash method of accounting regardless of whether its annual gross receipts exceed $10,000,000.

— Avoids, in most cases, one level of tax on sale or distribution of appreciated assets in a complete liquidation (but see section 7.2, below, regarding the built-in gains tax).

— Avoids onerous alternative minimum tax (AMT) for regular corporations (which requires a minimum tax on taxable income), increased by preference items and other adjustments. For example, the receipt by a C corporation of proceeds of life insurance contracts on a shareholder's life is generally not taxable. However, these proceeds could easily incur the AMT. S corporation owned life insurance can avoid the severe AMT consequences.

For tax years beginning after 1997, the AMT is repealed for certain small C corporations (see the chapter on Corporations, section 1.5, "Disadvantages of Operating as a Corporation," herein).

— Allows operating losses to pass through for potential deduction on Form 1040 of the shareholders. The losses are still subject to the passive loss, at risk, and hobby loss rules.

— Allows shareholders to obtain tax basis for amounts loaned by the shareholders to the S corporation.

— Generally eliminates the incentive for a state to assert that the corporation is "doing business" in that state (because S corporations are generally not subject to state income tax).

— Allows shareholders the advantage of one level of taxation without the complexities of the tax rules applicable to partnerships.

— Distributions paid to S corporation shareholders are not subject to employment taxes.

A corporation may find S corporation status beneficial if it is anticipating substantial losses. If the losses are ordinary losses, the tax savings for shareholders may outweigh the tax savings the corporation could receive as carrybacks or carryforwards. In this case it is usually in the best interest of the shareholders to elect S corporation status. Personal holding companies can also benefit from S corporation status, which permits the company to eliminate personal holding company tax. However, there is a 25-percent passive receipts limitation for S corporations that have retained earnings and have converted from C corporation status to S corporation status (see section 6.1, below).

Historically, S status has been elected to permit deduction of operating losses at the shareholder's level. Under the Tax Reform Act of 1986, unless the shareholder materially participates in the business (in a regular, substantial, and continuous manner), S losses are treated as passive activity losses to inactive shareholders and are deductible only against the shareholders' passive activity income. Thus, S corporation losses of inactive shareholders cannot be deducted against salary, dividends and interest, and so forth.

Unused losses from passive activities are carried forward indefinitely and can be used to offset passive income in succeeding years. Alternatively, suspended passive losses may be claimed upon complete disposition of the activity, if the divestiture is accomplished in a fully taxable transaction.

S corporations allow a shareholder to pass along business profits to family members and save money at the same time. The shareholder can give away shares to family members and divide the profits of the S corporation among them, based on their percentage of ownership. This limits the amount of profit on which the original taxpayer has to pay tax but keeps the money in the hands of family members who may fall into a lower tax bracket than the taxpayer. By naming children age eighteen or older (formerly fourteen or older) as shareholders, it is possible to have the additional profit taxed at the minimum rate. Such a plan does, however, have a major limitation: the taxpayer must claim a percentage of the profits as salary large enough to compensate for the amount of work he or she does for the corporation and the amount of capital he or she has provided to the corporation. If the IRS determines that the taxpayer is not claiming a sufficient percentage of the corporation's taxable income, it may increase the original taxpayer's percentage and lower the percentages of the other family members. In addition, the IRS may claim that the transfer of stock to the children is a "paper transaction" if the transfer did not include all rights and privileges of stock ownership. In such a case, the IRS may tax the entire income as income earned by the donor parent.

1.3 Disadvantages of Operating as an S Corporation

Despite its many advantages, there are situations in which S corporation status is not advantageous. Prior to January 1, 2003, the top individual tax rate was higher than the top corporate rate and dividends paid by C corporations were taxed to shareholders at regular ordinary income tax rates. Pursuant to the Jobs Growth and Tax Relief Reconciliation Act of 2003, the top individual tax rate was reduced to 35 percent—the top corporate rate and certain qualified dividends paid by C corporations are taxed to individual shareholders at the maximum rate of tax imposed on long-term capital gains of individuals (15 percent). The S corporation may no longer be as beneficial as it was in the past when the top individual rates were lower than the top corporate rates, and using a C corporation should be reconsidered. Other disadvantages of operating as an S corporation include the following:

— Limitations on the number and type of shareholders permitted to own stock of an S corporation (see section 2).

— Inability to issue differing classes of stock.

— S corporation stockholders are not eligible for the 50 percent exclusion or the rollover of gain on the sale of qualified small business stock since only C corporations qualify (see the chapter on Corporations, section 1.4, "Reasons to Incorporate," herein).

— No special allocation provisions exist for income and deductions, as in the case of a partnership or limited liability company taxed as a partnership.

— S corporations, like partnerships, limited liability companies, and individuals, are subject to "passive-activities" provisions that eliminate the sheltering of salaries, interest, and dividends with losses from tax shelters. C corporations (other than personal service corporations) can offset passive tax losses against operating income of the corporation but not investment income.

— Several states and the District of Columbia do not treat S corporations as pass-through entities and, as a result, S corporations in those

(Text continued on page 9)

jurisdictions pay state taxes at corporate rates. Also, federal tax-free distributions in those states could be subject to a second tax under state law. Several other states impose tax on all or a portion of the income of S corporations.

— No partial dividend-received deduction exists for S corporations.

— Certain employee tax-advantaged fringe benefits for shareholders owning more than 2 percent of S corporation stock are taxable as compensation to S corporation shareholders. (See section 8.4 of this chapter.)

— Operating problems may arise from insurgent shareholders, who might take actions to disqualify the S corporation status.

— Passive income tax occurs if the corporation's investment income exceeds 25 percent of its gross income (applicable to S corporations with Subchapter C accumulated earnings and profits at end of year; see section 6 of this chapter).

— Banks may be reluctant to lend to S corporations that distribute all of their earnings.

— Shareholders pay income tax on their allocable share of S corporation income even if the S corporation does not have any cash available for distribution to its shareholders (for example, because the corporation has invested its earnings in machinery and equipment).

Effective January 1, 2002, the Economic Growth and Tax Relief Reconciliation Act of 2001 repealed the rule that prevented a 5 percent or greater S corporation shareholder-participant from borrowing from employee retirement plan trusts. Accordingly, the inability to borrow from a retirement plan is no longer a disadvantage of operating as an S corporation.

1.4 Advantages of Operating as a Limited Partnership or Limited Liability Company

Taxpayers seeking the limited liability protection afforded by an S corporation, while still qualifying for pass-through treatment for federal and state income tax purposes, can generally obtain that result by using a limited partnership or limited liability company, which offers the following advantages over S corporations:

— No limitation on the number or type of owners

— No restriction on issuing multiple classes of ownership interests

— Ability to distribute appreciated assets (other than marketable securities) to owners without recognizing gain

— Ability to make special allocations of gains and losses for tax purposes

— Ability to include indebtedness of the entity in the tax bases of the owners, thereby allowing additional losses to flow through to the owners.

2. ELIGIBILITY REQUIREMENTS

If a corporation wants to be treated as an S corporation, it must file an election (Form 2553) within a specified period of time. See Appendix 1 on the *Accountant's Business Manual Toolkit CD-ROM* for a checklist of eligibility requirements.

2.1 Corporation Requirements

2.1.1 Domestic corporations

To be eligible for an S corporation election, a corporation must have legal existence and must have been created and organized in the United States. The corporation must be operated with a profit intent, not just as a hobby. (The hobby-loss curbs in IRC Section 183 are equally applicable to a C corporation, partnership, or individual.)

An association that is taxed as a corporation (including a limited liability company that elects to be taxed as a corporation) may elect S corporation status if it otherwise qualifies (Reg. 1.1361-1(c)).

2.1.2 Ineligible corporations

Certain corporations are ineligible to elect S corporation status, including:

— Insurance companies subject to tax under Subchapter L.

— A domestic international sales corporation (DISC) or former DISC.

— A financial institution that is allowed a deduction for bad debts under the reserve method of accounting for bad debts, per IRC Section 585 or IRC Section 593 (bank or thrift institution).

— A corporation electing the Puerto Rico or possessions tax credit (IRC Section 936).

Practice Tip. As an alternative to forming an S corporation as a corporation under state law, you can take the following steps:

1. Form the entity as a limited liability company under state law.
2. File an S corporation election (IRS Form 2553).

Many practitioners believe that an LLC/S corporation offers better protection against claims from creditors than a traditional corporation/S corporation.

2.2 Stock and Shareholders

2.2.1 Maximum number of shareholders

To be treated as an S corporation a corporation may have no more than 100 shareholders. When determining the number of shareholders it is important to consider the following factors:

— Husbands and wives who each own stock are counted as a single shareholder, regardless of whether the stock is owned jointly (although the consent of each spouse to the S election is required). If the marriage is dissolved and both former spouses retain stock in the corporation, they are counted as separate shareholders.

— Effective for tax years beginning after December 31, 2004, a family can elect for all "members of the family" to be treated as one shareholder. The term "members of the family" is defined as the common ancestor (no more than six generations removed), lineal descendants of the common ancestor, and the spouses (or former spouses) of such lineal descendants or common ancestor.

— Estates are counted as single shareholders as long as the stock remains part of the estate. Once the stock is distributed to the beneficiaries, each beneficiary receiving stock is counted as a shareholder.

— Persons who are not husband and wife and who own stock jointly are counted as separate shareholders.

If more than 100 shareholders want to form an S corporation they can form multiple S corporations, each consisting of no more than 100 shareholders, and have these corporations form a partnership for the joint operation of a single enterprise (Rev. Rul. 94-43, 1994-1 C.B. 27).

When a trust qualifies as a shareholder (see section 2.2.2, below) the following rules apply:

— Each beneficiary of a voting trust and electing small business trusts is treated as a shareholder.

— The grantor or owner of a grantor or Section 678 trust is considered the shareholder.

— The estate of the testator is considered the shareholder of a qualifying testamentary trust.

— The sole beneficiary of a qualified Subchapter S trust (QSST) is treated as the shareholder.

2.2.2 Eligible shareholders

Eligible shareholders of stock in an S corporation are limited to

— Individuals (except nonresident aliens). A nonresident alien can form a partnership with an S corporation to conduct a business. This way, the nonresident can share the profits and losses of the business without being a shareholder of the S corporation (Reg. 1.701-2(d)). If the nonresident alien spouse obtains an ownership interest in the shareholder's stock under applicable law, such as state community property law or a foreign country law, the corporation does not qualify as an S corporation (Reg. 1.1361-1(g)(1)(i)).

— The estate of a decedent.

— The estate of a bankrupt individual.

— Tax-exempt organizations described in IRC Section 401(a) (qualified pensions, profit sharing, and stock bonus plans) and IRC Section 501(c)(3).

— Specific trusts (defined below).

— An organization described in IRC Section 401(a) or 501(c)(3) that is exempt from taxation under IRC Section 501(a).

In addition, the IRS has ruled that an otherwise eligible shareholder of an S corporation can transfer the stock of the corporation to a single-member limited liability company owned by the shareholder without terminating the corporation's status as an S corporation, provided that the limited liability company does not elect to be taxed as a corporation. See, for example, Priv. Ltr. Rul. 9739014.

A partnership or a C corporation may not own any stock in an S corporation; even one share of stock in the hands of a partnership or C corporation violates the eligibility of the S corporation. Effective for taxable years beginning after December 31, 1996, an S corporation is allowed to be a wholly owned subsidiary of another S corporation if the parent elects to treat the corporation as a "qualified Subchapter S subsidiary." Under this election, the subsidiary (known as a QSub) is treated as having liquidated into its parent and thereafter is not treated as a separate corporation for tax purposes (although the Treasury Department has recently proposed rules that would treat a QSub as a separate taxable entity for purposes of employment taxes and certain excise taxes. See Prop. Treas. Reg. Sec. 1.1361-4(a)(7)). See Section 2.2.4, below.

Trusts that qualify as shareholders of S corporations include

— A voting trust for which each beneficiary is treated as a separate shareholder (Sec. 1361(c)(2)(B)(iv)).

— A trust owned entirely by a grantor who is a U.S. citizen or resident; such a trust remains an eligible shareholder for two years after the grantor's death (Sec. 1361(c)(2)(A)(ii)).

— A trust that has Subchapter S stock transferred to it as part of a will, restricted to a two-year period that starts on the day of the transfer (Sec. 1361(c)(12)(A)(iii)).

— A trust, all of which is treated as owned by the grantor (Secs. 671–677).

— A trust of which someone other than the grantor is treated as the owner of the entire trust under IRC Section 678.

— A qualified Subchapter S trust (Sec. 1361(d)(3)).

— An electing small business trust (see Secs. 641(d), 1361, and 1366).

A qualified Subchapter S trust (QSST) is a trust that owns stock in at least one S corporation and is required to distribute (or is not required to distribute but does, in fact, distribute) all of its income currently to an individual who is the sole income beneficiary of the trust. Note that IRC Section 1361(e)(3), relating to QSSTs, treats separate shares of a multiple beneficiary trust under IRC Section 663(c) as separate trusts for qualifications as QSST. In addition, a QSST must

— Distribute all trust income to only one income beneficiary who is a U.S. citizen or resident during the time the trust owns S corporation stock (Reg. 1.1361-1(e)).

— Distribute any trust corpus only to the income beneficiary.

— Provide that the income interest of the current income beneficiary terminates on the earlier of the termination of the trust or the death of the income beneficiary.

— Provide that all corpus will be distributed to the income beneficiary if the trust is terminated during the life of the income beneficiary.

The IRS has ruled that a trust provision allowing the trust to accumulate income does not prevent QSST status if the trust does not hold S corporation stock. A trust may be a QSST even if its terms do not require income to be distributed currently, provided that trust income is actually distributed during periods that S stock is held (Rev. Rul. 92-20, 1992-1 C.B. 301).

Unless otherwise provided by local (that is, state) law, income of a QSST includes distributions to the trust by an S corporation, but does *not* include the trust's pro rata share of the S corporation's items of income, loss, deduction, or credit (Reg. 1.1361-1(j)(1)(i)). Absent the preceding rule, a QSST would be required to distribute all of its income (including its pro rata share of S corporation income) even if it had not received any cash from the S corporation. Note, however, that the beneficiary must pay tax on the pass-through income regardless of whether the S corporation distributes any of that income.

If the trust is set up to provide funds for a beneficiary that are legal support obligations of the grantor, the trust does not qualify as a QSST (Reg. 1.1361-1(j)(2)(ii)(B)).

For sales of S corporation stock by a QSST after July 21, 1995, the trust recognizes gain or loss.

Electing small business trust. Effective for taxable years beginning after December 31, 1996, an electing small business trust (ESBT) is permitted to be a shareholder of an S corporation. An ESBT is a trust that owns stock in an S corporation, and all of the potential beneficiaries of the trust are individuals or estates eligible to be S corporation shareholders or charitable organizations holding a contingent remainder. No interest in the trust can be acquired by purchase, and each potential beneficiary is counted as a shareholder for the 75-shareholder (100 after December 31, 2004) limitation. The income earned by the trust that is attributable to the S corporation is taxed at the highest individual income tax bracket—35 percent (for ordinary income) and 15 percent (for capital gains). There is no deduction for distributing S corporation income to the trust beneficiaries. Unlike a QSST, the trustee of an ESBT is permitted to "spray" trust income among multiple beneficiaries.

Effective for tax years beginning after December 31, 2004, powers of appointment, to the extent they are not exercised, are ignored for purposes of determining the potential current beneficiaries of an ESBT. Accordingly, a special power of appointment that permits the appointment of an ineligible beneficiary will not, by itself, cause the trust to fail to qualify as an ESBT.

2.2.3 Classes of stock

S corporations may have only one class of stock outstanding. Outstanding shares must entitle all shareholders to identical rights to the dividends and liquidating distributions of the corporation. Regulation Section 1.1371-1(g) specifies that a corporation authorized to issue different classes of stock is not barred from making a valid S election if only one class of stock is issued and outstanding. In other words, the existence of other classes of stock authorized but unissued does not bar an S election. S corporations may, however, issue voting stock to shareholders with managing interests and may issue nonvoting stock, with identical rights to dividends and liquidating distributions, to shareholders who own stock for investment purposes. The nonvoting stock will not be classified as a second class of stock (Sec. 1362(d)(4)). Warrants, options, and convertible debentures issued by the corporation may constitute a second class of stock.

> *Practice Tip:* A shareholder of an S corporation can grant options with respect to such shareholder's S corporation stock without violating the one-class-of-stock rules.

Certain debt may be determined to actually represent capital, and if deemed to be capital, could be considered a second class of stock. IRC Section 1361(c)(5) provides a "safe harbor" wherein straight debt in an S corporation will not be treated as a second class of stock. Straight debt is a written unconditional promise to pay on demand or on a specific date a certain sum in money if

- The interest rate and interest payment dates are not contingent on profits, the borrower's discretion, or similar factors.
- There is no direct or indirect convertibility to stock of the S corporation.
- The creditor is an individual, estate, or trust eligible to hold S corporation stock or is a person actively engaged in the business of lending money.

2.2.3.1 Nonconforming distributions

The Treasury regulations interpreting the one-class-of-stock rules require that all outstanding shares confer identical rights to distribution and liquidation proceeds. However, under those regulations, as long as the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds (all collectively constituting "the governing provisions") of the S corporation provide identical rights for all shares to distribution and liquidation proceeds, any distributions that differ in timing or amount are not treated as creating more than one class of stock.

The regulations shift the emphasis from an actual in-fact disproportionate distribution to the legally enforceable rights of the shareholders under the governing provisions of the S corporation. Under the more liberal treatment of the regulations, a single-class-of-stock violation will not be triggered by situations such as

— Excessive compensation and fringe benefits received by employee-shareholders.

— Loans made by S corporations to their shareholders at a below-market interest rate, because a loan agreement is not a governing provision, just a business agreement. This disproportionate distribution will not give rise to a second class of stock even though the corporation must impute interest income and expenses on the loan under IRC Section 7872.

However, this rule would not apply if the IRS can prove that the excessive compensation or the loan was entered into to circumvent the single-class-of-stock requirement. In that case the business contract will be treated as a "governing provision" and will likely result in a second class of stock.

The regulations provide additional instances in which distributions disproportionate in timing and amount do not result in a second class of stock:

— State law mandated payments and withholding of income tax on distributions for nonresident shareholders.

— Payments pursuant to bona fide buy-sell and redemption agreements upon the death, disability, or termination of employment of a shareholder.

— Payments pursuant to an agreement that calls for cash distributions based on a shareholder's varying interest in the S corporation's income in the preceding taxable year.

It should be noted that even though nonconforming distributions do not automatically trigger a single-class-of-stock violation, they will be given appropriate tax effect under the facts and circumstances of the distribution.

The IRS has issued private letter rulings confirming that an S corporation that inadvertently makes nonconforming distributions can make "correcting" distributions without violating the single-class-of-stock rules. See, *e.g.*, PLR 200524020.

2.2.3.2 Debt instruments and other arrangements

Generally, a debt instrument will be characterized as a second class of stock only if it constitutes equity or otherwise results in the holder's being treated as the owner of stock under general tax principles. However, under the regulations, before a debt instrument meeting these criteria will be considered as creating a new class of stock, it must be shown that the instrument also contravenes either (*a*) the rights to distribution or liquidation proceeds conferred by the outstanding stock or (*b*) the limitations on eligible shareholders of an S corporation.

The regulations discuss specific instruments and arrangements that will not be considered as outstanding stock and therefore are not affected by the nonconforming distribution rule or the "one class of stock issued and outstanding" rule:

- — A debt instrument meeting the criteria for straight debt discussed in section 2.2.3, above.
- — Restricted stock that is nonvoting and substantially nonvested, issued as consideration for the performance of services and for which a Section 83(b) election has not been made.
- — Instruments, obligations, or arrangements issued in connection with the performance of services as deferred compensation if the recipient is not currently taxed on the income.
- — Call options issued to commercial lenders as additional consideration for loans and to employees and independent contractors in connection with the performance of services, are not considered a second class of stock provided they have an exercise price at least 90 percent of the fair market value of the underlying stock.
- — Unwritten advances from an S corporation shareholder that in the aggregate are never more than $10,000 and that are expected to be repaid within a reasonable time.
- — Debt obligations due to S corporation shareholders in the same proportion as they own the outstanding stock of the S corporation.

The regulations provide that obligations owned by a shareholder who owns all the stock of the S corporation are held proportionately to the corporation's outstanding stock.

Under the regulations, convertible debt is a second class of stock if

- — It is treated as equity under general principles of tax law and is used to contravene the single-class-of-stock rule or other S corporation rules; or
- — The convertible debt has rights equivalent to those of a call option that is substantially certain to be exercised and has an exercise price that is substantially below the fair market value of the underlying stock.

Since convertible debt is more likely to be considered a second class of stock than is a call option, the S corporation might find it advantageous to issue a call option that would fall into the exception described above instead of using convertible debt.

2.2.4 Qualified Subchapter S Subsidiaries (QSubs)

Beginning January 1, 1997, an S corporation is permitted to own 100 percent (but not less than 100 percent) of another S corporation, provided that the parent corporation elects to treat the subsidiary as a qualified subchapter S subsidiary (QSub). The IRS issued final Treasury regulations, effective as of January 20, 2000, governing the making and effect of a QSub election. A QSub election is made on IRS Form 8869. Pursuant to the American Jobs Creation Act of 2004, Congress granted the IRS the authority to grant relief for inadvertently invalid QSub elections and for inadvertent terminations of QSub elections. If an S corporation makes a valid QSub election, the subsidiary is deemed to have liquidated into its parent pursuant to IRC Section 332, and thereafter the separate existence of the QSub is ignored for all purposes under the Internal Revenue Code (although the Treasury Department has proposed rules that would treat a QSub as a separate taxable entity for purposes of employment taxes and certain excise taxes. See Prop. Treas. Reg. Sec. 1.1361-4(a)(7)). If a QSub election terminates (for example, because the parent corporation transfers some of the stock of the subsidiary) the subsidiary is treated as a newly formed C corporation as of the date of the termination; however, an S election or QSub election can generally be made for such newly formed corporation effective immediately after such termination. (See Treas. Reg. Section 1.1361-5(c).) In addition, following the termination of a QSub election, the corporation cannot elect to be a QSub or an S corporation for five years without the consent of the IRS, or as otherwise provided in the Treasury regulations. See Appendix 2, on the *Accountant's Business Manual Toolkit CD-ROM,* for a sample QSub election.

Practice Tip. An S corporation that desires to form a new wholly owned subsidiary will generally prefer to form a single-member LLC, rather than a QSub, in order to avoid the limitations on electing S status, or reelecting QSub status, following the termination of a QSub election. See the chapter on Limited Liability Companies, section 3.7, "Single-Member LLCs," herein.

Also as of January 1, 1997, an S corporation is permitted to own any percentage (including 100 percent) of the stock of a C corporation. Previously, an S corporation was not permitted to own 80 percent or more of a C corporation.

Note, however, that a C corporation is not permitted to own any shares of stock of an S corporation.

On November 15, 2001, the IRS published proposed regulations that would permit the merger of a QSub into another corporation to qualify as a "reorganization" within the meaning of Code Section 368. Those regulations were adopted as temporary regulations on January 23, 2003 and finalized on January 23, 2006. (See Treas. Reg. 1.368-2.)

3. MAKING AN S CORPORATION ELECTION

3.1 Timely Filing of Form 2553

To become an S corporation, a corporation that meets all the eligibility requirements for becoming an S corporation must make a valid election on or before the fifteenth day of the third month of the taxable year (March 15 for calendar-year corporations) or in the preceding year. If the election is made after this date, the corporation will not be treated as an S corporation until the beginning of the next tax year, unless the IRS treats the late S election as timely filed (that is, the IRS determines that there was reasonable cause for the late election). For new corporations, the two and one half month S election deadline begins to run on the date the corporation first has shareholders, acquires assets, or begins doing business.

> *Example.* Corporation X is formed and begins doing business on September 24, 1997. The two-month and fifteen-day period within which it must file its election is calculated as follows:
>
> - *Month 1.* September 24, 1997 to October 23, 1997.
> - *Month 2.* October 24, 1997 to November 23, 1997.
> - *Plus 15 days.* December 8, 1997.

An S corporation election is made by filing Form 2553. Form 2553 or a separate written consent must be signed by all of the stockholders (see section 3.2, below). Form 2553 must also be signed by a corporate officer who is authorized to sign the corporation's tax return and must be filed with one of two designated IRS Service Centers (Cincinnati, OH, or Ogden, UT) depending on where the company's principal place of business is. Prior to 2001, Form 2553 was filed with the IRS Service Center where the corporation will file its tax returns.

The election should be sent by certified mail or by registered mail with a return receipt requested. See Appendix 3, on the *Accountant's Business Manual Toolkit CD-ROM,* for a sample S election, and Appendix 8 for a chart describing the proper party to make an S corporation election on behalf of various trusts.

Rev. Proc. 2003-43, 2003-23 I.R.B. 998, provides guidance for taxpayers requesting relief for an untimely S corporation election, QSub election, QSST election, or ESBT election. See Appendix 9, on the *Accountant's Business Manual Toolkit CD-ROM,* for a flowchart illustrating the operation of Rev. Proc. 2003-43. Rev. Proc. 2004-48 provides relief for a late S corporation election and a late corporate classification election that was intended to be effective on the same date. In addition, Rev. Proc. 97-48 provides automatic relief for late S corporation elections in certain cases.

3.2 Shareholders' Consents

All shareholders in a corporation making an election must consent in writing to the election. If the election is to be effective in the year in which it is made, any person who was a shareholder at any time during the portion of the year before the election is made must consent to the election regardless of whether or not he or she is a shareholder at the time of the election. Consent may be made on Form 2553 or in a separate statement. If a corporation has more than five shareholders, an attachment may be used. See Appendix 4, on the *Accountant's Business Manual Toolkit CD-ROM,* for a sample attachment.

Any persons who become shareholders after the election has been filed are bound by the election unless it is revoked or terminated. Only a majority of shareholders (those owning more than 50 percent of the corporation's stock) may revoke the election. However, any shareholder can cause the election to be terminated by transferring shares to a disqualified shareholder.

It is possible to get a time extension when the election has been filed within the specified time limit but a shareholder has failed to consent in time. To receive such an extension the corporation must satisfy the IRS that there was reasonable cause for the failure to file the consent on time and must show that the interest of the government will not be jeopardized by allowing the election. Once the IRS has granted the extension, any shareholders who have not consented must do so within the extension period. In addition, new consents must be filed by any persons who were shareholders at any time during the year in which a shareholder failed to file a consent. Any additional persons who have become shareholders before the end of the consent period must also file consents. Remember that all consents must be filed within the extension period.

3.3 Election by a Beneficiary of a Qualified Subchapter S Trust (QSST)

A special election is required by the beneficiary of a QSST to qualify the trust as an eligible S shareholder. This election is made by the income beneficiary who is the deemed owner and must be made separately with respect to each S corporation the stock of which is held by the trust. The beneficiary must elect within two months and fifteen days beginning on the later of the following two dates:

— The date the stock is transferred to the trust.

— The first of the taxable year on which the corporation's S election is effective.

The election by a beneficiary of a QSST to qualify the trust is an election to be made in addition to the election made on Form 2553 and the consents to that form. If the trust is a shareholder at the time the Form 2553 S election is filed, the QSST election may be made on Part III of Form 2553. If the trust becomes a shareholder after the corporation has already elected S status, a separate statement according to Regulation Section 1.1361-1(j)(6) must be filed. Rev. Proc. 2003-43, 2003-23 I.R.B. 998, provides guidance for taxpayers requesting relief from an untimely QSST election. See Appendix 5, on the *Accountant's Business Manual Toolkit CD-ROM,* for a sample QSST election.

3.4 Election by Trustee of an Electing Small Business Trust (ESBT)

The election to be treated as an Electing Small Business Trust (ESBT) is filed by the trustee, not the beneficiaries, of the ESBT. To make an ESBT election, the trustee must file a statement with the appropriate IRS service center that:

- Contains the name, address, and taxpayer identification number of all potential current beneficiaries, the trust, and the S corporation.
- Identifies the election of an ESBT election made under IRC Section 1361(e)(3).
- Specifies the date on which the ESBT election is to become effective (which cannot be earlier than fifteen days and two months before the date on which the election is filed).
- Sets forth the dates on which the stock of the S corporation was transferred to the trust.
- Provides all information and representations necessary to show that all potential current beneficiaries are eligible to own stock of an S corporation, and that the trust meets the definitional requirements of an ESBT.

Note: Be advised that for taxable years beginning after December 31, 2004, a potential beneficiary that can only become a beneficiary pursuant to the exercise of a Special Power of Appointment is not treated as a "potential current beneficiary" before the exercise of the special power of appointment. See section 2.2.2. Rev. Proc. 2003-43, 2003-23 I.R.B. 998, provides guidance for taxpayers requesting relief from an untimely ESBT election. See Appendix 6, on the *Accountant's Business Manual Toolkit CD-ROM,* for a sample ESBT election.

3.5 Taxable Years

An S corporation that wants to use an accounting period other than the calendar year must establish a business purpose to the satisfaction of the IRS or comply with Rev. Proc. 2006-46, 2006-45 I.R.B. 859.

Rev. Proc. 2006-46:

- Clarifies that an S corporation may change automatically to its required taxable year.
- Allows an S corporation to change automatically to a natural business year that satisfies the 25 percent gross receipts test, regardless of whether such year results in more deferral of income than its present taxable year.
- Allows, in appropriate circumstances, an S corporation to adopt, change to, or retain a 52-53-week taxable year ending with reference to the required taxable year, natural business year, or ownership taxable year.
- Allows any S corporation to automatically change from a 52-53-week taxable year to a non-52-53-week taxable year that ends with reference to the same calendar month, and vice versa.
- Generally prevents an S corporation from using Revenue Procedure 2006-46 to change its annual accounting period if the taxpayer is under examination and does not obtain consent from the appropriate director, or is before an area office or before a federal court and its annual accounting period is an issue under consideration.
- Reduces the period of time required between a prior accounting period change and a change effected under Revenue Procedure 2006-46 from six calendar years to 48 months, and provides that a change to a required or ownership taxable year, and a change to (or from) a 52-53-week taxable year from (or to) a non-52-53-week taxable year ending with reference to the same calendar month, will not be considered changes within the most recent 48-month period.
- Disregards the interests of certain tax-exempt entities for purposes of determining the ownership taxable year of an S corporation, unless the S corporation is wholly owned by such tax-exempt entities.
- Adds a term and condition requiring the taxpayer to compute its income and keep its books and records (including financial statements) on the basis of the requested taxable year, except in certain circumstances.

- Adds a term and condition to prevent the carryback of certain capital losses generated in the short period.
- Extends the filing requirements for filing a Form 1128 to the due date of the taxpayer's federal income tax return (including extensions) for the first effective year.
- Provides audit protection for S corporations that change their annual accounting period under Revenue Procedure 2006-46.

To the extent a fiscal request is attempted, Part II of Form 2553 must be completed as part of the S election process.

The Revenue Act of 1987 contained a special provision for fiscal year-end S corporations under which an S corporation could elect to retain its current fiscal year, even though it would be required by the 1986 Tax Reform Act to change to a calendar year. The 1987 act also allowed an election under Section 444 whereby an S corporation can adopt or change to a new fiscal year in which the deferral period would be three or fewer months (meaning that it can adopt a fiscal year-end of either September, October, or November). However, for existing corporations, the deferral period may not be increased. For example, a regular corporation with a November year end could only make a Section 444 election for November; September and October would not be permitted.

The election is made by filing Form 8716 with, or at the time of, filing the Form 2553 S election, and by designating the Section 444 election on Part II of Form 2553.

There is a price to be paid for this election. S corporations must make a "required payment," thus taking away the advantage of a tax deferral. In general, S corporations pay approximately the same amount in "required payments" as their owners would have paid in actual tax payments for the short period had the entity reported on the calendar tax year. The required payment is submitted with IRS Form 8752.

The required payments are not deductible by the S corporation (or by any other person) for federal income tax purposes. Rather, these required payments are in the nature of refundable deposits, which do not earn interest. Furthermore, the payments are not passed through to S shareholders. If the amount of required payment exceeds the amount currently due, the corporation is entitled to a refund (IRC Sec. 7519(c)).

Those S corporations allowed a fiscal year based on the established business purpose test are not affected by the Revenue Act of 1987. They need not make required payments as a condition of retaining their fiscal years.

Effective as of January 18, 2000, a fiscal year C corporation can generally change its taxable year to a calendar year for purposes of electing S corporation status effective as of January 1 of the next calendar year (Rev. Proc. 2000-11).

3.6 LIFO Recapture

An existing C corporation that computes the value of its inventory on the last-in, first-out (LIFO) method is generally required to pay tax on its "LIFO recapture amount" upon electing S status. IRC Section 1363(d). A corporation's LIFO recapture amount is equal to the excess of the value of its inventory computed under the LIFO method, over the value of its inventory computed under the first-in, first-out (FIFO) method. The resulting tax is payable in four equal annual installments. See Treas. Reg. 1.1363-2.

4. TERMINATING AND REVOKING AN ELECTION

4.1 Termination

An S corporation retains its S corporation status until the election is terminated or revoked. Termination occurs when any of the eligibility requirements for electing S corporation status are violated. For example, the corporation has more than 75 (100 after December 31, 2004) shareholders, issues a second class of stock, or a shareholder in a community property state marries a nonresident alien. Elections can be terminated for certain S corporations if the corporation has excessive passive investment income (see section 6 of this chapter). If a terminating event occurs, the corporation loses its S corporation status as of the day of the event: the termination is not retroactive to the beginning of the year.

A corporation should report a terminating event to the IRS, including the cause and the date. If a transfer of stock to a nonqualified shareholder is the cause of the termination, the corporation should also include the number of shares transferred, name of the recipient, and the names of the original shareholders. If a second class of stock was issued, the number of shares of new stock should be reported along with a description of the features of the new stock that make it different from existing stock still outstanding. See section 5.2, below, for circumstances under which the IRS can waive an inadvertent termination of an S election.

4.2 Revocation

An election can be revoked by persons holding more than 50 percent of the corporation's outstanding stock. In contrast to a termination, a revocation can be retroactive to the beginning of the taxable year if it is made on or before the fifteenth day of the third month of the taxable year. If the revocation is made after this day, the corporation can specify whether it wants the revocation to take place immediately, at the beginning of the next taxable year, or at any date in between. A corporation may specify a date for the revocation only if the date chosen is on or after that of the revocation. To make a revocation, a corporation must file a written statement with the IRS Service Center where the election was filed.

4.3 Reporting Following a Termination or Revocation

If a corporation's status changes from that of an S corporation to that of a C corporation at any time during a taxable year, the corporation must file two tax returns: one for the portion of the year when the corporation was an S corporation (S short year) and one for the remainder of the year (C short year). The returns for the two short years are both due on the date specified for the return of the C short year. The corporation can allocate income or loss either by a pro rata daily method or by electing the normal tax accounting method (interim closing of the books). (See IRC Section 1362(e)(2), (3).) The election to close the books requires the consent of all who were shareholders during the S short year and all who are shareholders on the first day of the C short year. If more than 50 percent of the shares of the corporation were sold or exchanged during the termination year, or an election is made under IRC Section 338 to treat the purchase of its stock as an asset purchase, normal tax accounting rules (interim closing of the books) must be used (Sec. 1362 (e)(6)).

4.4 Reelecting: The Five-Year Waiting Period

In general, after termination of an election, a corporation must wait a full five years before making another election. The five-year waiting period applies regardless of whether termination was voluntary or involuntary. The IRS has the power to consent to an earlier election (Sec. 1362 (g)).

In other situations, the five-year waiting period will not apply if the corporation revoked its election effective on the first day of the taxable year for which the election would have been effective. In addition, the five-year waiting period will not apply to a corporation if the termination occurred because the corporation failed to meet the definitional test for an S corporation on the first day of the first taxable year for which its election to S status was effective (Reg. Sec. 1.1362-5(b)). In the foregoing situations, there is no need to wait the five years, because the S corporation status never became effective.

5. PREVENTING UNWANTED TERMINATION OF ELECTIONS

Termination of an election, whether intentional or inadvertent, causes a corporation to be reclassified as a C corporation. Shareholders who want the corporation to remain an S corporation should take steps to ensure that the election is not terminated because of careless lack of compliance.

5.1 Invalid Elections

If an election is invalid from the onset, no corrective action can be taken afterward to correct the situation, and the corporation will not be exempt from income taxation at the corporate level (although the corporation can seek relief under Section 1362(f) of the Code by filing a request for a private letter ruling). If the election is not effective because it was filed after the fifteenth day of the third month of the taxable year, it will become effective at the beginning of the next taxable year. In this case the corporation will only be responsible for paying corporate income tax plus interest for the period of time before the election became effective (additional penalties may also be levied for failure to pay estimated tax). In addition, the corporation may be subject to tax on its excess passive income (see sections 6 and 7.3, below). More seriously, the corporation will have exposure to the built-in gains tax for the first ten years in S status, by reason of its prior classification as a C corporation (see section 7.2, below) and may be subject to the limitation on passive income that is imposed on former C corporations (see section 6, below).

If, however, the election is invalid because the election process was invalid, no election ever occurred and the corporation is responsible for all corporate taxes and interest accumulated plus any penalties incurred. If it is discovered that no election was ever made, the corporation can make a new election immediately, since in such a case the five-year waiting period does not apply. Again, the passive income limitation and built-in gains tax issues will arise because of the prior C corporation status.

To prevent any of these situations from arising, the shareholders should verify that the election was indeed valid before treating the corporation as an S corporation. Even though the IRS Service Centers send S election acceptance letters to filing corporations, proof of mailing the election by certified mail and a receipt should be requested.

Rev. Proc. 2003-43, 2003-23 I.R.B. 998 may provide relief from an invalid election in certain circumstances.

5.2 Inadvertent Termination of Elections

Any action that causes a violation of the eligibility requirements of an S corporation will cause the corporation's election to be terminated

(Text continued on page 23)

despite the fact that the action may be inadvertent or carried out by certain shareholders without the knowledge and consent of other shareholders (for example, if a shareholder sells his or her shares to an ineligible shareholder, such as a corporation or partnership). If the termination is inadvertent, a corporation may receive permission from the IRS under IRC Section 1362(f) to treat it as though it had never occurred: the corporation will be treated as an S corporation during the period of termination if the IRS agrees that the termination was inadvertent and steps are taken to remedy the situation within a reasonable amount of time. If it is believed that the S corporation's election was inadvertently terminated, a ruling must be requested from the IRS. Before a ruling is issued, the corporation and shareholders must consent to any adjustment required by the IRS for a specific period (Reg. Sec. 1.1362-4).

5.3 Methods of Protecting the Election

5.3.1 Transfer of stock to escrow

If shareholders agree to transfer possession of their shares to an escrow agent, no shareholder can transfer stock without first consulting the agent. The agent, who can be one of the shareholders, could then discuss any proposed transfers of stock with all the shareholders before allowing them.

5.3.2 Shareholders' agreements

If all shareholders consent, an agreement to protect the election can be created. An agreement to protect an election should include

— A statement of intention to continue the election.

— An agreement not to take any action that would jeopardize the election without the consent of the other shareholders.

— A restriction on transfers of shares.

— A right-of-first-refusal either by the shareholders who are not transferring stock, or by the corporation redeeming the stock.

— A predetermined buyout price.

— A provision to prevent a majority of shareholders from revoking the election.

6. PASSIVE INCOME PROBLEMS

Passive income, also called passive investment income, generally includes gross receipts from investment items. Rents (except when significant services are performed or substantial costs are incurred in conducting an active rental business), royalties (as defined in Reg. Sec. 1.1362-2(c)(5)(ii)(A)), dividends, interest (including tax-exempt interest but excluding interest from notes resulting from the sale of inventory or the performance of services), annuities, and gains from sales and exchanges of stocks and securities are usually classified as passive income and, before 1982, presented problems to many S corporations.

For S corporations that have never been C corporations, no passive income restrictions apply. For example, new S corporations have no restrictions on income earned from rental property. This is also the case for S corporations with no C corporation accumulated earnings and profits at the end of the taxable year. Problems arise for corporations with C corporation earnings and profits when passive income constitutes more than 25 percent of the corporation's gross receipts (see section 6.1, below). In this situation, passive income in excess of the allowable limit will be taxed at the highest corporate rate. (See section 7.3 for an explanation of this tax on excess passive income.) In addition, excessive passive income will lead to termination of an election at the beginning of the fourth year if

- The corporation has C corporation earnings and profits at the end of three consecutive tax years; and
- Passive investment income accounts for more than 25 percent of the corporation's gross receipts in each of those three years.

It is therefore necessary for S corporations with C corporation earnings and profits to prevent passive income from exceeding the allowable level.

6.1 Gross Receipts

To determine if passive income presents a problem for an S corporation one must understand the IRS's definition of gross receipts. The IRS defines gross receipts as the total amount of receipts not reduced by returns, allowances, costs, or deductions. For sales and exchanges of capital assets other than stocks and securities (stock trading gains are passive receipts), however, only a net gain from such transactions is counted when figuring gross receipts. In the case of stocks and securities, only gains are considered; losses do not offset gains in measuring gross receipts (Reg. Sec. 1.1362-2(c)(4)). In addition, loans, repayments of loans, contributions to capital, and issuance by a corporation of its own stock do not count as gross receipts.

6.2 Preventing Passive Income Problems

6.2.1 Eliminate accumulated earnings and profits

Both the S termination risk and the excess passive receipts tax (see section 7.3, below) can be eliminated by paying out the C corporation's accumulated earnings and profits. This may be accomplished by an

(Text continued on page 25)

election to bypass the normal distribution tiers, or by the special deemed-dividend election (see section 9.2.1). Remember, however, that the S corporation shareholders will be taxed on the distribution as a dividend. Earnings and profits consist of all recognized income (both taxable and nontaxable) reduced by all losses and payments (both deductible and nondeductible).

6.2.2 Increasing gross receipts

A corporation that is in danger of having passive income exceeding the 25-percent gross receipts limit can protect itself by increasing its gross receipts from nonpassive-income sources. Business asset sales are counted in the gross receipts test at full sale price. Another method is to sell capital assets other than stocks and securities for a capital gain. The capital gain on the sale or exchange will increase the corporation's gross receipts but, because the gain was not on the sale or exchange of stocks or securities, it will not be counted as passive income.

6.2.3 Additional methods

Additional methods for preventing passive income problems include selling the investment assets that produce the rental, dividend, interest, or other passive income, and reinvesting the proceeds into active business assets. Also, the Section 1375 passive tax (but not the three-year termination rule) can be defeated by reducing the S corporation taxable income to zero, such as with bonuses or other expenses. Finally, if the entity is beyond the reach of the built-in gains tax (see section 7.2, below), a liquidation as an S corporation will often be preferable to a termination of S status, which brings the assets back into C corporation status.

7. TAXATION AT THE CORPORATE LEVEL

In the great majority of instances, S corporations are not subject to corporate income taxes. S corporations that were C corporations before the election are, however, subject to investment credit recapture on assets acquired when they were C corporations, if such assets are disposed of during the recapture period of an S corporation. In addition, excess passive investment income may also be subject to corporate tax. A built-in gains tax exists to prevent elections before sale or liquidation for the purpose of avoiding corporate-level tax.

7.1 *General Utilities* Repeal

The Tax Reform Act of 1986 repealed the *General Utilities* doctrine (*General Utilities & Operating Co.*, 296 US 200 (1935)). Before the Tax Reform Act of 1986, a C corporation could sell virtually all of its assets for cash, distribute the cash and balance of its assets to its shareholders, and avoid corporate-level tax, except for investment credit and depreciation recapture, by liquidating within a twelve-month period after adopting a plan of liquidation (Sec. 337). The shareholder would pay a tax on the distribution of the proceeds. The shareholder tax on distribution of the proceeds is not an outcome of the Tax Reform Act of 1986, but a continuation of the law as it existed before the repeal of the *General Utilities* doctrine.

Following the repeal of the *General Utilities* doctrine, if a C corporation sells its assets and liquidates, or merely distributes appreciated assets to its shareholders, it will pay a corporate-level tax on the gain, with its shareholders being subject to tax on the distribution of the proceeds. This double tax will generally not apply to the sale of assets of certain S corporations (see section 7.2, below).

7.2 Recognition of Built-in Gains Under IRC Section 1374

IRC Section 1374 provides a tax on "built-in" gains when a C corporation elects S status after December 31, 1986. Ordinary income and capital gain will be recognized to an S corporation that was formerly a C corporation on a distribution or sale of its property to the extent of any appreciation that occurred before conversion to S corporation status, if the gains are recognized within ten calendar years of the date the election took effect. The tax is computed at the maximum corporate rate (currently 35 percent) on any appreciation in the corporation's assets before the date of the S election. The corporation can take into account any C corporation tax attributes, such as net operating loss and credit carryforwards, in the calculation of its tax.

Under Notice 90-27 (1990-1 C. B. 336), S corporation shareholders are not able to avoid built-in gains on installment sales after March 25, 1990. When gain is recognized after the ten-year recognition period, it is taxed under IRC Section 1374 to the extent that it would have been so taxed in a prior year had the installment method not applied. Therefore, if part of the gain is deferred to the eleventh year, the entire deferred gain is subject to tax under IRC Section 1374 in the eleventh year (Reg. Sec. 1.1374-4(h)).

Assets subject to the built-in gains tax include not only those disposed of through sale or exchange but also through other asset-based income recognition mechanisms, such as collection of accounts receivable by a cash-basis taxpayer. The IRS takes the position that these items will be considered a disposition for purposes of triggering the built-in gains tax (Reg. Sec. 1.1374-4(b)(3)). In addition, the sale of appreciated inventory may be subject to this tax. For built-in gains purposes, the fair market value of the inventory at the time of conversion to S status is determined as the amount a willing buyer would pay to a willing seller for inventory in a purchase of all the assets of the S corporation assuming the buyer expects to continue the business (Reg. Sec. 1.1374-7). Thus, a bulk sale approach of the entire business, not only the inventory, is used. The inventory value often will not exceed tax basis; most accrual method taxpayers will not have built-in gain on their inventories.

The ten-year built-in gains tax may be minimized or even eliminated if taxable income for the year is lower than the recognized built-in gain. However, for S elections made on or after March 31, 1988, any built-in gain that is defeated by the taxable income limit becomes a carryforward to each remaining year in the ten-year recognition period. Thus, to completely avoid a built-in gain, taxable income must be zero in the year of initial recognition *and* for each remaining year in the ten-year period.

> *Practice Tip:* Because the built-in gain tax is imposed only on appreciation in a corporation's assets before the effective date of its S election, a C corporation that intends to file an S election should consider obtaining an appraisal of its assets as of the effective date of its S election to establish the fair market value of its assets as of that date.

7.3 Tax on Passive Investment Income

Passive income is only subject to corporate tax under IRC Section 1375 if a corporation has earnings and profits from years when the corporation was a C corporation. For S corporations with C corporation earnings and profits, excess passive income is taxed at the highest corporate rate (35 percent). A corporation's excess passive income can be figured as follows:

— Determine net passive income by subtracting allowable deductions that are directly attributable to the production of the passive income from gross passive income. (See section 6 above for the definition of passive income and gross receipts.)

— Determine what percentage of gross passive income exceeds the 25 percent of gross receipts limit.

— Multiply the percentage determined above by the amount figured for net excess passive income.

Example. Calculation of Excess Passive Income Tax

During the year, F corporation had the following:

Gross receipts		$200,000
Total passive investment income	$80,000 (A)	
Less:		
Expenses attributable to passive income	20,000	
Net passive income	$60,000 (B)	
25% of gross receipts (200,000 × .25)	$50,000 (C)	

$$\left(\frac{\text{Total Passive Income less 25\% of Gross Receipts}}{\text{Total Passive Income}}\right) \times \text{Net Passive Income} = \text{Excess Net Passive Income}$$

$$\frac{80{,}000\ (A) - 50{,}000\ (C)}{80{,}000\ (A)} \times 60{,}000\ (B) = \text{Excess Net Passive Income}$$

$.375 \times 60{,}000 = 22{,}500$

$22,500 Excess net passive income*
× .35 Highest corporate rate
$7,875 Tax on excess net passive income

If this condition of excess passive receipts and C corporation earnings and profits exists for three consecutive years, the S status will terminate (see section 6).

*Note that the excess passive income subject to the tax may not exceed the corporation's taxable income

7.4 Estimated Tax

S corporations are required to pay estimated tax, for tax liability attributable to the following situations:

— Tax on capital gain under IRC Section 1374 (see section 7.2 herein)

— Tax on excess passive investment income (see section 7.3 herein)

— Tax from recapture of past investment tax credits for assets acquired by a former C corporation before the effective date of the S corporation election (Sec. 1371(d)(2))

The required annual estimated tax payment is the lesser of

— 90 percent of the tax shown on the return for the tax year, or

— The sum of 90 percent of the tax liability incurred for built-in gains tax and investment credit recapture, plus 100 percent of the tax due on excess passive income reported in the preceding year.

An S corporation cannot use the exceptions that allow estimated tax based on the prior year's built-in gains and tax credit recapture. The prior-year tax based on excess passive income is allowed, even if there was no excess passive income in the prior year.

8. TAXATION AT THE SHAREHOLDER LEVEL

8.1 Passthrough Items

The principal factor differentiating the shareholders of an S corporation from the shareholders of a C corporation is that the shareholders of an S corporation pay taxes on passthrough items at the shareholder level regardless of whether such items are distributed to the shareholders, whereas shareholders of a C corporation pay tax on corporate income only to the extent of distributions by the corporation. Shareholders of an S corporation must take into account the taxable items, similar to those governed by partnership rules under IRC Section 702. However, the partnership and S corporation rules are not identical. Thus, an S corporation shareholder must report his or her pro rata share of

— Nonseparately computed income or loss (taxable income).

— Items of income, loss, deduction, or credit, the separate treatment of which could affect the shareholder's tax liability (Sec. 1366 (a)(1)).

The following are additional examples of some of the separately stated items that pass through to shareholders:

— *Capital gains and losses.* Capital gains or losses pass through to the shareholders as capital gains or losses.

— *Section 1231 gains and losses.* Section 1231 gains (relating to realty and depreciable property used in a trade or business) are passed through separately, to be combined with the shareholder's other Section 1231 gains or losses.

— *Charitable contributions.* The corporate 10 percent limitation will not apply. If the S corporation makes a charitable contribution of $250 or more, the S corporation must obtain the contemporaneous written acknowledgment from the charity and not the shareholders, who are subject to the individual limitations on deductibility of the charitable deduction.

— *Tax-exempt interest.* Such interest passes through and is not taxed to the shareholder when it is received by the S corporation. However, tax-exempt income, which increases basis but does not increase the accumulated adjustments account (AAA) (see section 9.2.2, below), is treated as distributed only after all accumulated earnings and profits have been distributed (Secs. 1368 (a)(1)(A); 1368 (e)(1)(A)).

  Example: SAM Corporation has ordinary income of $70,000 and tax-exempt income of $20,000 during the first year it elected S status. SAM Corporation has $100,000 of accumulated earnings and profits from years before its S election. During the year the corporation distributed $90,000 to its shareholders. The shareholder pays tax on $90,000, because $70,000 is his or her distributable share of the corporation's taxable income. The remaining $20,000 results from the corporation's making a distribution in excess of AAA. The distribution comes out of the corporation's accumulated earnings and profits from the years before the S election. The $20,000 nontaxable income increases stock basis but not AAA.

— *Foreign tax credit.* Foreign taxes paid by the corporation pass through as such to the shareholders, who claim the taxes either as deductions or credits, subject to the applicable limitations. An S corporation is not eligible for the foreign tax credit with respect to taxes paid by a foreign corporation in which the S corporation is a shareholder, and these tax credits do not pass through to its shareholders.

— *Credits.* These include the credit for backup withholding on dividends, interest income, and other types of income. In addition, credits for nonconventional fuel sources and for increasing research activities are passed through to the shareholders. However, any gas tax and diesel fuel credits are claimed by the S corporation (Sec. 1366 (b)(1)).

— *Depletion.* S corporations treat depletion as partnerships do; that is, the corporation states such items separately and passes them through to the shareholders.

— *Foreign income and loss.* Domestic and foreign income or losses each pass through separately, without aggregation at the corporate level.

— *Self-employment tax.* The shareholder's share of net income from an S corporation is not subject to self-employment tax; therefore, net losses from an S corporation cannot be used to reduce the shareholder's self-employment income (Ltr. Rul. 9530005).

(Text continued on page 29)

8.2 How Shareholders Treat Passthrough Items

All items of income, loss, credit, and deduction passed through to the shareholders are allocated on a per-share, per-day basis. Passed-through items must be reported in the shareholder's taxable year that includes the last day of the S corporation's taxable year. Net operating losses are allocated as other corporate items are, with the exception that each shareholder's ability to deduct losses is affected by his or her basis in the stock (see section 8.3, below). If shares are transferred during the taxable year, the transferee is considered as the owner of the shares on the day of the transfer.

Example: At the beginning of the taxable year, Z Corp had 500 shares of outstanding stock that were owned by two people:

Barbara	200 shares
Elena	300 shares

On June 1, Elena sold fifty shares of stock in Z Corp to Dawn. At the end of the taxable year Z Corp's only passthrough item was its taxable income of $50,000. To calculate each shareholder's share of taxable income, the instructions in Form 1120S suggest the following steps:

— Compute percentages of stock owned for the year:

Barbara		40%
Elena	Before June 1	60%
	After June 1	50%
Dawn	Before June 1	0%
	After June 1	10%

— Compute percentages of the year before and after transaction:

January 1 to June 1	(151/365)	41%
June 1 to December 31	(214/365)	59%

— Multiply each shareholder's percentage of stock owned by the percentage of the year during which they owned them:

Barbara:	40% × 100%	40.0%
Elena:	60% × 41%	24.6%
	50% × 59%	29.5%
Dawn:	10% × 59%	5.9%
		100.0%

— Multiply each shareholder's percentages as determined above by the corporation's taxable income to determine her share of the corporation's taxable income:

Barbara:	40% × $50,000	$20,000
Elena:	(24.6% + 29.5%) × $50,000	$27,050
Dawn:	5.9% × $50,000	$ 2,950
		$50,000

8.2.1 If a shareholder terminates his or her interest

If a shareholder terminates his or her entire interest in the corporation and if both the corporation and all "affected shareholders" consent, under IRC Section 1377(a)(2) the corporation can elect to treat the taxable year as if it consisted of two separate years, with the first year ending at the close of the day the shareholder's interest terminated. The term *affected shareholder* means the shareholder whose interest is terminated and all persons to whom such shareholder has transferred shares during the taxable year. In the case of a redemption, however, the term affected shareholders includes all persons who were shareholders of the corporation during the taxable year.

The election to treat the taxable year as two separate years does not terminate the S corporation election, and only one corporate return (Form 1120S) has to be filed for the year. The treatment of the S corporation year as two separate taxable years means the books are closed. The income or loss accruing before the shareholder left the corporation is allocated among all shareholders. The income or loss accruing after the shareholder terminates his or her interest is allocated only to the remaining shareholders. The election represents an alternative method of allocating pass-through items. If no election is made, then the income or loss is computed under the pro rata method. Under this method, an S shareholder's pro rata share of each tax item is determined by assigning an equal portion of each tax item to each day of the S corporation's tax year and dividing that portion pro rata among the outstanding shares on each day (see section 4.3). See Appendix 7, on *The Accountant's Business Manual Toolkit CD-ROM,* for a sample election under IRC Section 1377(a)(2).

Example: Y Corp is a calendar-year S corporation, with 100 shares of common stock outstanding. John owns fifty shares all year. Mary owns fifty shares until September 30th when she sells all of her shares to Steve. The corporate accounting records show that the corporation had $30,000 profit at transfer date and experienced a $10,000 loss after the transfer date, making a profit of $20,000 for the year ended December 31. The results to Mary and Steve will be different, depending upon which method is used for allocation of income and loss.

Method 1: Pro Rata Mathematical Allocation Formula

	1/1 to 9/30	*10/1 to 12/31*	*Total*
Number of days	273	92	365
Ratio: $\frac{\text{Number of days}}{365}$	.7479	.2521	1.00
Income (Ratio × $20,000)	$14,958	$5,042	$20,000
Allocated as follows			
John	$ 7,479	$2,521	$10,000
Mary	7,479		7,429
Steve		2,521	2,521
	$14,958	$5,042	$20,000

Method 2: Use of Actual Accounting Records and Election under Section 1377(a)(2)

The corporation elects to treat the tax year as if it consisted of two years, with the first one ending at the close of the day the shareholder's interest terminated. John (not required to consent for taxable year beginning after December 31, 1996), Mary, and Steve must consent to the corporation's election. The income for each shareholder is computed as follows:

	1/1 to 9/30	*10/1 to 12/31*	*Total*
Income (or loss) for period	$30,000	$(10,000)	$20,000
Allocated as follows			
John	$15,000	$ (5,000)	$10,000
Mary	15,000		15,000
Steve		(5,000)	(5,000)
	$30,000	$(10,000)	$20,000

Because of these differing results to the buyer and seller, it may be important to secure an agreement among the shareholders at the time of sale as to which method will be used at year-end to allocate the income or loss. In many cases, the results of either method will be neutral to the seller because any extra income increases stock basis, which then brings a reduced stock sale gain.

8.2.2 A substantial disposition of stock

If there is a disposition by nine shareholders of 20 percent or more of the issued stock of the corporation (but less than 100 percent of stock owned by such shareholders) in one or more transactions during any thirty-day period in the corporate tax year, the S corporation may, with the consent of its shareholders, make an election similar to the one in section 8.2.1, above, to treat the taxable year as if it were two separate tax years, for purposes of allocating items of income and loss to shareholders (Reg. Sec. 1.1368-1(g)(2)).

8.2.3 If a shareholder dies

If a shareholder dies, his or her final return will include the pro rata share of passthrough items up to and including the date of death (Reg. Sec. 1.1377-1(a)(2)(ii)) and will be included on the decedent's final return (Sec. 1366(a)(1)). Items for the remainder of the year will pass through to the estate or the person acquiring the stock.

Since death is considered a termination of the deceased shareholder's interest, the S corporation can make the election to split the tax year—see section 8.2.1, above (Reg. Sec. 1.1377-1(b)(4)).

8.3 Shareholder's Basis

8.3.1 Basis in stock

Basis is important because it measures the amount of S corporation loss that is deductible by a shareholder. Also, basis is increased annually for any undistributed income, thereby assuring that double tax will not occur when the stock is eventually sold or liquidated. Under current law, the basis of a shareholder's S corporation stock is computed as follows:

— Original cost or basis, however arrived at

— Increased by
  - Nonseparately computed income (Sec. 1367 (a)(1)(B)). (This would be the shareholder's share of the corporation's "taxable" income.)
  - Separately stated items of income (Sec. 1367(a)(1)(A)). (This includes capital gains, Section 1231 gains, and the like.)
  - Excess of the deductions for depletion over the basis of the property subject to the depletion (Sec. 1367(a)(1)(C)).

  The depletion increase does not include depletion attributable to oil and gas property (Reg. Sec. 1. 1367-1(b)).

— Decreased by
  - Nonseparately computed loss (Sec. 1367(a)(2)(C)).
  - Separately stated items of deduction or loss (Sec. 1367(a)(2)(B)) such as capital losses and Section 1231 losses.
  - Any expense of the corporation not deductible in computing its taxable income and not properly chargeable to capital account (Sec. 1367(a)(2)(D)). Examples of nondeductible noncapital expenses include fines and penalties and 50 percent disallowed meals and entertainment.
  - The amount of the shareholder's deduction for depletion of oil and gas wells under IRC Section 611 (Sec. 1367(a)(2)(E)).
  - Distributions (that is, nondividend distributions), which are not includable in the shareholder's income (Sec. 1367(a)(2)(A)). This category includes distributions of items that have already been taxed to the shareholder, such as the accumulated adjustments account (AAA) and previously taxed income (PTI), and includes distributions that are applied against stock basis to the extent the basis does not go below zero.

Under the ordering rules (Reg. Sec. 1.1367-1(e)) the adjustment to basis is made in the following order:

1. Increase in basis attributable to income items;
2. Decrease in basis attributable to noncapital, nondeductible expenses and oil and gas depletion;
3. Decrease in basis attributable to items of losses;
4. Decrease in basis attributable to distribution by corporation.

The ordering rules decrease the basis for nondeductible items before they decrease basis for deductible items. It is possible, if the nondeductible items are large enough, the basis would be reduced and the shareholders would not be able to use the full loss. If this were to happen, there is a provision for the shareholders to make an election under Regulation Section 1.1367-1(f) to reverse the order by reducing the basis by deductible losses first, then by noncapital or nondeductible expenses to the extent of basis. Any of the items in excess of basis will reduce basis in the succeeding taxable year.

The Small Business Job Protection Act of 1996 provides that the adjustment for distributions made by an S corporation during the tax year are taken into account before applying the loss limitation for the year. Therefore, distributions during a year reduce the adjusted basis in determining the allowable loss for the year, but the loss for the year does not reduce the adjusted basis in determining the tax status of the distributions made during that year.

8.3.2 Basis in debt

When losses are passed through to S corporation shareholders, they first reduce the basis of the shareholder's stock; when the stock basis is zero, further basis reductions are made in shareholder loans to the corporation. There can be no negative basis. The shareholder's basis in stock cannot be increased until any reduction of basis in debt has been restored. Basis is increased by passthrough of S corporation income. Losses not deductible by reason of insufficient basis in stock or indebtedness are not lost forever but may be carried forward and deducted in later years when basis increases.

In contrast to a partner, a shareholder in an S corporation only has basis in the indebtedness of the S corporation to that shareholder (partners have basis in partnership indebtedness to others for which they may be held personally liable). A shareholder's personal guarantee of an S corporation's note or loan does not increase basis for loss purposes unless the shareholder pays the corporate note or substitutes his or her own note for those of the corporation, and the creditor relieves the corporation from its liability on the note and substitutes the shareholder as the primary obligor. The rule that shareholders only obtain basis for amounts they loaned the corporation, while partners have basis for all partnership debts for which the partners are personally liable, is the reason that partnerships and limited liability companies taxed as partnerships have been the preferred vehicle for most tax-advantaged investments even after SSRA.

Practice Tip: It may be possible to structure a third-party loan to provide basis to the shareholders by having the lender lend funds directly to the shareholders, and then having the shareholders loan the funds to the S corporation (*i.e.*, a "back-to-back" loan).

8.3.3 Reduction of basis of individual shares

Whether the shareholder basis is attributable to stock or debt, it is first necessary to reduce the individual basis in shares to which the loss can be attributed, and then the basis in debt. The following example shows the calculations involved in figuring the reduction of basis of individual shares.

Example: At the beginning of the taxable year Sue owned three shares of stock in Q Corp. During the year Sue sold one of her shares and later purchased another share. At the end of the taxable year Sue was notified that her share of the corporation's losses was $2,000. Sue's basis in each of her shares after loss allocation is calculated as follows:

Share:	*#1*	*#2*	*#3*	*#4*	*Total*
Days shares held during year:	365	365	182	92	1,004
Basis of shares at beginning of year or at purchase:	$500	$800	$400	$900	$2,600
Loss allocation:					
Share 1: (365/1004) × $2,000					
Share 2: (365/1004) × $2,000					
Share 3: (182/1004) × $2,000					
Share 4: (92/1004) × $2,000					
	727	727	363	183	2,000
Basis minus loss:	$(227)	$ 73	$ 37	$717	$ 600
Reallocate subzero basis to:					
Share 2: (73/827*) × $227					
Share 3: (37/827) × $227					
Share 4: (717/827) × $227					
*827 = 73 + 37 + 717					
	227	(20)	(10)	(197)	0
Basis after loss allocation:	$0	$53	$27	$520	$ 600

Regulation Section 1.1367-1(c)(3) adopts a separate basis approach for each share of stock. Basis adjustments are allocated on a per-share, per-day method. If a decrease attributable to a share exceeds its basis, the excess is applied to reduce (but not below zero) the remaining bases of all other shares of stock owned by the shareholder in proportion to the remaining basis of each of those shares (Reg. Sec. 1.1367-1(c)(3)). Therefore, if Sue was planning to sell one of the shares the following year, she would be advised to sell Share 4 since that share had a higher basis than her other shares.

If a shareholder's basis in debt has been reduced as a result of passthrough losses, repayment received from the corporation on the debt will generate taxable gain to the shareholder. The debt has to be evidenced in writing in order to create capital gain on repayment as opposed to ordinary income.

8.3.4 Treatment of cancellation of indebtedness income

Several taxpayers have taken the position that cancellation of indebtedness income that is exempt from recognition pursuant to IRC Section 108 is nonetheless treated as income of an S corporation, resulting in a corresponding increase in the shareholders' stock basis (resulting in a potential tax loss to the shareholders upon liquidation of the S corporation). The Tax Court rejected that position in *Nelson v. Commissioner,* 110 T.C. No. 12 (February 19, 1998). In addition, on August 18, 1998, the IRS issued proposed treasury regulations that follow the position of the Tax Court in *Nelson* (see Prop. Treas. Reg. Section 1.1366-1(a)(1)(viii)). On January 9, 2001, however, the U.S. Supreme Court rejected the holding of the *Nelson* case and accepted the taxpayer's argument (*Gitlitz v. Commissioner,* 2001-1 USTC ¶50,147).

Section 402 of the Job Creation and Worker Assistance Act of 2002, however, amended IRC Section 108(d)(7) to effectively overturn the result of the *Gitlitz* decision effective October 11, 2001. Accordingly, income from discharges of indebtedness that occur after October 11, 2001, does not increase the tax basis of an S corporation shareholder. Taxpayers may be able to amend prior returns to take advantage of the *Gitlitz* result with respect to discharges occurring on or prior to October 11, 2001.

8.4 Fringe Benefits

Any person who owns more than 2 percent of the stock of an S corporation is treated like a partner when it comes to fringe benefits. A person who is a more-than-2-percent shareholder at any time during the S corporation's taxable year must treat fringe benefits as income. The following is a list of such fringe benefits:

— Accident and health plans and medical expenses (Secs. 105 and 106)
— Group-term life insurance of $50,000 (Sec. 79)
— Meals and lodging furnished for convenience of the employer (Sec. 119)

Accident and health insurance payments paid on behalf of 2-percent-or-more shareholders must be reported as wages on the employee's W-2 form (Rev. Rul. 91-26, 1991 C. B. 184). The insurance premiums are exempt from the Social Security and Medicare tax base, although they are treated as wages for income tax purposes (IRS Ann. 92-16, IRB no. 1992-5). Although the IRS, to date, has only issued specific guidance for medical insurance premiums, the Form 1120S tax return instructions direct that all of these fringe benefit expenditures are to be reclassified as compensation if provided, directly or indirectly, to a more-than-2-percent shareholder.

9. DISTRIBUTIONS

One of the advantages of operating an S corporation is the fact that income is typically taxed only once. Generally, income escapes tax at the corporate level, and the shareholder pays tax on the income by reporting it on his or her personal income tax return.

9.1 By a Corporation With No Accumulated Earnings and Profits

Distributions are handled differently by S corporations with accumulated earnings and profits and by S corporations without accumulated earnings and profits. (See section 9.2, below, for corporations with accumulated earnings and profits.) For S corporations that have no accumulated earnings and profits, the application of distributions is in the following order:

1. As a nontaxable return of capital to the extent of the shareholder's basis.
2. As a gain from the deemed sale or exchange of stock (capital gain) (Sec. 1368(b)).

The taxable or nontaxable characteristics of a distribution cannot be determined until the taxable year ends. First, basis of the stock is adjusted by the passthrough items, then distributions are taken into account.

As discussed above, the tax treatment of adjustments during a loss year have been changed by the Small Business Job Protection Act of 1996, so that the adjustments to basis for distributions are made before applying the loss limitation for the year. The net result is that the distribution reduces the adjusted basis for determining the allocable loss, but the loss for the year does not reduce the adjusted basis for purposes of determining the tax status of the distribution.

9.2 By a Corporation With Accumulated Earnings and Profits

9.2.1 Order of applying distributions

A distribution of accumulated earnings and profits (E & P) is a taxable dividend to the recipient. An S corporation without accumulated E & P *cannot* distribute a taxable dividend, and is subject to the simplified distribution rules (see section 9.1, above).

An S corporation will have accumulated E & P in one of three ways:

1. The S corporation was previously a C corporation, and generated during C years E & P that was not paid out as dividends to shareholders.
2. The S corporation was in existence in S status for tax years beginning before 1983, and generated positive E & P (for tax years beginning after 1982, an S corporation does not generate E & P).
3. The S corporation acquired a C corporation in a merger or other tax-free reorganization, such that C corporation E & P carried over to the S corporation.

The Small Business Job Protection Act of 1996 eliminated, effective for taxable years beginning after December 31, 1996, any pre-1983 E & P attributable to S corporation years.

S corporations with E & P apply distributions in the following order:

1. As a distribution of the accumulated adjustment account (AAA) (see section 9.2.2, below), which is treated in the same manner as a distribution from an S corporation without accumulated earnings and profits (return of capital up to basis in stock and a disposition of stock subject to capital gain treatment to the extent AAA exceeds basis) (Sec. 1368(c)(1)).
2. As a dividend to the extent of the corporation's accumulated earnings and profits (Sec. 1368(c)) (ordinary dividend income).
3. As a nontaxable reduction of basis to the extent of the remaining basis, if any, in stock (tax-free—reduces basis of stock).

4. As a taxable gain from the deemed sale or exchange of stock subject to capital gain treatment (Sec. 1368(c)(3)).

With the consent of all shareholders who received a distribution, the corporation may elect, under IRC Section 1368(e)(3), to bypass first-tier distribution and treat the entire distribution as taxable as a dividend to the extent of accumulated earnings and profits. This would be beneficial if the S corporation wants to avoid the tax on passive investment income. (See section 7.3, above.)

The treatment of distributions during the loss year has been changed by the Small Business Job Protection Act of 1996 (see section 9.1, above). The Small Business Job Protection Act of 1996 also provides that, in determining the amount of AAA for the tax treatment of distributions made during the tax year by an S corporation with accumulated earnings and profits, net negative adjustments to AAA (for example, the excess of losses and deductions over income) for that taxable year are disregarded. Distributions are measured first, before the net loss affects AAA.

For S corporations with previously taxed income (PTI) from years before 1983, the distribution rules from pre-SSRA years are still in effect, and distributions are applied in the following order:

1. AAA
2. PTI
3. Dividend to extent of AE & P
4. Nontaxable return of capital to the extent of remaining basis
5. Taxable disposition of stock

S corporations having shareholders with PTI must make an additional election to bypass PTI if they want to distribute accumulated earnings and profits before PTI. The AAA and PTI bypass elections operate independently of each other, and either one can be made without the other (Reg. Sec. 1.1368-1(f)(2)(ii)). See Appendix 10 and Appendix 11, on the *Accountant's Business Manual Toolkit CD-ROM,* for sample elections under Reg. Sec. 1.1368-1(f).

In conjunction with the bypass election in distributing E & P the corporation may also elect to distribute all or part of its E & P through a deemed dividend, if the corporation lacks the cash to make an actual distribution. Each shareholder owning stock on the last day of the tax year must consent in writing to the corporate deemed-dividend election (Reg. Sec. 1.1368-1(f)(3)).

9.2.2 Accumulated adjustments account (AAA)

The purpose of the AAA is to maintain a running tabulation of an S corporation's ability to distribute profits tax-free to shareholders, because the income has already been taxed. The AAA starts at zero on the first day of an S corporation's first taxable year beginning after 1982. For subsequent years the AAA will have a positive balance from earnings or a negative balance (deficit) if there are accumulated post-1982 S corporation losses. AAA is adjusted by the same amounts that affect a shareholder's stock basis (see section 8.3.1, above). However, tax-exempt income does not increase AAA and related expenses do not reduce it. Tax-exempt income, therefore, cannot generally be distributed tax-free even if there are accumulated earnings and profits.

9.3 Property Distributions

On distributions of appreciated property by an S corporation to the shareholders, gain is recognized to the corporation to the same extent as if it had sold the property to the shareholder at its fair market value (Sec. 311(b)). This is a significant difference between the taxation of S corporations and the taxation of partnerships, and limited liability companies taxed as partnerships, which can generally distribute appreciated property to their owners without triggering gain.

9.4 Post-Termination Transition Period Distributions

After the termination of an S corporation's election, the corporation may still make cash distributions (not in property) during a post-termination transition period, which are applied against stock basis to the extent of AAA. This gives the corporation an escape hatch, so it has some time to distribute its AAA (which has already been taxed) as a tax-free return of capital in the event the election is revoked or involuntarily terminated. IRC Section 1377(b) defines this period as one of the following:

— The period beginning on the day after the last day of the corporation's last taxable year as an S corporation and ending on the later of one of the following:
  - The day that is one year after the last day
  - The due date for filing the return for the last year as an S corporation (including extensions)

— The 120-day period beginning on the date of a determination that the corporation's election under Section 1362(a) had terminated for a previous year. (A determination is a court decision that has been finalized, a closing agreement, or an agreement between the corporation and the IRS that the election had ceased to be valid in a prior year.)

— The 120-day period beginning on the date of any determination (after termination of the S corporation) that adjusts items of income, loss, or deductions of former S corporations. The definition of *determination*, used in defining post-termination includes a final disposition by the Secretary of a claim for a refund and, under regulations, certain agreements between the Secretary and any person, relating to the tax liability of the person.

9.5 Reduction of Tax Rate on Dividends

The Jobs and Growth Tax Relief Reconciliation Act of 2003 reduced the tax rate on dividends received by an individual to 15 percent (5 percent or zero under certain circumstances) for dividends received after December 31, 2002, and before January 1, 2009. Those rules apply to a distribution by an S corporation out of accumulated earnings and profit. Distributions by an S corporation out of AAA are not treated as dividends for these purposes.

9.6 Distributions Treated by IRS as Compensation to Owner-Employees

Some S corporations, to avoid payroll and unemployment taxes for payments to owner-employees, treat these payments as distributions of earnings rather than as compensation—a questionable practice. To stop this, the IRS is recharacterizing these payments as compensation and assessing FICA and FUTA taxes if inadequate compensation has been paid to owner-employees. In *Veterinary Surgical Consultants, PC v. Commissioner*, 117 TC No. 14 (2001), the Tax Court held that distributions to the sole shareholder of a veterinary practice were compensation because all of the S corporation's income was generated by the personal services of the shareholder.

Shareholders who render services to their S corporations should consider entering into employment agreements with the corporations to receive compensation for their services. The taxpayers could then argue that the compensation is reasonable and distributions in excess of the compensation are dividends not subject to employment tax.

Alert. The undercompensation of S corporation shareholder/employees has become a hot audit issue for the IRS.

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Limited Liability Companies

LIMITED LIABILITY COMPANIES

SUGGESTED REFERENCES

APPENDIX 1: Sample Operating Agreement—Manager Managed (*see Toolkit CD-ROM*)

APPENDIX 2: Sample Operating Agreement—Member Managed (*see Toolkit CD-ROM*)

APPENDIX 3: Operating Agreement Checklist (*see Toolkit CD-ROM*)

APPENDIX 4: LLC Creation Checklist (*see Toolkit CD-ROM*)

APPENDIX 5: LLC Termination Checklist (*see Toolkit CD-ROM*)

APPENDIX 6: Application for EIN by Single-Member LLC (*see Toolkit CD-ROM*)

APPENDIX 7: S Election by an LLC Electing to be Taxed as a Corporation (*see Toolkit CD-ROM*)

APPENDIX 8: Sample Check-the-Box Election (*see Toolkit CD-ROM*)

1. INTRODUCTION

Limited liability companies (LLCs) are attractive because they offer both liability protection and pass-through taxation without the limitations that apply to Subchapter S corporations (for example, limited number and types of shareholders, one class of stock, and others).

All 50 states and the District of Columbia have laws permitting the formation and operation of LLCs within their borders.

The nationwide availability of LLC status and the obvious benefits of such status have led to a rapid increase in the number of entities choosing to operate as LLCs. LLCs have generally become the preferred entity choice for small to medium-sized businesses.

As a result, it is important for well-rounded practitioners to understand the advantages and disadvantages of the LLC format. The purpose of this chapter is to provide general information to facilitate such understanding.

2. DEFINING AN LLC

LLCs are unincorporated legal entities created under applicable state law. However, the fundamental intent of state LLC statutes is to allow the formation of entities that are legally similar to corporations.

2.1 Advantages of LLC Status

An LLC is more properly viewed as a self-contained entity that owns its assets and is liable for its debts. Therefore, the personal assets of LLC owners (referred to as *members*) are generally beyond the reach of LLC creditors, and the assets of the LLC are generally beyond the reach of members' creditors. In contrast, a general partnership can be viewed as an aggregation of partners who share ownership in partnership assets and who are each jointly and severally liable for partnership debts. A sole proprietor is similarly exposed to business liabilities.

The limited liability of LLC members is the fundamental nontax advantage of LLC status. The key tax advantage of multi-member LLCs (meaning LLCs that are owned by two or more members) is that they can be flow-through entities for federal income tax purposes but are not subject to the restrictions applicable to S corporations (for example,one class of stock rule, limitations on number and types of shareholders, etc.).

Multi-member LLCs are considered neither partnerships under state law, even though partnership taxation is available to them, nor corporations, even though they have the corporate characteristic of protecting members from exposure to entity-level liabilities. Instead, the LLC is simply a different kind of legal entity that can be formed and operated under the provisions of the state's LLC statute.

The key tax advantage for single-member LLCs is that they can be "disregarded entities" for federal income tax purposes. Accordingly, a single-member LLC is not required (and, in fact, is not permitted) to file a separate federal income tax return.

> *Practice Tip:* Several states now allow the formation of other forms of entities, such as limited liability partnerships (LLPs), which offer the same benefits—pass-through taxation and limited liability for all owners—as LLCs.

2.2 Disadvantages of LLC Status

Unfortunately, LLCs have disadvantages as well. One significant negative factor is a lack of uniformity among the laws of the various states governing LLCs. Most statutes include a mix of provisions derived from state business corporation acts and limited partnership acts. In 1995, however, the National Conference of Commissioners on Uniform State Laws approved the Uniform Limited Liability Company Act (ULLCA). Following the approval of ULLCA, four states (South Carolina, West Virginia, Vermont, and Hawaii) have adopted the ULLCA and several states have amended their LLC statutes to conform more closely to the provisions of ULLCA. Another disadvantage of LLCs is the lack of case law and other precedents interpreting the state LLC statues (as compared to the numerous cases and precedents interpreting state corporate law statutes). Finally, because a multimember LLC is generally taxed as a partnership for federal income tax purposes, it is required to comply with the complex rules governing partnership taxation.

The discussion of LLCs in this chapter is by necessity very general in nature. Therefore, practitioners should not rely on the information herein when assessing specific client issues. Instead, the provisions of the applicable state LLC statute should be examined in detail.

3. LLC OPERATIONS AND MANAGEMENT

3.1 Kinds of Businesses Eligible to Operate as LLCs

Generally, state statutes permit LLCs to conduct any lawful business except those outlawed by the LLC acts themselves or prohibited under the particular LLC's articles of organization.

A number of states do not allow LLCs to be used for certain professional practices or in certain lines of business, such as banking or insurance. Several states do, however, permit doctors, lawyers, and other professionals to operate as a professional limited liability company (PLLC) (which is akin to the professional corporation).

The AICPA permits the use of LLCs for CPA practices, provided LLCs are allowed under applicable state rules, including state CPA society rules.

3.2 Formation and Governing Documents

LLCs are formed under the laws of a particular state by filing articles of organization (called a certificate of organization or certificate of formation by some states) with the secretary of state. The articles of organization are set forth in a document similar to a corporation's articles of incorporation. In states allowing single-member LLCs (see section 3.7), generally, all that will be necessary will be to file the LLC's articles of organization with the secretary of state.

Multi-member LLCs will generally find it advisable to draft a separate contractual arrangement called an *operating* agreement (also called *regulations,* or *limited liability company agreements* in some states). The operating agreement is similar to the partnership agreement of a limited or general partnership. Many single-member LLCs choose to adopt an operating agreement to govern the operation and management of the company in the event additional members are admitted (or in the event that multiple persons will inherit an interest in the company upon the death of the single member). The *Accountant's Business Manual Toolkit CD-ROM* includes a sample LLC operating agreement checklist (appendix 3) and a sample LLC creation checklist (appendix 4).

A thoughtfully drafted operating agreement will include basic operating rules regarding LLC management issues, cash and property contributions, profit- and loss-sharing ratios, allocations of tax items, rights of the members to current and liquidating distributions, rights of members to transfer their ownership interests, and events causing dissolution or winding up of the LLC.

LLC statutes generally provide for the possibility that an operating agreement will *not* exist in written or oral form. In such cases, the statutes supply so-called *default* language specifying the contractual relationships among the members. The default rules will cover how the LLC is managed, member rights to profits and distributions, restrictions on transfers of ownership interests, and events causing dissolution of the LLC. This arrangement also resembles a corporation where the officers, under the guidance of the directors, run the corporation.

These default provisions will apply unless an operating agreement exists to override them. Because statutory default provisions are necessarily general, they will be unsatisfactory in many real-life situations. It is highly advisable for an LLC to have an operating agreement that contemplates the unique aspects of the business at hand and the specific needs of the various members. For example, if the LLC intends to make special allocations of income or loss items, it will be necessary to have a detailed operating agreement that contains the provisions required by Section 704 of the Code and the Treasury regulations issued thereunder.

State LLC statutes include certain mandatory provisions that cannot be modified by agreement among the members. For example, the statute may be inflexible regarding the approvals required for legal transfers of LLC ownership interests. However, members will generally be able to customize their operating agreements as needed without running afoul of statutory limitations. Nevertheless, it is clearly necessary to have an adequate understanding of what is permitted and prohibited by the applicable LLC statute.

3.3 Management

Members of LLCs can generally choose to manage the LLC themselves or appoint *managers*. If the members reserve all management powers for themselves, the LLC is run more or less like a general partnership; such LLCs are often described as *member-managed*. If the members appoint one member as the managing member, the arrangement resembles a limited partnership run by its general partner. If the members appoint managers (who need not be members) to manage the business and affairs of the LLC, the arrangement resembles a corporation managed by its board of directors. These LLCs are often described as *manager-managed*. Note that a manager is generally not required to be a member of the company (that is, the members can appoint one or more independent outside managers). LLC statutes contain default management language, usually providing that the LLC will be managed by all members unless the articles of organization or operating agreement stipulate otherwise. Note that LLC statutes provide great flexibility for determining management structure. Many LLCs have a board of managers (also referred to as a board of governors) that functions in the same capacity as a board of directors.

The *Accountant's Business Manual Toolkit CD-ROM* provides sample operating agreements for manager-managed LLCs (appendix 1) and member-managed LLCs (appendix 2).

3.4 LLC Ownership Interests

As stated earlier, the owners of the LLC are called members. They are analogous to partners in a partnership or shareholders in a corporation. Generally, the members will have significant restrictions on their ability to transfer LLC ownership interests to nonmembers.

Some LLC statutes require that the transfer of ownership interests be approved unanimously by the nontransferring members unless the operating agreement provides different rules. Other states require less than unanimous consent for transfers.

Until proper member consent is obtained, the transferee generally does not become a full member entitled to all rights of membership, such as the right to vote and to inspect the LLC's books and records. The transferee is only entitled to step into the shoes of the transferor member with regard to his or her share of profits and capital.

Ownership interests may or may not be evidenced by the issuance of LLC ownership certificates. State laws generally permit but do not require the issuance of such certificates. A creditor having a lien on an LLC ownership interest will generally prefer that the interest be represented by a certificate, thereby allowing the creditor to perfect its security interest by maintaining possession of the certificate.

3.5 Dissolution

LLC members generally have the right to voluntarily withdraw from the LLC and receive payment for the value of their ownership interests.

> *Practice Tip.* The ability of members of an LLC to voluntarily withdraw and receive payment for the value of their ownership interests generally prevents LLC members from being entitled to a minority interest discount with respect to their membership interests.

The operating agreement may specify that the LLC will legally dissolve after a designated number of years of existence or after the attainment of a stated business goal (such as the sale of a real estate development). Typically, however, LLCs have perpetual existence.

LLCs are also generally dissolved upon the occurrence of certain other events, such as unanimous written consent of the members or following the sale of all of the assets of the LLC and the cessation of its business.

The *Accountant's Business Manual Toolkit CD-ROM* includes a sample LLC termination checklist (appendix 5).

3.6 Liability of LLC Members

As stated earlier, LLCs offer the advantageous corporate characteristic of limiting the exposure of members and managers to entity-level liabilities. This is a fundamental reason for considering the LLC as a form of doing business.

Specifically, status as an LLC member or manager does not in and or itself expose the member or manager to any risk of personal financial loss beyond the value of the LLC ownership interest, plus any unfulfilled capital contribution obligations. (Nonmember managers are not even exposed to that risk.) This is analogous to the legal positions occupied by corporate shareholders and limited partners. Managing members and managers may be personally liable in the event that they breach their fiduciary obligations. This is analogous to the legal position occupied by corporate directors.

However, if the LLC's articles of organization are not properly filed with state authorities, the persons purportedly conducting the activities as an LLC may be exposed to third-party liabilities. In addition, the corporate principle of "piercing the veil" applies to an LLC that does not observe certain formalities of maintaining its separate existence (for example, keeping its funds in bank accounts that are separate from the accounts of its members). See section 3.3 of the chapter on Corporations.

With regard to the issue of limited liability, multi-member LLCs have two significant advantages over limited partnerships. First, a limited partnership generally must have at least one general partner with unlimited exposure to partnership liabilities (although some states permit the formation of limited liability limited partnerships (LLLPs) pursuant to which the general partner does not have unlimited exposure to partnership liabilities). In the case of an LLC, however, *no* member need be exposed to LLC liabilities. Second, under some state statutes a limited partner can lose limited liability protection by becoming too actively involved in managing the limited partnership. However, this is not a concern for LLC members who can have any degree of management involvement without risking loss of their limited liability protection.

The liability-limiting advantages of LLCs are critically important, but they should not be overstated. Although the personal assets of LLC members and managers are protected from general LLC debts, they generally remain exposed to liabilities resulting from the individual actions of those members and managers. This is a matter of state law.

For example, if an LLC is used to operate a professional practice, the LLC itself is generally liable for professional malpractice and negligence on the part of its members or managers. However, the members and managers generally are also personally liable for damages caused by their own professional malpractice or negligence and for their own negligence in supervising other professionals, who may be members, managers, or employees. In short, LLCs generally do *not* offer liability protection to members and managers beyond what corporations offer to their shareholders.

In addition, like corporate shareholders, LLC members may be required on occasion to personally guarantee certain LLC debts as a condition of obtaining financing or for other reasons. Members are personally obligated with respect to such guaranteed LLC debts.

Despite the preceding warnings, LLC members and managers are in the favorable position of generally being insulated from exposure to entity-level debts (except under personal guarantees), including liabilities resulting from the tortious acts of other members, managers, or employees.

3.7 Single-Member LLCs

Before 1997, the federal income tax classification of single-member LLCs was unclear. Specifically, there was a significant risk that the IRS would treat single-member LLCs as C corporations, with the resulting problem of double taxation. Accordingly, they were not generally considered advisable.

However, the *check the box* entity classification regulations (described in more detail in section 4.1) favorably resolved the issue of how single-member LLCs will be taxed after December 31, 1996.

Under the check-the-box regulations, unless a single-member LLC elects to be taxed as a corporation, the separate existence of a single-member LLC is simply ignored for federal income tax purposes. In other words, an LLC owned by an individual and used to operate a business will be treated as a sole proprietorship unless it elects to be taxed as a corporation. An LLC that is wholly owned by another legal entity (for example, a corporation, partnership, or another LLC) will be treated as an unincorporated branch of the parent entity unless it elects to be taxed as a separate corporation. The fact that a single-member LLC is "invisible" for federal income tax purposes does *not*, however, affect the liability limiting advantages of the LLC under state law.

Practice Tip: While single-member LLCs are generally invisible for federal and state income tax purposes, they are generally respected for sales tax purposes. Thus, a corporation that leases property from its wholly owned single-member LLC may be liable for sales tax on the lease payments.

The ability of sole proprietors to gain liability protection by forming single-member LLCs (while continuing to handle their taxes as before by filing Schedules C and SE along with Form 1040) may turn out to be the most prevalent use of LLCs in the small business world. The advantage of liability protection should not be underestimated, because claims can result from such commonplace occurrences as a delivery person slipping on the sidewalk in front of a business owner's office in the home or a car accident caused by an employee running errands.

As with a corporation, it *will* be necessary to segregate business and personal assets and liabilities to achieve the intended liability protection benefits. This means establishing separate bank accounts, titling property in the correct fashion, maintaining separate financial records, having the LLC rather than the individual owner enter into contracts, and so on. In other words, the expected liability protection may not be achieved without some attention to detail. Nevertheless, most sole proprietors should strongly consider forming LLCs, particularly if the business has employees.

One of the most exciting uses for single-member LLCs is as a replacement for subsidiary corporations. By forming a single-member LLC instead of a wholly owned subsidiary corporation, a corporate taxpayer can obtain the benefits of consolidation without being subject to the administrative complexities of the consolidated return regulations.

> *Practice Tip.* An S corporation that desires to form a new wholly owned subsidiary will generally prefer to form a single-member LLC rather than a qualified subchapter S subsidiary (QSub) because of certain limitations that apply following the termination of a QSub election. See the chapter on S Corporations, Section 2.2.4, "Qualified Subchapter S Subsidiaries."

A single-member LLC that is disregarded for tax purposes is not required to obtain a federal employer identification number (EIN); however, it may be advisable to obtain one for banking or employment tax reporting purposes. See Appendix 6, on *The Accountant's Business Manual Toolkit CD-ROM,* for a sample application for an EIN by a single-member LLC that is disregarded for tax purposes.

4. CLASSIFICATION OF LLCs FOR TAX PURPOSES

4.1 Why Tax Classification Is an Issue

The former entity classification tax regulations required assessing the presence or absence of the following four corporate characteristics:

— Limited liability for entity owners
— Free transferability of entity ownership interests
— Continuity of legal life of the entity
— Centralized management

If an unincorporated entity such as an LLC possessed three or four of these characteristics, it was classified as a corporation for federal income tax purposes. However, evaluating whether or not corporate characteristics were present was often an uncertain process. Therefore, it was sometimes difficult and relatively expensive to determine whether multi-member LLCs qualified for the desired partnership classification. Moreover, as mentioned earlier, the proper tax classification for single-member LLCs was not addressed under the former regulations.

This was a frustrating situation because LLC owners justifiably wanted certainty that LLCs would not be treated as corporations and thus be subject to double taxation and other relatively unfavorable corporate tax rules.

4.2 The Check-the-Box Regulations

In December of 1996, the U.S. Treasury addressed the preceding problem by issuing the "check-the-box" entity classification regulations (Regs. 301.7701.1–3). Effective on January 1, 1997, the check-the-box regulations implement an extremely simple approach to classifying LLCs. After that date, it is no longer necessary to consider the four corporate characteristics in deciding how a newly formed LLC will be treated for federal income tax purposes.

Under the check-the-box regulations, multi-member LLCs are treated as partnerships unless they elect to be treated as corporations (which will be attractive in only limited circumstances).

The existence of single-member LLCs is generally ignored. As stated earlier, this means that an LLC owned by a single individual can be treated as a sole proprietorship. An LLC that is wholly owned by another legal entity is treated as an unincorporated branch or division of the parent entity. (Alternatively, a single-member LLC can elect to be treated as a corporation in the relatively unlikely event that is deemed advisable.)

In summary, a multi-member LLC that does not file an affirmative election will be taxed as a partnership; a single-member LLC that does not file an affirmative election will be disregarded.

Practice Tip: An LLC that desires to be taxed as a corporation can elect to be taxed as an S corporation (assuming it is otherwise eligible to make an S election—that is, no prohibited shareholders, etc.) by filing IRS Form 2553. It is no longer necessary to file a separate check-the-box election. The IRS recently revised the instructions to Form 2553 to permit an LLC to report the percentage owned of each of its members (rather than the number of "shares" owned by the members).

See Appendix 7, on *The Accountant's Business Manual Toolkit CD-ROM,* for a sample S election by an LLC that elects to be taxed as a corporation.

4.3 Making an Affirmative Check-the-Box Election

Despite the favorable default classification rule explained in the preceding paragraph, some may consider it prudent to guarantee the expected results by making an affirmative check-the-box election. Additionally, an affirmative election is required to obtain a result other than the default result.

A check-the-box election is accomplished by filing Form 8832 (Entity Classification Election) with the designated IRS Service Center. Form 8832 should also be filed with the LLC's tax return for the year the election is made (or the owner's tax return in the case of a single-member LLC whose existence is to be ignored for federal income tax purposes).

The effective date of the election will be the date specified on Form 8832—if it is not more than 75 days before the election filing date or more than twelve months after the election filing date. If no date is specified, the effective date will be the election filing date. If the specified effective date violates the 75-day or twelve-month rule, the effective date will be 75 days before the filing date or twelve months after the filing date, respectively.

The Form 8832 must be signed by each LLC member or by an authorized manager or member, if allowed under state law.

Generally, a second check-the-box election cannot be made within 60 months after the first such election.

The check-the-box regulations do *not* change the federal income tax results of conversions to LLC status. For example, an existing corporation could decide to convert, under applicable state law to an LLC, and then make a check-the-box election to be treated as a partnership. However, any such transaction will be regarded as a complete corporate liquidation for federal income tax purposes. The result is corporate-level gain recognition if the corporation holds appreciated property. There may be taxable gain recognition at the shareholder level as well. (See section 6.2 for additional discussion.)

As noted above, an LLC can elect to be taxed as an S corporation without making a check-the-box election. It is sufficient to merely file Form 2553. This technique has become popular in states that are perceived to have favorable LLC statutes. In such states a taxpayer who desires to form an S corporation can take advantage of the favorable LLC statute by forming an LLC, but still achieve S corporation status for federal income tax purposes by making the appropriate elections.

See Appendix 8, on *The Accountant's Business Manual Toolkit CD-ROM,* for a sample check-the-box election by a single-member LLC that desires to be taxed as a corporation.

5. TAXATION OF MULTI-MEMBER LLCs

5.1 Partnership Taxation in General

The tax advantage of operating as a multi-member LLC is that the entity can be treated as a partnership for federal income tax purposes.

The partnership tax provisions are found in Subchapter K of the IRC. Subchapter K encompasses IRC Sections 701 through 761. The partnership tax rules are considered much more favorable than those that apply to C corporations, because partnerships are subject to only a single level of federal income tax under the principles of pass-through taxation.

The partnership rules are also considered more favorable than the S corporation tax rules. Although pass-through taxation principles also apply to S corporations, they are subject to strict eligibility provisions that often make using an S corporation impractical and S corporations are prohibited from making special allocations of income and deduction items. In addition, certain favorable pass-through taxation rules apply to partnerships but not to S corporations. Furthermore, as discussed below, tax consequences of liquidating a partnership are generally more favorable than the tax consequences of liquidating an S corporation.

LLCs taxed as partnerships file Form 1065 and issue Schedules K-1 to their members, who are treated as partners for tax return purposes. The LLC's income, gains, losses, deductions, and credits will flow through to the members, in accordance with the allocation provisions of the LLC's operating agreement, and the members will then take these items into account in preparing their returns.

The various other IRC provisions applicable to partnerships and partners (for example, IRC Section 448 regarding use of the cash method and IRC Section 1402 regarding the determination of self-employment income) also apply to LLCs taxed as partnerships and their members.

5.2 LLC Taxation Compared to Limited Partnership Taxation

Generally, there are few differences between the tax rules that apply to limited partnerships and multi-member LLCs. However, one potentially significant difference is in the allocation of basis from entity-level debt (under IRC Section 752).

In the case of limited partnerships, limited partners generally receive additional basis only from partnership nonrecourse debt. Nonrecourse debt is debt for which no partner, including the general partner, is personally liable. Usually, nonrecourse debt is secured by specific partnership assets, most commonly real estate. However, in today's economic environment, nonrecourse debt is relatively rare. Therefore, limited partners often do not receive any additional basis from the partnership's debts.

In the case of LLCs, *all* entity-level debt is nonrecourse by definition—unless it has been guaranteed by an LLC member. (The LLC's debt may be secured by all the entity's assets, but it is typically *not* guaranteed by members.) Therefore, the entity-level debt can usually be allocated for IRC Section 752 basis purposes among all members. This additional basis from entity-level debt is an advantage of LLC status for LLC members who would be limited partners if the entity were operated as a limited partnership.

Another difference between limited partnerships and LLCs arises in applying the passive activity loss (PAL) rules. Under the PAL regulations, limited partners must satisfy a stricter test to be considered to materially participate in the partnership's trade or business activities. The IRS currently takes the position that members of an LLC are treated as limited partners for purposes of the PAL rules, even if the member is a member-manager that participates in the management of the LLC. That position has been criticized by commentators and practitioners who argue that a member-manager of an LLC should be treated the same as a general partner of a limited partnership. At least one court has held than an LLC member who actively participates in the management of the LLC should be treated as a general partner for purposes of applying the PAL rules. See *Gregg v. United States*, 87 A.F.T.R. 2d 2001-337 (D. Or. 2000).

Finally, a member of an LLC may be treated differently from a limited partner for purposes of self-employment taxes imposed under the Self-Employment Contributions Act. Specifically, an individual member of an LLC that is engaged in a trade or business will be subject to self-employment tax on such member's share of the LLC's income if such member is treated as a "general partner" for self-employment tax purposes (which is generally the case if the member actively participates in the business of the LLC). (See Prop. Reg. §1.1402(a)-2.)

5.3 LLC Tax Restrictions Compared to S Corporation Restrictions

There are no federal income tax law restrictions that affect the ability of an entity to qualify as an LLC. Multi-member LLCs are treated under the pass-through taxation principles applicable to partnerships. In contrast, a number of strict federal income tax rules must be satisfied for a corporation to be eligible for S status.

Specifically, an S corporation can have no more than 100 shareholders, and shareholders can be only individuals (other than nonresident aliens), estates, and certain kinds of trusts or tax-exempt organizations. LLCs are not subject to any restrictions on the number of members or kinds of entities that can be members. (In relatively unusual circumstances, some care must be taken with LLCs to avoid C corporation tax status under the IRC Section 7704 publicly traded partnership provisions.)

S corporations are also limited by the one-class-of-stock rule, which prevents S corporations from making special allocations of income and deduction items, and from paying preferred returns to equity holders. On the other hand, LLCs can issue a variety of equity ownership interests specifically tailored to meet the financial requirements of their members. Such interests can, for example, include varying rights to cash flow, liquidation proceeds, and allocations of tax items.

Finally, certain corporations are by definition ineligible for S status. Ineligible corporations include the following:

- — Corporations that are not domestic corporations
- — Certain financial institutions
- — Domestic international sales corporations (DISCs) or former DISCs
- — Insurance companies other than certain casualty companies
- — Certain corporations electing to take the IRC Section 936 possessions tax credit

Note that under state law, certain types of businesses may not be able to be operated as an LLC. For example, some states do not permit LLCs to engage in the business of banking or insurance.

A former C corporation that accumulated earnings and profits during its C corporation years must not earn more than 25 percent of its gross receipts from passive sources in three consecutive years, or it will lose its S status (IRC Sec. 1362(d)(3)).

The preceding restrictive S corporation eligibility rules generally make the flexibility of LLCs very attractive by comparison. However, that is not to say LLCs are always preferable to S corporations for tax reasons.

One disadvantage of LLCs is that LLCs may be legally dissolved upon the withdrawal of any member and upon the occurrence of certain other events. The members can generally vote to continue the LLC. However, a number of statutes require unanimous consent. This can present practical problems that make operating as an LLC difficult. Another potential disadvantage of operating as an LLC is that (unlike an S corporation) an LLC that is taxed as a partnership is not a "corporation" for purposes of the Internal Revenue Code. Accordingly, such an LLC cannot take advantage of the reorganization provisions of the Code (Secs. 351, 368, and so on) that apply to corporations. On November 15, 2001, however, the IRS published proposed regulations that would permit the merger of a corporation into a single-member LLC to qualify as a reorganization. Those regulations were adopted as temporary regulations on January 23, 2003 and finalized on January 23, 2006. (See Treas. Reg. 1.368-2.)

Moreover, when the owners' objectives can be satisfied with a simple ownership and capital structure the flexibility to create multi-member LLC ownership interests with varying financial and tax characteristics may not be viewed as a meaningful advantage over S corporations.

Finally, many clients and third parties (such as lenders) are more familiar and comfortable with the traditional corporate form of management (president, chief executive officer, board of directors, and so on) that applies to S corporations. For example, from a lender's perspective, it is not always clear who is authorized to execute a deed or mortgage on behalf of an LLC.

5.4 LLC Taxation Compared to S Corporation Taxation

The federal income tax rules for S corporations are often described as virtually identical to the partnership tax rules. However, there are actually significant differences. Most of the differences are in favor of partnerships, including multi-member LLCs treated as partnerships.

An S corporation shareholder obtains basis for loss deduction purposes only to the extent of basis in stock plus the amount of any loans made to the corporation (IRC Sec. 1366). This is the case even if the shareholder personally guarantees some or all of the corporation's debt. However, an LLC member is treated as a partner and obtains additional basis in the LLC interest for the share of LLC debts (IRC Sec. 752).

Because no member is personally liable for LLC debt, it will be allocated for basis purposes among the members pursuant to the IRC Sec. 752 regulations covering nonrecourse liabilities. However, unless the LLC's nonrecourse debt is qualified nonrecourse financing secured by real property, the IRC Sec. 465 at-risk rules will generally apply.

It is important to recognize that the additional basis from LLC debt can eliminate or minimize current taxable gain when a member contributes low-basis property burdened by debt to the LLC. Under IRC Sec. 357, taxable gain *always* results when the amount of debt exceeds the basis of property contributed by a shareholder to an S (or C) corporation.

Under the partnership tax rules, a purchaser of an LLC ownership interest can step up the tax basis of the share of appreciated LLC assets to reflect the purchase price. This benefit is available if the LLC makes an IRC Sec. 754 optional basis adjustment election. After an IRC Sec. 754 election, the allocations to the purchasing member of deductions related to LLC assets (for example, depreciation deductions) will be based on the higher purchase price rather than on the LLC's historical tax basis. Also, if the LLC sells the appreciated property, the purchasing member's allocation of taxable gain will be smaller.

No similar basis adjustment provision is available to purchasers of S (or C) corporation shares (although a purchaser of S corporation stock may be able to step-up the basis of the corporation's assets under the rules of IRC Sec. 338(h)(10)).

Under the partnership tax rules, LLC members can generally make tax-free contributions of appreciated property to the LLC at any time throughout the life of the entity (IRC Sec.721). Also, LLCs can generally make tax-free distributions of appreciated property to members (IRC Sec.731). The ability of LLCs to distribute appreciated property to its members generally makes LLCs the preferred entities for owning real estate.

However, if appreciated property is contributed to an S (or C) corporation, nonrecognition treatment is available only if the transferor or transferors are in control of the corporation immediately after the transaction (IRC Sec. 351). If appreciated corporate property is distributed to S (or C) shareholders, gain is recognized at the corporate level just as it would in the event that the property was sold for full-market value (FMV) (IRC Secs. 311(b), 336(a), and 1371(a)).

The key point is that the partnership taxation rules often give LLCs and their members substantial flexibility to make transfers of appreciated property without immediate recognition of taxable gains. This is not the case for S corporations and their shareholders. Additionally, as discussed in section 5.2 above, a member of an LLC may be subject to self-employment tax on his or her share of the income of an LLC that is engaged in a trade or business.

Finally, under the partnership taxation rules, special tax allocations of income, gain, loss, deduction, or credit can be made among the members (IRC Sec. 704). In contrast, all S corporation pass-through items must be allocated among the shareholders strictly in proportion to stock ownership (IRC Sec. 1366). The ability to make special tax allocations to meet the needs of LLC members can be a significant advantage of LLC status compared to S corporation status.

5.5 State and Local Tax Considerations

Although generally there are no major differences between the federal income tax rules for multi-member LLCs and those for partnerships, the same cannot always be said for state income tax rules.

Most states follow the federal income tax treatment for LLCs. In such states, an LLC classified as a partnership for federal income tax purposes will be classified as a partnership for state tax purposes as well. In this regard, most states do not distinguish between LLCs formed in-state (*domestic LLCs*) and those formed in other states (*foreign LLCs*).

In most states, LLCs treated as partnerships are not subject to income tax at the entity level, but members are taxed on their shares of LLC income.

A number of states require LLCs to file information returns showing members' shares of income, and some states require LLCs to pay or withhold taxes on behalf of nonresident members. It appears that a number of states will allow LLCs to file composite returns on behalf of their nonresident individual members, which then relieves these members from any further state filing responsibilities.

However, LLCs are subject to entity-level state income taxes in a number of states. In Texas, LLCs (whether single-member or multi-member) are subject to the state's franchise tax, which is actually somewhat similar to an income tax. In the states of Washington and Michigan, LLCs are subject to the state business taxes that apply to all business entities.

Whether LLCs must pay state franchise taxes on capital varies. A number of states tax capital only if the LLC is classified as a corporation for federal income tax purposes, while others tax capital in any case. In still other states, the rules are unclear. In Florida, a membership interest in an LLC is subject to Florida's intangible tax (which was repealed effective January 1, 2007), while a limited partnership interest is not.

With regard to other state and local business taxes, LLCs are generally treated in the same manner as other kinds of business entities. For example, LLCs are generally required to collect sales taxes and pay use taxes on items purchased in other states. LLCs must generally comply with state and local business organization, registration, and licensing rules and pay applicable fees and taxes. Transfers of real estate to LLCs may be subject to state and local real estate transfer taxes. A number of states also charge LLCs annual fees in the form of minimum taxes.

State and local taxes are often significant enough to affect the attractiveness of LLCs as business entities. The issue should be carefully assessed in making choice-of-entity decisions.

6. TAX ASPECTS OF CONVERTING EXISTING ENTITIES INTO LLCs

6.1 Partnership Conversions

The conversion of an existing domestic general or limited partnership into a U.S. multi-member LLC classified as a partnership can generally be accomplished without federal income tax consequences to the converting partnership or partners (Rev. Rul. 95-37).

The former partners generally become LLC members without recognizing any gain from the transaction, and the taxable year of the

(Text continued on page 19)

converting partnership does not close. In other words, the LLC is considered a continuation of the same taxable entity.

These results apply whether the partnership conversion is accomplished by formally liquidating the partnership and forming an LLC, or by merging with a newly formed LLC, or by a purely legal conversion to LLC status. In addition, the tax consequences are the same if the LLC is formed in the same state as the converting partnership or in a different state.

If conversion is via liquidation of the old partnership, this can be mechanically accomplished by having the partnership contribute all its assets and liabilities to the newly formed LLC in exchange for LLC ownership interests. The LLC interests are then distributed to the partners in liquidation of the partnership. The former partners now hold LLC interests, and the LLC now holds all the assets and liabilities of the old partnership.

Alternatively, a liquidation can be accomplished by having the partners contribute their partnership interests to the newly formed LLC in exchange for LLC interests. The partnership then distributes all assets and liabilities to the LLC in liquidation. Again, the former partners now hold LLC interests, and the LLC now holds all the assets and liabilities of the old partnership.

Finally, state law may permit an existing partnership to merge with the newly formed LLC with the LLC being the surviving entity. Merger transactions, if they are allowed, are generally cleaner than liquidations, from a legal standpoint, because the LLC simply assumes all the rights and obligations of the former partnership.

A few state LLC statutes permit conversion of a partnership into an LLC by simply filing articles of organization and complying with certain other filing and paperwork requirements. Like a merger transaction, this is cleaner than a transaction involving a liquidation of the old partnership.

With regard to the tax implications of converting an existing general or limited partnership into a multi-member LLC by any of the above methods, Rev. Rul. 95-37 apparently leads to the following conclusions:

— Former partners do not recognize gain on the conversion unless changes in their percentages of liabilities (under IRC Sec. 752) would cause the basis in their interests to fall below zero.

— Former partners obtain the same basis in their new LLC interests as in their old partnership interests unless the conversion results in changes in their shares of liabilities under IRC Sec. 752.

— The members' holding periods for the new LLC interests tack on to the holding periods for the old partnership interests.

— The LLC is considered a continuation of the former partnership. As a result, the tax year continues and there is no need for a new taxpayer identification number (TIN). The LLC continues to use the former partnership's tax accounting methods and elections.

6.2 Conversions of S and C Corporations

The conversion of an existing S or C corporation into an LLC can be accomplished in several ways. The same basic principles apply to conversions into both multi-member and single-member LLCs. The assets of the corporation can be contributed to the newly formed LLC in return for LLC ownership interests that are then distributed to the shareholders in complete liquidation of the corporation.

Alternatively, the corporation can distribute its assets to the shareholders in complete liquidation, and the shareholders can then contribute their undivided interests in the assets to the newly formed LLC in exchange for LLC ownership interests.

Finally, the corporation may be permitted under state law to merge with the newly formed LLC with the LLC being the surviving entity. The corporation does this by making a tax-free contribution of all assets and liabilities to the LLC in exchange for LLC interests (under IRC Section 721). The corporation then goes out of existence by distributing the LLC interests to shareholders in complete liquidation.

In any of the preceding cases, there will generally be corporate-level gain or loss recognition as if the property distributed in complete liquidation were sold by the corporation for FMV (IRC Section 336). This means a converting corporation with appreciated assets—whether it is an S or C corporation—may recognize significant taxable income or gain as a result of the liquidation transaction.

At the shareholder level, the receipt of the liquidating distribution in exchange for corporate stock is treated as a taxable sale or exchange of the stock for proceeds equal to the FMV of the distributed property (IRC Section 331). Gain or loss may be recognized by the shareholder on the transaction—depending on whether the FMV of the distributed property is greater or less than the basis of the corporate stock exchanged.

In the case of a converting S corporation, any corporate-level gain is passed through and increases the shareholders' basis in their stock. Therefore, the gain already recognized at the corporate level is not recognized again when the stock is deemed sold in exchange for the liquidating distribution. However, if the S corporation is a former C corporation, the IRC Section 1374 built-in gains tax may apply to some or all of the corporate-level gain.

Example 1. Assume Shareholders A and B each own 50 percent of Corporation X, which has been an S corporation from the date it was incorporated. A and B each contributed $100 to Corporation X, and Corporation X used the $200 to purchase a parcel of land for investment. The land is currently worth $1,000. If Corporation X is converted to an LLC, the tax consequences would be as follows:

- Corporation X is deemed to liquidate. Gain of $800 flows through to A and B and increases their basis to $1,000 ($200 initial basis plus $800 gain).
- A and B are deemed to receive $1,000 worth of property in exchange for their stock of X (now having a basis of $1,000).
- A and B collectively pay tax of $120 (assuming a 15-percent tax rate on capital gains) on the $800 gain.

In the case of a converting C corporation, the shareholders receive no basis step-up from any corporate-level gain. As a result, there is generally taxable gain at both the corporate and shareholder levels upon the liquidation of a C corporation with appreciated assets.

Example 2. Assume the same facts as Example 1, except that Corporation X is a C corporation. If Corporation X is converted to an LLC, the tax consequences would be as follows:

- Corporation X recognizes gain of $800 and pays tax of $280 (assuming a 35-percent corporate rate).
- A and B are deemed to receive $720 ($1,000 value of land less $280 tax paid by X) in exchange for their stock of X (having a basis of $200). A and B collectively recognize gain of $520 and pay tax of $78 (assuming a 15-percent tax rate on capital gain).
- Total tax cost is $358 (as compared to $120 in Example 1).
- A and B each have a $500 basis in their investment in the new LLC, and the LLC has a basis of $1,000 for the land.

Since the conversion of S or C corporations to LLC status involves liquidation transactions, the federal income tax cost for corporations with significantly appreciated assets will often be unacceptably high. In such situations, there will often be unfavorable state income tax consequences as well.

However, if the corporation does not hold significantly appreciated assets, it is possible that liquidation and conversion to LLC status can be accomplished without adverse tax consequences.

If a corporate conversion is undertaken, the resulting LLC will be a new taxable entity. New multi-member LLCs will almost always desire partnership tax classification, and new single-member LLCs will almost always desire to have their existence ignored for federal income tax purposes. Under the check-the-box entity classification regulations (see section 4.1), these outcomes are permitted. The new LLC will then fall under general tax rules regarding selecting tax accounting methods and periods, making various tax elections, depreciating property, and so on.

> *Planning Tip:* In Priv. Ltr. Rul. 200528021, the IRS ruled that the merger of an S corporation into an LLC that elected to be taxed as an S corporation was a tax-free "F reorganization." Accordingly, an S corporation that desires to convert to an LLC taxed as an S corporation may be able to do so without triggering corporate or shareholder level tax.

7. TAX ASPECTS OF CONVERTING FROM OR TO A SINGLE-MEMBER LLC

The IRS has published guidance on the federal income tax consequences of converting a single LLC to a multi-member entity taxed as

(Text continued on page 21)

a partnership (Rev. Rul. 99-5, I.R.B. 1999-6) and the federal income tax consequences of converting a multi-member entity taxed as a partnership to a single-member LLC (Rev. Rul. 99-6, I.R.B. 1999-6).

7.1 Conversion From a Single-Member LLC to a Multi-Member LLC

The conversion of a single-member LLC that is disregarded for federal income tax purposes to a multi-member LLC that is taxed as a partnership can occur if either the single member sells a portion of his or her membership interest in the LLC (a conversion by purchase) or the LLC issues new membership interests to another person in exchange for a contribution of additional capital to the LLC (a conversion by capital contribution). The tax consequences of the conversion of a single-member LLC to a multi-member LLC are described in Revenue Ruling 99-5, I.R.B. 1999-6.

The owner of a single-member LLC is treated as owning the assets of the LLC directly. Accordingly, a conversion by purchase is treated as an asset sale, with the results illustrated by the following example:

> "A" is the sole owner of "Old LLC," a single-member LLC that is disregarded for federal income tax purposes. "B" purchases 50 percent of A's membership interest in Old LLC for $5,000. The federal income tax consequences to A, B, and Old LLC are as follows:
>
> - B is treated as having purchased, and A is treated as having sold, a 50-percent interest in each asset owned by Old LLC.
> - A recognizes gain or loss equal the difference between the $5,000 purchase price paid by B and 50 percent of A's basis in Old LLC's assets (IRC Sec. 1001).
> - A and B are treated as having contributed the assets of Old LLC to a new LLC ("New LLC"), taxed as a partnership in exchange for membership interests in New LLC.
> - Neither A nor B recognizes gain or loss on the deemed contribution of assets to New LLC (IRC Sec. 721(a)).
> - A's basis in his membership interest in New LLC is equal to 50 percent of his basis in Old LLC's assets (IRC Sec. 722).
> - B's basis in his membership interest in New LLC is $5,000 (IRC Sec. 722).
> - New LLC's basis for the assets acquired from A and B is equal to the basis of those assets in the hands of A and B, respectively, immediately before the deemed contribution (IRC Sec. 723).
> - A's holding period for his membership interest in New LLC includes his holding period for the capital assets of Old LLC (IRC Sec. 1223(1)).

- B's holding period for his membership interest in New LLC begins on the date after the purchase (Rev. Rul. 66-7, 1966-1 C.B. 188).
- New LLC's holding period for the assets acquired from A and B includes the holding period of those assets in the hands of A and B, respectively, immediately before the deemed contribution (IRC. Sec. 1223(2)).

The federal income tax consequences of a conversion by capital contribution are illustrated by the following example:

> "A" is the sole owner of "Old LLC," a single-member LLC that is disregarded for federal income tax purposes. "B" contributes $10,000 to Old LLC in exchange for a 50-percent membership interest in Old LLC. The federal income tax consequences to A, B, and Old LLC are as follows:
>
> - A is treated as having contributed the assets of Old LLC to a new LLC ("New LLC") taxed as a partnership in exchange for a 50-percent membership interest in New LLC.
> - B is treated as having contributed $10,000 to New LLC in exchange for a 50-percent membership interest in New LLC.
> - Neither A nor B recognizes gain or loss on the deemed contribution to New LLC (IRC Sec. 721(a)).
> - A's basis in his membership interest in New LLC is equal to A's basis in the assets of Old LLC (IRC Sec. 722).
> - B's basis in his membership interest in New LLC is $10,000 (IRC Sec. 722).
> - New LLC's basis in the assets acquired from A is equal to A's basis in such assets immediately before the deemed contribution (IRC Sec. 723).
> - A's holding period for his membership interest in New LLC includes his holding period for the capital assets of Old LLC (IRC Sec. 1223(1)).
> - B's holding period for his membership interest in New LLC begins on the date after the contribution (Rev. Rul. 66-7, 1966-1 C.B. 188).
> - New LLC's basis for the assets acquired from A includes A's holding period for those assets immediately before the deemed contribution (IRC Sec. 1223(2)).

7.2 Conversion From a Multi-Member LLC to a Single-Member LLC

The conversion of a multi-member LLC that is taxed as a partnership to a single-member LLC that is disregarded for federal income tax purposes can occur if either an existing member purchases the membership interests of the other members (an existing member purchase) or a new person purchases the membership interests of all the members of the LLC (a new member purchase). The tax consequences of the conversion of a multi-member LLC to a single-member LLC are described in Revenue Ruling 99-6, I.R.B. 1999-6.

For tax purposes, the consequences to the selling LLC members and the purchasing LLC member are analyzed differently. The selling LLC members are treated as having sold a membership interest, while the purchasing member is treated as having purchased assets.

The federal income tax consequences of an existing member purchase are illustrated by the following example:

> "A" and "B" each own a 50-percent membership interest in "Old LLC," a multi-member LLC that is taxed as a partnership. A sells his entire membership interest in Old LLC to B for $5,000. The federal income tax consequences to A and B are as follows:
>
> - A is treated as having sold his membership interest in Old LLC to B for $5,000. A recognizes gain or loss in accordance with the rules of IRC Section 741.
> - The tax consequences to B are determined as if Old LLC made a liquidating distribution of its assets to A and B, and B then purchased the assets distributed to A for $5,000.
> - B recognizes gain or loss on the deemed liquidating distribution to the extent required by IRC Section 731(a).
> - B's basis in the assets deemed purchased from A is $5,000 (IRC Sec. 1012).
> - B's basis in the assets received in the deemed liquidating distribution is determined under IRC Section 732(b).
> - B's holding period for the assets deemed purchased from A begins on the date after the purchase (Rev. Rul. 66-7, 1966-1 C.B. 188).
> - B's holding period for the assets received in the deemed liquidation includes Old LLC's holding period for such assets (IRC Sec. 735(b)).

The federal income tax consequences of a new member purchase are illustrated by the following example:

> "A" and "B" each own a 50-percent membership interest in "Old LLC," a multi-member LLC that is taxed as a partnership. A and B each sell their membership interests in Old LLC to C for $5,000. The federal income tax consequences to A, B, and C are as follows:
>
> - A and B are treated as having sold their membership interests in Old LLC to C for $5,000 each. A and B recognize gain or loss under the rule of IRC Sec. 741.
> - The tax consequences to C are determined as if Old LLC made a liquidating distribution of its assets to A and B, and C then purchased those assets from A and B for a total of $10,000.

- C's basis in the assets acquired from A and B is $10,000 (IRC Sec. 1012).
- C's holding period for the assets acquired from A and B begins on the date after the purchase (Rev. Rul. 66-7, 1966-1 C.B. 188).

Please note that the foregoing discussion ignores certain complexities that can arise if the LLC in question has "hot assets" or elects a tax classification that differs from its default classification under the check-the-box regulations.

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OBTAINING FINANCING

1. INTRODUCTION

In many situations, accountants are asked to advise clients or businesses in need of funds. Often, the inflow of new funds can mean the survival of the entity. In addition, accountants may be requested to prepare data for presentation to potential lenders and investors. The importance of proper assistance in these tasks must not be underestimated.

Financing sources change constantly as the needs of borrowers change. Services provided by creditors are also changing. Many current financing tools evolved to meet borrowers' special needs. As a result, particular financing needs may require creativity in dealing with creditors. This chapter explores many of the financing avenues currently available and provides information that will enable accountants to better assist clients and businesses in obtaining funds from both internal and external sources. It should be viewed as an overview and preliminary guidance source discussing general considerations.

This chapter is limited to initial considerations of needs and sources and to preparation of a financing package to present to lenders. Because rates and costs are subject to constant change, the generalizations herein should be used only to provide comparisons between the rates and costs of alternative sources.

2. THE DECISION TO BORROW

Before preparing a loan proposal for a lender, a business' accountant should take several steps, including

— Analyzing the borrower's needs

— Discussing the effects of borrowing with management

— Examining alternative financing sources and matching the appropriate source to the need

2.1 Analysis of Needs

The first step in obtaining financing is specifically identifying the need for a loan. Even if tight cash flow is readily apparent, identifying the most significant drain on cash flow is essential. Reviewing the financial statements and asking pertinent questions of management should allow the accountant to identify whether—

— Customers are aging their accounts longer and causing revenue to suffer.

— A build-up of inventory has occurred, or costs of materials have increased.

— Significant investment in new equipment or facilities has occurred.

— Vendors are being paid quicker to obtain early pay discounts.

— Payoff of other loans has occurred through balloon payments.

— Profitability has suffered, either through loss of customers or uncontrolled costs.

Regarding the payment of vendors to obtain early pay discounts, the computation of the point of indifference with respect to purchase discounts is as follows:

[Discount percent ÷ (due date − discount date)] × 360 days = annualized interest income from taking advantage of the discount.

> *Example:* For payment terms of 1%/10 days, net/30, the interest rate is computed as follows:
>
> $[.01 \div (30 - 10)] \times 360 = 18\%$
>
> This is then compared against the firm's aggregate borrowing costs. If the interest rate as computed above is greater than the borrowing rate (and the cash is available), taking advantage of the purchase discount is advised. In terms of dollars and cents, this is computed as follows:

Invoice amount:	$ 10,000
Terms:	1%/10, net/30
Aggregate borrowing rate:	8%
Interest earned by taking discount:	
$10,000 × .01 =	100
Interest cost by taking discount:	
[($10,000 × 8%) ÷ 360] × (30 days − 10 days) =	44
Net interest profit by taking discount:	$ 56

Of course, proactive planning should identify the need for funds prior to experiencing cash flow problems. The business' normal budgeting process should identify foreseeable drains on cash flow, such as asset acquisitions and debt retirement. A monthly budget of financing requirements should be prepared as a part of the annual financial budget. See the Business Performance Measures chapter for guidance in developing proactive business management tools.

Identifying key performance indicators and monitoring them on a regular basis can identify unforeseen cash flow drains before they seriously affect the business. In some cases, timely reaction can prevent the need for new financing. At other times, monitoring changes in the business' key indicators can give additional time to properly structure the needed financing to obtain the most favorable terms.

Common financing needs include business start-up capital, long-term working capital, seasonal working capital, equipment financing, business expansion, and debt restructuring. Each of these needs may require different financing alternatives.

2.2 The Effects of Borrowing

Management should understand the risks of borrowing. Servicing new debt will adversely affect cash flow in the future. Risks exist whether the debt service is structured over a period shorter than the useful life of the asset purchased with the borrowed funds, or if debt service extends well beyond the useful life of the asset purchased with the borrowed funds.

Creditors normally obtain a security interest in assets to collateralize the loan. Management should be careful not to encumber more assets than necessary, as this could affect future borrowing opportunities and other business transactions. The lender could prevent the sale or liquidation of mortgaged property unless the corresponding debt is satisfied.

Loan covenants with the lender often limit a company's freedom to incur additional debt, acquire major assets, or pay officer compensation and dividends. Monitoring the borrower's compliance with the loan covenants may impose a significant burden on the borrower's chief financial officer and other accounting professionals. Lenders may also require the company to incur additional costs for a certified audit or reviewed financial statements. Such covenants might also require a company to maintain certain financial ratios such as working capital, debt to equity, or gross margin. Inadvertently failing to maintain the required ratios can put a loan in default, allowing the lender to call the loan prematurely. Typical loan covenant provisions might include—

- — Maintenance of compensating cash balance.
- — Customer payment through a lock box.
- — Prior approval to change inventory mix.
- — Restriction on purchasing property and equipment.
- — Restriction on acquiring new businesses.
- — Maintenance of current status of income, payroll, and sales tax payment.

— Restriction on incurring additional debt.
— Restriction on making loans to insiders.
— Restriction on declaring dividends.
— Restrictions on corporate reorganization, change of control, or sale of business.
— Direct assignment of proceeds from a third party.
— Restrictions on the level of officer compensation and bonuses.
— Maintenance of certain types of insurance coverage and limits.
— Identifying the lender as beneficiary on key person life insurance.

The following represents sample language that might be included in the financial statements of a company related to a covenant on the payment of dividends:

> *Example:* The amount of dividends on common stock that may be paid by subsidiaries to the parent is limited by certain financial covenants set forth in the XYZ Bank mortgages. At December 31, 200X, $12,000,000 of subsidiaries' retained earnings was available for dividend payments to the parent. At December 31, 200X, $30 million of the parent's retained earnings was not available to pay dividends to shareholders due to restrictions in the debt agreements.

It is not uncommon for lenders to look beyond the company's assets for additional security. Owners may be asked to pledge personal property or personally guarantee the loan's repayment in the event of default. The same restrictions on sale of mortgaged property apply when a third party offers collateral. The third party may also find it more difficult to obtain personal loans for other ventures due to the additional leverage. Third party guarantors or co-makers should consult legal counsel to ensure these risks are explained and understood.

While many loans contain restrictive covenants or require third-party guarantors or comakers, the actual implications of these covenants and guarantees often depend on the banking relationship and the borrower involved. As described at paragraph 3.2.4, many banking relationships are based on "character"; specifically, the education, experience, track record, personality, and business skills of the borrower. Therefore, even in situations where a restrictive covenant may come into play or additional guarantees might be required, borrowers with a good relationship with the lender can often negotiate the covenants and guarantees. While restrictions may occasionally be extended and expanded, borrowers who continuously attempt to negotiate with the lender often find their negotiating power to be limited. Alternatively, those borrowers who only rarely encounter the restrictions presented by the covenants may be able to negotiate with the lender and obtain exceptions.

Lenders normally also measure risk for the specific industry of the borrower (for example, loans to an individual in the food or beverage business would normally be considered much riskier than loans to an individual in a professional business). So, again, the ability to negotiate covenants and guarantees is more likely to be considered by lenders for borrowers in industries with lower risk.

Example: Lisa is the sole owner of an accountancy corporation. Corporate loans restrict the amount of compensation Lisa is able to draw out of the corporation. Lisa would like to purchase a home, but needs about $20,000 of additional cash for the down payment, which she would like to draw out of the corporation as additional salary.

Because of the past growth and successful track record of her corporation, Lisa may well be able to negotiate an exception to the compensation restriction with the lender. However, if Lisa were operating in a riskier industry sector, such an exception might not be approved, even with a similar track record for the business.

2.3 Matching Financing to Needs

In obtaining financing, it is important to match the loan repayment term and collateral with the asset created from the loan proceeds. Because it is the benefits derived from the use of an asset that create the cash flow necessary to service the debt, there are many potential risks in ignoring this relationship.

For example, it might appear to improve current cash flow to finance a piece of equipment having a five-year economic life over a ten-year loan amortization. Debt service in the early years would appear to be less than the benefits derived from the equipment. Consider, however, that at the end of the equipment's useful life over half the original loan amount would remain. Debt service would need to continue for several years in addition to the cost of a replacement unit or the higher cost of repairs and maintenance necessary to extend its useful life.

Lenders are generally disinterested in securing loans with assets that devalue faster than the loan amortizes. Nonetheless, this occurs with certain types of newly acquired assets, such as state-of-the-art technology or fixed assets which lose their specific identity upon installation.

Many business assets, such as equipment, tend to produce a regular stream of benefits. New equipment or facilities bring an increased efficiency to the business, allowing it to create the same level of revenue under a lower cost structure. Assets producing a regular stream of benefits are most logically financed on an installment loan basis.

A single payment at loan maturity might be appropriate for assets which tend to appreciate in value over time, such as investment real estate or equity securities. These assets might not produce an income stream until they are later sold.

Some assets appear to produce benefits in a relatively short time period, but need to be replaced or replenished immediately. No real cash flow is created to service the acquisition indebtedness. Such is the case with a base level of inventory or accounts receivable. Because inventory is constantly replaced as sold, financing base inventory under a long-term working capital loan is appropriate.

Seasonal needs to increase inventory or incur production input costs should be realized as additional cash flow at the end of the busy season. Tourism retailers, recreational facilities, agricultural producers, and seasonal service businesses all fall into this category. Seasonal working capital loans should be structured so that the business can fully repay this debt during every off season.

Several other questions should be addressed for a thorough analysis. The accountant will want to know—

— The amount needed.

— How soon funding must occur.

— The intended use of the loan proceeds.

— How long the funds will be needed.

— How funds will become available for repayment.

— Whether sufficient collateral exists to secure the debt.

Cost of funds tends to vary inversely with the creditworthiness of the borrower, and the quality of the security. Cost of funds tends to vary directly with the length of the loan term.

Where traditional financing is unavailable or is prohibitively costly, businesses should seek out alternative sources of capital. Pursuing equity capital via a capital stock offering not only provides additional sources of funding, the company's balance sheet appears stronger. Claims by equity owners are usually subordinated to the claims of all other secured creditors. The true cost of obtaining equity capital is in the diluted ownership that results and the ability of most stockholders to share in the future appreciation in the company's net worth (see section 5.1.3).

Leasing programs provide an additional source of alternative funding. Lease-to-own programs allow nearly the entire cost of an asset to be financed. Operating leases are not reflected on the balance sheet, so the total debt load of a company does not appear to increase from entering into an operating lease. Capital leases, however, are reflected on the balance sheet as liabilities (see section 4.3).

2.4 Preparing Financial Projections and Client Information

The accountant must remember that cash-flow projections and sales forecasts are vital in material lending decisions. Such projections require consideration of the capital sources to best match the client's needs.

In addition to cash-flow projections and sales forecasts, other information related to the client's goals and objectives, as well as to the client's business and industry, should be gathered. The objectives behind the funds request might influence the accountant's determination of the type of lender to approach. For example, certain funding sources specialize in providing venture capital for new businesses, while other financing sources provide funds for expansion and facilities acquisition.

The accountant should gather data on the business ownership, finances, operations, and personnel and might also want to seek information regarding the client's attorney, banker, and credit reporting agencies. The information gathered and evaluated in the process is essential for the preparation of a financing proposal package (discussed in section 10).

2.4.1 Evaluation management

The owners' financial strength should be analyzed. An assessment should be completed as to whether the owners could provide additional sources of funds. Prior financial statements should be analyzed to complete sales forecasts and projections, and if such information is not available, the accountant should help the client develop the forecasts and projections.

The accountant should also complete a summary of the education, experience, and other capabilities of the client's key personnel. This will help the lender evaluate the enterprise's ability to meet debt obligations plus the potential for growth and business success. In the case of a start-up business, the information related to personnel is particularly important since historical financial data are not available. Once again, the accountant can assist the client in preparing personnel data when résumés of key management personnel are not available.

2.4.2 Comparing to peer group

The accountant should also consider the type of product being sold, the industry position of the client along with the potential market for the products, and other factors, such as competition, company facilities, and inventory-turnover ratios. The accountant needs to gain a thorough understanding of the client's business and industry and also of the general business and economic conditions. An analysis of gross profit ratios and other trends for the past few years should also be completed. Ratio analysis is discussed in detail in section 9.2.

The accountant should also study industry data related to the client and compare key ratios to those of the industry in general. Many financial institutions subscribe to annual statement studies by independent organizations to analyze the industry averages. The following ratios are commonly used by financial institutions:

— Current assets to current liabilities

— Net profits to tangible net worth

— Average collection period of receivables

— Net sales to inventory

— Net fixed assets to tangible net worth

— Total debt to tangible net worth

— Net profit and net sales

2.4.3 Projecting cash flows

A financial projection assists the client in determining the precise funding requirements and the repayment schedule. Additionally, a financial projection shows lenders how the company expects to grow and fund its projected debt retirement.

The accountant should help the client project cash flow of receipts and disbursements over the loan amortization period. If an operating budget already exists, the needed information may be readily available. If an operating budget does not exist, the accountant should assist the client in projecting cash receipt and disbursement amounts. The accountant might want to categorize the client's products into various groups to establish sales patterns and then interview management and other key personnel to establish the assumptions on which the sales estimates can be based. Additionally, prior-period statements can be analyzed, and various financial models may also be used.

To complete the projection, the accountant should establish assumptions for cost of sales, expenses, and other factors affecting net income. The sales estimate can be established based on volume projections and unit sale prices. Cost of sales can be estimated based on historical information or on projected future cost factors.

A projected income statement on the accrual accounting method should be converted to cash receipts and disbursements by adjusting for various uncollected and unpaid items. Accounts receivable and accounts payable factors can be considered, along with other income and expense items not generating or requiring cash. For a further discussion, see the chapter on Business Plans.

2.5 Effect of Debt on Tax Basis

If the borrower is an entity, the decision to obtain financing and the structure of the financing may have an effect on the tax basis of the owners of the entity. If the borrowing entity is a C corporation, the debt will not affect the tax basis of the corporation's shareholders with respect to the stock of the corporation. If the borrowing entity is an S corporation, for purposes of deducting losses that flow through from the S corporation, a shareholder will be able to include in basis indebtedness of the corporation to the shareholder. See IRC Sec. 1366(d). Note that this rule applies only to indebtedness of the S corporation to the shareholder, and does not apply to indebtedness of the corporation to a third-party lender. Accordingly, if an S corporation is borrowing funds from a third-party lender, it may be beneficial, for tax purposes, to structure the loan as a back-to-back loan, whereby the third-party lender advances funds to the shareholders and the shareholders then lend the funds to the S corporation. For further information, see the chapter on S corporations, herein.

> *Example:* Don is the sole shareholder of Donald, Inc., an S corporation. The corporation is in need of $250,000 to use as operating capital. Don does not have the funds, so Don applies for a $250,000 loan from the bank. The bank, however, will not grant the loan without adequate security. Don is able to obtain debt basis by borrowing the money from the bank and lending it to the corporation if the transaction is properly structured.
>
> To properly structure the transaction, the bank should loan the money to Don, and Don immediately loans the funds to Donald, Inc., in exchange for a note. Don pledges the note from the corporation as security on his bank loan. Also, the corporation gives Don a security interest in its assets as the corporation acquires them. Don in turn pledges the security interest in the assets as collateral on his bank loan. Accordingly, the bank is in the same position as if it had loaned the money directly to the corporation, with Don guaranteeing the loan. To properly structure the transaction, the corporation should not pledge the corporate assets directly to the lender, to avoid having the loan being treated as made directly to the corporation. Don must be the party that assigned the security interest to the lender to properly achieve debt basis in the transaction.

If the borrowing entity is a partnership (including a limited liability company that is taxed as a partnership), a partner will receive tax basis in its partnership interests for any indebtedness of the partnership that is allocated to such partner under the rules of IRC Sec. 752. Those rules apply to indebtedness of the partnership to a partner or to a third party.

3. SHORT-TERM FINANCING

3.1 Trade Credit

Trade credit exists when businesses make sales or purchases on terms resulting in future, rather than immediate, payment. For example, a purchase on the twentieth of March might not require payment until the tenth of April. If payment were then made on April 10, the buyer would have received twenty-one days of "interest-free" credit.

Trade credit is a "spontaneous" financing source because it becomes available from ordinary business transactions. It is a very flexible credit source because it may be repaid at the purchasing company's option and does not affect control of the company. As a result of the flexibility and relative ease of obtaining trade credit, many firms choose to utilize all credit that is available to them in the normal course of their business. From the standpoint of the seller, however, trade credit may be a costly (but necessary) sales promotion device.

3.1.1 Trade credit terms

Trade credit terms can fluctuate widely between various industries and companies and may also vary according to the seller's perception of the risk each buyer represents. Accordingly, it may be important for the buyers to show as much objective data as possible that provide a basis for obtaining favorable terms.

In some industries, more standardized credit terms are based on various factors, including

— The nature of the product (higher-turnover items usually have shorter-term credit, reflecting increased ability to pay and lack of security after assets are sold).

— The buyer's financial soundness (sound buyers are usually accorded more favorable terms, since providing them credit involves less risk).

— The seller's financial soundness (sound sellers are better able to use credit terms as a sales promotion device because of their resources).

— The competitive conditions the seller faces (most often in highly competitive businesses, trade credit extension becomes necessary).

Trade credit terms may be stated in such terms as "2/10, net 30." This means that if payment is made within ten days, a 2 percent cash discount will be allowed, but full payment will be due within thirty days, regardless.

The early-payment discount should be taken when the buyer can borrow at a rate of interest that is less than the cost of not taking advantage of the cash discount. In the example above the cost of not taking the discount may be computed using the following formula:

$$\text{Cost of not taking discount} = \frac{2\ (\text{discount percent})}{(100 - \text{discount percent})}$$

$$\text{TIMES}$$

$$\frac{360}{20\ (\text{due date less discount period})}$$

$$\text{EQUALS}$$

$$\frac{2}{98} \times \frac{360}{20}$$

$$\text{EQUALS}$$

$$\text{approximately } 36.7\%$$

The cost of using trade credit for twenty days instead of paying early is at an effective interest rate of 36.7 percent.

3.1.2 Sight drafts and time drafts

Sight drafts and time drafts are used when a seller demands payment from a buyer and title to goods is not transferred until the payment is made. A sight draft requires a buyer to pay at the time of receipt of goods or services (i.e., "at sight" of the goods or services). A time draft allows the buyer to defer payment for a specified time after receipt. Examples of time drafts might be 30, 60, or 90 days. Drafts involve the extension of credit from the seller to the buyer. The seller must wait for money until payment is made.

3.1.3 Letters of credit

A letter of credit is used when the buyer's bank, upon the request of the buyer, promises to pay the seller an agreed sum of money provided required documents are properly prepared and delivered to the bank within a specified time period. By using letters of credit, the credit risk of the buyer is replaced with the credit risk of the bank of the buyer. Almost all letters of credit are irrevocable, such that the credit cannot be altered or canceled by the buyer without the permission of the seller. Using letters of credit may be expensive for the buyer because funds may need to be committed before merchandise or documents giving title have been received. However, letters of credit do protect both the buyer and seller from loss.

3.1.4 Advantages and disadvantages

There are several advantages to using trade credit. It allows firms more flexibility in their financing sources without affecting the control of the business. Trade credit is often less formal and more available than other credit sources, because the seller is often in a good position to judge the buyer's ability to resell the product. Furthermore, because trade credit is sometimes used as a sales promotion device, the terms may be extremely favorable in order to further the seller's goal of extending its markets.

On the other hand, utilizing trade credit is not always a sound financing policy. Often, if the early-payment discount is not taken, the cost of this credit becomes very high and the buyer would find better financing elsewhere. Trade credit is dependent on goods purchased and services offered by specific trade creditors.

3.1.5 Customer deposits

Similar to vendor trade credit, customer deposits are also a "spontaneous" financing source at no-interest cost. Businesses that receive a percentage of the sale price before making the sale are able to cover the working capital needs of acquiring or manufacturing the inventory item. An added benefit of customer deposits is that the company does not carry an account receivable, which reduces the amount of financing extended to its customers.

3.2 Short-Term Financing Through Commercial Banks

Short-term bank credit is an extremely popular source of financing for all types of businesses. Often a business relationship is established with a local commercial bank through which the bank may become a participant in the business's financial planning. The types of loans offered by commercial banks vary greatly and using a commercial bank for short-term financing provides many options.

Short-term financing emphasizes the borrower's financial capacity in the near future. Therefore, emphasis on cash flow lending as opposed to net worth lending increases. Banks are increasingly looking for projections and other assurances that indebtedness can be repaid through cash generated, and are placing a lower emphasis on the borrower's net worth. Certain lending based solely on net worth as opposed to cash flow factors has historically given rise to problems. For example, as more lending occurred in the agricultural sector based on the value of farmland, a significant decline in farmland values, and accordingly in net worth, occurred, resulting in lenders' finding themselves under-collateralized.

Many banks use the prime rate and other indexes as bases of interest rates. This allows the interest rates of many loans to vary, minimizing the lending institution's interest rate risk. Thus, when the prime rate and other specified amounts increase, the interest rates on many loans also increase automatically.

In determining the cost of bank credit, the real borrowing cost of such credit must also be analyzed. Some arrangements require compensating balances to be maintained. A compensating balance is a required minimum noninterest-bearing checking account balance that a borrower must maintain with the lender bank. The balance is generally equal to 15 to 20 percent of the amount of the loan outstanding, but it varies by bank. Compensating balances raise the effective interest rate on bank loans.

3.2.1 Characteristics

Short-term commercial loans have several unique characteristics. For example, a short-term commercial loan is usually for a period of ninety days or less. It may be secured or unsecured, depending on the amount of risk the bank faces in evaluating the prospects for timely repayment. This type of financing is generally used to take advantage of suppliers' trade discounts, to expand inventory levels, or to finance seasonal liquidity shortages.

3.2.1.1 Security agreements

When a bank loan is secured, the borrower normally executes a security agreement. Under a security agreement, the borrower pledges certain business assets as collateral. For example, when the lender takes a security interest in accounts receivable and inventory, the business pledges those assets as collateral under the terms of the security agreement. Security interests are often publicly recorded to protect the lender's interest.

3.2.1.2 Cosigners

On certain loan types, another individual is required to cosign the debt instrument on the borrower's behalf. In the event the borrower defaults on payments under the loan terms, the lending institution is then able to pursue collection attempts with the cosigner, who essentially offers a personal guarantee for loan repayment.

Agreements with a cosigner are common in new business relationships. In these agreements, a friend or relative, often the new businessperson's parent, cosigns and guarantees the note, thus allowing financing to occur.

Example: Charlie, a recent college graduate, is looking to start a new business to develop software for fantasy sports leagues. Charlie anticipates the need for approximately $50,000 of capital to start the business. However, upon meeting with the bank, Charlie finds that the bank will require a cosigner on his loan, due to Charlie's relative inexperience and current minimal net worth.

Accordingly, Robert, Charlie's father, cosigns the note with Charlie, allowing the financing to occur and providing the needed start-up capital for Charlie's business. In the event Charlie defaults on the loan, the bank will look to Robert for payment.

3.2.1.3 Guarantors

The lending institution might alternatively obtain the borrower's personal guarantee. While such a loan is not collateralized by business or other assets, a guarantee for loan repayment exists with the borrower's full faith and credit. Normally, borrowers with higher incomes and significant net worths are able to obtain loans offering no more than personal guarantees (also see section 3.2.4). Given the liability shield afforded investors in limited partnerships, limited liability companies (LLCs), and corporations, lenders routinely require the personal guarantee of the owners to protect their position. Lenders may also require the spouses of the owners to sign personal guarantees to prevent an owner from avoiding the guarantee by transferring assets to his or her spouse. For more information on the liability exposure of these entities, see the chapters on Partnerships, Limited Liability Companies, and Corporations.

3.2.2 Bank credit cards

Bank credit cards issued by commercial banks are another type of short-term credit. The credit card eliminates virtually all the risk of accounts receivable to the retailer and allows the bank to extend receivables-based credit to the bank's customers. The accountant must carefully weigh the benefit of this immediate cash flow against the normally higher cost the bank will charge for this service.

3.2.3 Line of credit

Another type of short-term credit offered by commercial banks is a line of credit. Typically, when a bank grants a line of credit to a business it provides that, so long as certain conditions and terms are met, the bank is willing to provide the business an agreed amount of funds. Interest is charged only on the amount actually owed to the bank during the period of credit. The bank may, however, ask for a fee to keep the line of credit open or may cancel at its own option. Normally, the borrower is an established business with known profitability.

3.2.4 Character loans

Short-term commercial bank credit may also take the form of character loans, which are generally unsecured and made available because of the outstanding credit rating of the business or individual applying for the funds. Even though not secured by specific business assets, these loans often require the personal guarantee of the borrower, an officer, or a related party.

In general, these short-term commercial bank loans are self-liquidating, meaning repayment will follow the normal liquidation of inventory and receivables. Much bank lending is for a short period under the above-mentioned loan arrangements, which leaves the bank in a position to meet the needs of other commercial borrowers entering seasonal periods in which additional borrowing is necessary.

3.2.5 Choosing a lender

The accountant should point out the differences among banks when considering them as a source of financing. A larger bank will be able to spread its risk out over a broader range of investments and therefore may be able to provide financing to a business that might be considered too risky for a small bank. A smaller bank, on the other hand, may offer more personal service.

Many times, the business relationship with a specific bank's management or loan officer may be much more important than with the bank as a whole. This is particularly true with small businesses and smaller banks.

Another factor to consider in choosing a commercial bank is the amount of financial and business counseling it may be able to provide. For example, some bank loan officers specialize in working with growth companies or companies in the developmental stage.

Another characteristic in which banks differ is the degree of loyalty that will be evidenced in bad economic times. This is most important to companies in high-risk and seasonal businesses for which a forced loan liquidation at the wrong time could be disastrous.

The accountant should examine the degree of loan specialization when choosing a commercial lender. The bank chosen should be the one with the greatest amount of experience in the borrower's industry. By choosing an experienced lender, the borrower may receive more active support and creative cooperation in the particular line of business in which it is engaged.

Finally, the accountant should consider such commonsense factors as whether or not the bank is large enough to handle the borrower's financing needs or whether the borrower has had previous dealings with an area bank in another capacity and has thereby developed a good credit record with that bank.

Bankers are normally concerned with the following factors:

— *Character:* Will the borrower do everything in his or her power to repay the indebtedness?

— *Capital:* Has the borrower invested a sufficient amount of his or her own capital in the business?

— *Capacity:* Does the borrower have the managerial skill to use the funds wisely and profitably?

— *Collateral:* Does the borrower have such a high personal credit standing that he or she can borrow unsecured, or do sufficient assets exist to pledge as collateral?

— *Circumstances:* If the business is of a seasonal nature, what is the competitive position of the company, the nature of the product, and so forth?

— *Coverage:* Is there insurance to protect against the death of an owner, the stoppage of operations due to business interruption, and so forth?

A banker studying a borrower's financial statements will look for indications such as: the inventory level in relation to sales; excessive salaries paid to the owners; substantial officer loans; a high percentage of past-due receivables; extremely high investments in property, plant, and equipment; an overextended credit position; or an unstable company structure.

On a more detailed level, the banker will want information regarding the following:

— *Inventory:* This may include detail reflecting the amount in raw materials, work-in-process, and finished goods by type of product, in addition to any obsolete or consigned inventory.

— *Receivables:* Any receivables that are pledged, a listing of aged receivables, the largest receivable customers, and the percentage these receivables represent.

— *Equipment:* Type, age, and condition of equipment, along with an appraisal.

In almost all cases of closely held business borrowing, the officers or stockholders of the company will be required to give a personal guarantee and might also be required to maintain a compensating balance with the bank. As described in sections 3.2.1.2 on cosigners and 3.2.1.3 on guarantors, if the position of the company is extremely weak, the bank may request another guarantee on the loan.

The loan interest rate will vary with the loan's size and terms, and with the risk associated with granting the funds.

3.2.6 Advantages and disadvantages

The advantages of using a commercial bank for this type of financing include a close working relationship between lender and borrower. A borrower who might be considered a high credit risk elsewhere might be an acceptable candidate for a commercial bank loan. Clients should be advised to seek financing from banks large enough to have a sophisticated profitability analysis, thereby evaluating profitability from all sources of business the client provides to the bank. In addition, by using commercial bank loans, the company establishes a working financial relationship that may be essential in times of business emergency as well as a foundation for supporting the client's growth, acquisitions, or expansion needs.

Disadvantages of commercial banks as a source of short-term funds include the fact that they have a limited lending capacity. Title 12 of the United States Code (Section 84) provides that loans by a national banking association to a person outstanding at one time *and not fully secured* by collateral having a market value at least equal to the amount of the loan may *not exceed 15 percent* of the unimpaired capital and unimpaired surplus of the association.

The total funds *fully secured* by readily marketable collateral having a market value may *not exceed 10 percent* of the unimpaired capital and unimpaired surplus of the association.

Another disadvantage of commercial banks as sources of short-term lending is the possibility that they may provide only limited management counsel. Because of the loan volume banks ordinarily handle, it is impractical for them to provide detailed counsel to more than a few of their many customers.

3.3 Commercial Paper

Corporations with a national reputation and a good-to-excellent credit rating may turn to a commercial paper house, which resells the promissory notes of reputable corporations and businesses. Commercial paper financing is normally only available to extremely large corporations and is not available to small, closely held corporations. There are two types of commercial paper—industrial paper (issued by major industrial firms) and finance paper (sold directly by finance companies).

Generally, commercial paper yields are slightly higher than Treasury bills of the same maturity. Although maturity generally ranges from two to six months, average maturity is about five months. Commercial paper is generally bought in round dollar amounts and as a series of notes. Dealers prefer handling the paper of businesses with high net worths because of the high expense of handling these notes.

There are several advantages in using the commercial paper market to obtain financing:

— It allows the broadest and most advantageous distribution of paper.

— It provides more funds at lower rates than most other financing methods.

— The borrower can avoid the expense and inconvenience of having to obtain financing from other institutions, which may each require a compensating balance.

— As the borrower's paper (and therefore product) becomes more widely known, some goodwill may accrue.

— The commercial paper dealer is often available to offer expert financial advice to clients.

The main disadvantage of commercial paper is its high cost. The company must have enough liquidity to cover this cost. Also, a company that faces temporary financial difficulty may receive better consideration from a commercial bank than from a commercial paper house.

3.4 Commercial Finance Companies

Finance companies generally participate in financing other companies' credit sales as well as providing funds for short-term purposes. These finance companies borrow funds from investors and bankers in large denominations and then lend them directly to businesses and other customers. As a result, commercial finance companies are often less desirable as a financing source than banks because the interest cost of funds is higher. Commercial finance companies also provide several services.

3.4.1 Financing accounts receivable

Accounts receivable financing involves the pledging or sale of the company's receivables. Because accounts receivable can be reasonably and accurately valued and are usually liquid, they make a suitable asset for pledging to obtain funding. Then, as the accounts receivable are collected, the indebtedness is reduced. When the full value of the receivables is not pledged, the excess collections are returned to the debtor.

The procedure for financing accounts receivable between the seller and the financial institution begins with creating a legally binding contract between the parties. This contract generally includes:

— The percentage to be advanced on accounts sold or pledged (often approximately 80 percent).

— The procedures to be followed for account collections.

— The parties' legal obligations.

— The schedule of the accounts assigned.

— The procedure for dealing with overpayments to the lender.

— The interest amount the lender will charge.

The more specific the contract, the less likely it is that problems will arise.

3.4.2 Factoring accounts receivable

When receivables are actually sold to a financial institution, the sale may be made with or without recourse. The financial institution would normally prefer that the sale be made with recourse, so that the risk of the account not being fully collected lies with the business selling the receivables. If the accounts receivable are purchased without recourse, the process is called *factoring*.

When the lending company factors the accounts receivable, it is in fact assuming the credit risk and therefore the service will be more expensive. Usually, a factor will charge a percentage commission on net invoice amounts factored and will also charge interest at a rate between 3 and 4 percent over the prime rate.

3.4.3 Collection

Once the contract has been drawn, collection may be made directly or indirectly. If the collection is made indirectly, the account customers will send their remittances directly to the debtor, who immediately forwards them to the lender. Account customers are not notified of the assignment.

When collection is direct, account customers are notified to remit directly to the lender. This can present a problem because the account customers are informed of the financing type used and some adverse effects on the company's goodwill may result.

3.4.4 Security interest

The security interest taken by the debtor will be in the form of a floating lien under the Uniform Commercial Code. The creditor will normally require a fully perfected lien.

3.4.5 Advantages and disadvantages

Some advantages of using accounts receivable financing include, first, the availability of funds and the greater cash flow provided. A second advantage is that as the firm expands and requires more funds, the amount of accounts receivable available should also expand. Also, if the accounts are factored, the company does not have to rely completely on its own credit department.

Disadvantages of accounts receivable financing begin with high administrative expense. Second, as mentioned earlier, some stigma may become apparent, and other creditors may be hesitant to extend financing when the receivables are removed as a possible source of repayment.

3.5 Inventory Financing

Inventory financing may be obtained with a secured or an unsecured loan. A company that is a good credit risk may obtain an unsecured loan; companies considered poorer risks often have to grant a security interest in their inventory. Security interest includes field warehouse receipts, trust receipts, and chattel mortgage securities, as defined below. Bankers will carefully review collateral and frequently monitor inventory levels to ensure the value is not diminished.

3.5.1 Field warehouse financing

Warehouse lending uses inventory as security. Field warehousing represents an economical method of financing inventory in which the warehouse is established at the place of the borrower. Two elements are necessary in the establishment of a field warehouse: First, public notification of the field warehouse arrangement must be made; second, the field warehouse must be supervised by a custodian. The custodian, a field warehouse company, should be a third party employed by the lending institution. In a relatively small field warehousing operation, an employee of the borrower may be hired as the custodian; however, lending institutions usually consider this practice undesirable due to the lack of an independent supervisor.

The lending institution establishes a loan on which the borrower can draw based on the warehoused inventory. As the borrower receives purchase orders, it transmits them to the bank. The bank directs the custodian to release the inventories. Per the agreement, as remittances are received by the borrower, they will be turned over to the bank. These remittances by the borrower are applied against the loan made by the bank.

3.5.2 Trust receipts financing

A trust receipt is an instrument acknowledging that the borrower holds the inventory in trust for the lender. Upon receiving funds from the lender, the borrower conveys a trust receipt for the inventory. The inventory may be stored at a warehouse or held on the premises of the borrower. The trust receipt indicates that the inventory is held in trust for the lender or is segregated in the borrower's premises on behalf of the lender. Sale proceeds are remitted to the lender per the trust receipt instrument.

Trust receipts financing requires that a trust receipt be issued for specific inventory items, normally serially numbered. Automobile dealer financing is a good example of trust receipts financing.

3.5.3 Chattel mortgage security financing

A chattel mortgage security gives the lender a secured interest in the inventory. As the inventory is sold, the receipts are paid to the lender as stated in the mortgage terms. In many jurisdictions, a chattel mortgage must be recorded and must include a complete description of the goods.

3.5.4 Advantages and disadvantages

The advantages of inventory financing are quite similar to those applicable to accounts receivable financing, as discussed in section 3.4.5. Financing is easy to obtain, while providing the ability to generate greater cash flow. An expanding firm will likely have an expanding inventory base from which to draw cash funds.

Disadvantages include a high administrative expense associated with the financing. Because the inventory is now security on an inventory-financed loan, a business may have difficulty borrowing money for other needs.

4. INTERMEDIATE-TERM FINANCING

Intermediate-term financing is the term generally used to describe debt that is repaid in less than ten years but after more than one year. In this chapter, the intermediate financing types discussed include only financing where the principal is repaid in periodic installments.

The installment repayment method makes refinancing with the same source difficult, so the maturity date of intermediate-term financing is extremely important. Typically, the company will have few intermediate-term needs; this type of financing is used to finance permanent assets, and the liquidation or sale of the asset financed will not be used as a source of repayment. In such instances, companies are required to commit future earnings toward the loan repayment and, therefore, these funds are not available for other requirements.

4.1 Term Loans

Term loans are business loans that extend more than one year. These loans may be secured or unsecured (depending upon the debtor's financial condition). Repayment, or amortization, of term loans is made by periodic repayments over the loan life. By retiring the loan slowly, the borrower will be able to make adequate provision for debt retirement during the life of the loan. To protect the lender against default, most term-loan contracts include an acceleration clause providing that all installments will become due upon default of any payment.

The interest rate depends on many factors, including the loan amount, the borrowing company's credit rating, the maturity date, and the bank's relationship to the borrower. Generally, this rate is slightly higher than the rate that would be charged for a short-term loan. The interest rate may also be tied to the bank's prime rate.

An alternative to term loans is lease financing (see section 4.3 of this chapter). Advantages and disadvantages exist with each, and in certain situations, a sale-leaseback transaction may be appropriate. Under such a transaction, an asset is sold to a third party and then leased back to the original owner at a stated amount. Such transactions often allow a future buyback of the asset at a fixed price or fair market value at a certain point in time.

4.2 Installment Equipment Financing

New equipment manufacturers often provide financing arrangements for their customers. This is another type of intermediate-term financing because the loan terms often allow several years for repayment. This financing is used solely for purchasing equipment and may be available through several sources, such as the equipment manufacturer, commercial credit corporations, and commercial banks.

Generally, this financing method requires a large down payment on the equipment to assure continued payments. The equipment is usually pledged as collateral so the loan's outstanding balance always is expected to be less than the asset's value. The lender normally retains the option to repossess in case of default.

When considering this type of financing the accountant should determine that the cash flow is likely to be sufficient to make the periodic payments required.

4.3 Lease Financing

Lease financing has become increasingly popular in recent years. It allows a company to acquire equipment or plant assets without a large required down payment. Banks, insurance companies, and specialized leasing companies all provide this type of financing.

Leasing can be used to acquire equipment temporarily or permanently. A true lease (or operating lease) typically has a shorter term with ownership of the equipment remaining with the lessor at the end of the lease. A finance (or capital) lease is generally characterized by a longer term and a bargain purchase option that may vest the ownership in the lessee.

There are many reasons why an equipment user might decide to lease rather than buy:

— A lease arrangement eliminates a large down payment, thereby maximizing the amount of funds available to the company in the short term.

— A lease is often more easily obtained than other credit sources, because the leasing companies have the security of actually owning the equipment.

— Lessors are often responsible for servicing any equipment leased, thereby eliminating concerns about technical and administrative services.

— Leasing eases concerns about obsolescence.

— Leasing may allow a company to take advantage of the tax benefit of faster writeoff of the lease payment compared to the current tax depreciation allowances.

As a financial adviser, one should also weigh the disadvantages of leasing:

— The firm loses the opportunity to take advantage of any increases in the resale market price that might exist at the end of the lease unless it also has an option to purchase at a fixed price.

— For companies that can obtain other financing easily, leasing equipment is generally more costly than borrowing to pay for it.

— Because the lessee does not actually own the equipment, problems with replacement equipment at the end of the lease or lessor interference with the equipment's use during the lease may arise.

4.3.1 Lease accounting rules: FASB 13

Before counseling a client as to the effects of a leasehold, the accountant must be familiar with Financial Accounting Standards Board (FASB)

Statement 13. This statement provides that a lease may be treated as either a capital lease or an operating lease, depending on the terms of the lease. Where the risks and benefits of ownership are passed on to the lessee (a capital lease), the lessor must treat the lease as a sale or a financing transaction. The lessee must treat the lease as an acquisition of an asset with a corresponding liability.

To ensure that the lease will qualify for tax treatment as a lease, it must follow the guidelines set forth in Revenue Procedure 2001-28 (2001-19 C. B. 1156). An awareness of the IRS requirements will help the accountant structure the lease agreement so that potential IRS problems will be minimized.

Under the IRS guidance in Revenue Procedure 2001-28, the lessor is required to represent and demonstrate certain facts relating to the estimated fair market value and estimated remaining useful life at the end of a lease term. The intention of this requirement is to assure that the purported lessor has not transferred the use of the property to the purported lessee for substantially its entire useful life. The IRS guidance goes on to indicate that in the case of "limited use" property, at the end of the lease term, there will probably be no potential lessees or buyers other than members of the original lessee group. As a result, the lessor of such limited use property will probably sell or rent the property to a member of the lessee group, thus enabling that taxpayer to enjoy the benefits of the use or ownership of the property for substantially its entire useful life. The IRS has indicated it will not issue advance rulings concerning whether certain transactions purporting to be leases of property are, in fact, valid leases when the property is limited use property.

> *Example:* Acme builds a masonry smokestack attached to a masonry warehouse building owned by Baker, and leases the smokestack to Baker for use as an addition to the heating system in the warehouse. The lease term is 15 years; the smokestack has a useful life of 25 years, and the warehouse has a remaining useful life of 25 years. It would not be commercially feasible to disassemble the smokestack at the end of the lease term and reconstruct it at a new location. Accordingly, the smokestack would be considered to be limited use property.

4.3.2 Analysis of leasing costs

In analyzing the lease costs, a discounted cash flow analysis should be used to compare the after-tax cash flows of leasing with other financing alternatives, with a present value approach applied to each alternative. This method allows the accountant to determine the present value of the net after-tax cost of each alternative. (Software is available to assist in lease-versus-buy calculations and FASB 13 calculations.)

The true lease cost must include any front- or back-end charges, any nonrefundable fees, applicable sales tax, and any commitment fees that must be paid. Some leases may allow a purchase at the end of the lease at a fixed amount or at fair market value.

4.4 Government Lending Programs

Several governmental agencies provide financial assistance to businesses. The accountant must be aware of the financial opportunities made available by the state and local governments. Similarly, minority-enterprise small business investment companies can provide a financing source if the company qualifies.

4.4.1 The Small Business Administration (SBA)

The Small Business Administration (SBA), an agency of the federal government, provides business loans to small businesses. In order to be considered by the agency, a small business must be a for-profit business that is independently owned and operated.

4.4.1.1 Eligibility requirements

Criteria used in determining whether a business qualifies as a *small business concern* include the following:

— Number of employees

— Dollar volume of business

— Type of industry in which the business is competing (Some industries, such as newspaper publishing, are not eligible.)

— The business not dominant in its industry

— Liquidity levels (If either the company or its guarantors have excess liquidity, the company would be ineligible.)

4.4.1.2 Guaranteed loan programs

The SBA does not generally provide direct loans to small businesses. The SBA will guarantee loans to small businesses if other financing is not available. The SBA loan program, the "7A Program" is one of the most common SBA financing packages. These guarantees are generally limited to 75 percent of the loan amount up to an aggregate ceiling of $750,000 per company. Some loans under $150,000 may obtain an 85 percent SBA guarantee.

Credit terms for SBA loans are similar to those for any good bank customer. Interest rates normally fluctuate, based upon the prevailing prime rate. Common maturities are as follows:

— Working capital	up to 7 years
— Equipment	up to 10 years
— Real estate	up to 25 years

Loans with combined purposes generally are set up with a melded term. Loan proceeds cannot be used to finance changes in ownership among family members.

In addition to the 7A Program, the SBA offers additional guaranteed loan programs designed to meet the specialized needs of small businesses as follows:

1. Low Documentation (Low Doc) Program, designed to streamline and expedite the loan process for loans up to $150,000.
2. CAPlines Program, offering various lines of credit for working capital needs of small businesses.
3. SBAExpress Program, allowing traditional lenders to use their own forms and approval process for loans up to $150,000.
4. International Trade Loan Program, for facility loans and working capital needs of businesses involved in international trade.
5. Export Working Capital Program (EWCP), providing short-term working capital for exporters.
6. Microloan Program, providing small loans for up to $35,000 for working capital needs.
7. Prequalification Pilot Loan Program, targeting disadvantaged borrowers for new and emerging businesses for real estate and working capital loans.

The SBA requires a *new company* requesting SBA financing to have adequate capital to invest in its own business. For example, a borrower is often expected to contribute one-third to one-half of the total funds needed to start a new business. For an *existing business* applicant, the SBA places more emphasis on the company's credit factors. In all cases, loan repayment is expected to be made from business profits. A projected cash flow statement is, therefore, a necessary component of the SBA application.

The SBA loan application process can require a significant investment of time. In most cases, banks recommend having an accountant assist in preparing the application. Inaccuracies in the application, or incomplete data, could disqualify the applicant from obtaining SBA funds.

See the *Accountant's Business Manual Toolkit CD-ROM* for Appendix 1, "Personal Financial Statement Form," and Appendix 2, "Statement of Personal History Form," from the SBA. For more information and useful forms, go to the SBA Web site at www.sba.gov.

4.4.2 SBA Disaster Business Loans

SBA Disaster Business Loans are available to any large or small business located in a declared disaster area which has suffered physical damage, or a small business which has sustained economic injury after a disaster; the business owners may be eligible for financial assistance from the U.S. Small Business Administration. The business may apply for a low-interest loan to repair or replace damaged property.

Even if the property was not damaged by such a disaster, the small business owner may be eligible to apply for a working capital loan from the SBA to relieve any economic injury caused by the disaster.

4.4.2.1 Physical Disaster Loans

Businesses of all sizes may apply for a Physical Disaster Loan of up to $1.5 million to repair or replace damaged real estate, equipment, inventory and fixtures. The loan may be increased by as much as 20 percent to protect the property against future disasters of the same type. These loans will cover uninsured or under-insured losses.

4.4.2.2 Economic Injury Disaster Loans (EIDL)

Small businesses and small agricultural cooperatives suffering substantial economic injury may be eligible for an Economic Injury Disaster Loan of up to $1.5 million to meet necessary financial obligations—bills the company would have paid if the disaster had not occurred.

4.4.2.3 Interest Rates

The interest rate on both these loans is 4 percent if one has no credit available elsewhere. Repayment can be up to 30 years, depending on the business(s ability to repay the loan. For businesses and non-profit organizations able to obtain credit elsewhere, the interest rate must not exceed the interest rate charged in the private market at the time of the disaster or 8 percent, whichever is less.

4.4.2.4 Application Information

Businesses may apply directly to the SBA for possible assistance. Downloadable forms are available at: www.sba.gov/disaster_recov/. In addition to the loan form, a business owner is required to supply copies of their federal income tax information for the 3 most recent years, a short history of the business, and personal and business financial statements. The SBA must review the financial statement and one for each partner, officer, director and stockholder with 20 percent or more ownership. The SBA requires the principals of the business to personally guarantee repayment of the loan, and in some instances to secure the loan by pledging additional collateral. For more information about SBA disaster assistance for businesses, call toll-free at 1-800-659-2955.

The disaster loan is intended to help restore property to pre-disaster condition, and, under certain circumstances, to protect the structure from future disasters. These funds cannot be used to upgrade or expand a business unless required by city or county building codes.

The SBA can refinance all or part of a previous mortgage in some cases when the applicant does not have credit available elsewhere, has suffered uninsured damage (40 percent or more of the property value), and intends to repair the damage. Specifics are available from an SBA disaster loan officer.

For physical disaster loans, amounts over $10,000 must be secured. EIDL loans over $5,000 must be secured. The SBA won't decline a loan if the business owner doesn't have enough collateral, but will ask for whatever collateral is available. That usually consists of a first or second mortgage on the damaged business property.

One may apply for an SBA disaster loan to cover the damage to their home and its contents only. One may want to contact the U.S. Department of Agriculture for recovery assistance for a farm.

The loan will provide operating funds until the business recovers. One may use the loan to make payments on short-term notes, accounts payable and installment payments on long-term notes. One may request an EIDL for the amount of economic injury and operating needs, but not in excess of what the business could have paid if the disaster had not occurred. The SBA will not refinance long-term debts or provide working capital needed before the disaster.

Neither lack of profit nor loss of anticipated sales alone is enough to establish substantial economic injury. Substantial economic injury is defined as the inability to meet current obligations because of the disaster, and indicators may include a larger-than-normal volume of receivables, a lower sales volume, and delinquencies in debt payments.

4.4.3 SBICs and MESBICs

The SBA also licenses, regulates, and provides financial assistance to small business investment companies (SBICs) and minority-enterprise small business investment companies (MESBICs). These investment companies provide advisory services and venture capital in the form of long-term loan funds and equity financing to small business concerns and small companies owned by minority owners who are economically disadvantaged.

These companies provide loans either directly or on a participation basis. The maximum interest rate charged is determined by the SBA. The maturity date cannot exceed twenty years, subject to an extension or renewal limitation of an additional ten years.

General requirements for obtaining SBA financing include

— Adequate collateral to protect the government interest.
— Earnings projections sufficient to make loan repayments.
— A demonstration that the company will not be able to receive funds from conventional sources at reasonable terms and rates.
— A showing that adequate collateral will be available to cover the loan.
— A brief company history including products and services provided.
— Management personnel's and principal shareholders' backgrounds.

With these requirements in mind, local offices also provide the necessary forms for loan applications and detailed information about the current status of these programs.

4.4.4 VA and USDA

Financial assistance is also available through programs administered by the Veterans Administration (VA) Office of Small and Disadvantaged Business Utilization and the United States Department of Agriculture (USDA). Certain borrowers may qualify for assistance through the VA and USDA (formerly the FmHA) programs, depending upon financing needs, income levels, and other factors. Information on VA loan qualifications is available at www.va.gov. Information on USDA loan qualifications is available at www.usda.gov.

4.4.5 Industrial revenue bonds

Industrial revenue bonds are issued by state or local economic development authorities. Such states and localities are able to issue tax-free bonds to support projects that create or retain jobs. The borrower in such a case arranges for a lender (usually a bank) to accept the mortgage on the equipment or building to be acquired. The state or locality then sells tax-exempt bonds to the lender to be used only for acquiring the building or equipment. Only the underlying assets and rentals charged for the asset use are applied to retire the bonds, and as such, the bonds are not the responsibility of the state or locality.

The primary advantage to the lender is that the interest on these bonds may be exempt from federal taxes. The advantage to the borrower is that the interest rate is normally around 65 percent to 75 percent of the prime rate, rather than one or more points over the prime. States and municipalities use this program to add employment or maintain jobs that might be lost, thus enhancing their tax bases.

4.4.6 State and local programs

Various financial programs are available through state and local governmental units. These financing sources realize that granting funds will normally create employment opportunities in their area and an attendant increased tax base. The local Chamber of Commerce or economic development organization is a good source to locate financing programs in a particular area.

4.5 Business Development Corporations

Business development corporations (BDCs) are private organizations that lend to companies that do not qualify for standard types of financing. BDCs are attractive because they are more flexible than other financing sources. For instance, a loan can be unsecured or secured. Also, a BDC can provide purchase and sale leasebacks in addition to granting loans that are guaranteed by the SBA. Generally, the interest rate is 2 to 4 percent above the prime rate with an average term of four to ten years. Not all states have BDCs.

4.6 Community Development Companies

Community development companies (CDCs) share the same objectives as BDCs, except that CDCs are nonprofit organizations. Financing is generally developed through SBA-guaranteed loans; therefore, this financing source is not as flexible, because the SBA criteria apply. CDCs' focus is to promote economic development in communities.

5. LONG-TERM DEBT FINANCING

Long-term debt has many forms and may be an advantageous financing method for long-term needs for several reasons:

— Interest payments may be tax-deductible.

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— In inflationary periods, it will benefit the firm to pay interest and principal with inflated dollars.

— By obtaining debt rather than equity financing, the control of the business is not diluted.

— In periods when extraordinary profits are earned, the creditors do not participate.

In certain circumstances, long-term debt may have some disadvantages. For instance, long-term debt requires a repayment schedule that must be honored regardless of cash flow. In times of economic hardship, the borrower must make the loan payments or face potential default. If other financing alternatives might later become more attractive, a prepayment provision should probably be included in the debt agreement.

5.1 Instruments of Long-Term Debt Financing

Although there are many types of instruments that may be used for long-term debt financing, this section discusses the two main types: bonds and mortgages.

Long-term financing can also occur through an installment purchase of property, with the seller acting as the lender in the transaction. Negotiation of an installment contract may result in a lower interest rate than is available through other financing sources.

In all cases of long-term borrowing, the lender will consider the following:

— The borrower's net earning power

— Management's capability

— Both the company's and the industry's long-range prospects

5.1.1 Bonds

A bond is an interest-bearing debt certificate with agreed maturities. It is a promise to pay a certain amount of money with payments of principal and interest at agreed dates. Most bond certificates also include an *indenture,* which is a rather elaborate legal instrument representing the collective security of all bondholders holding bonds of a single issue. The indenture describes and restricts the general bondholder's rights and must comply with the terms of the Bond Indenture Act of 1959. Most indentures contain two parts. The first part covers agreements between the borrower and the bondholders as to how the business will be conducted. The second part specifies how the bondholders will be protected if the borrower defaults.

Although bonds may provide the corporation with a significant capital source, their use increases the amount of risk. Because their payment provisions are not flexible, bonds increase the pressure on management to realize current operating profits to provide funds for bond payments.

Certain bonds are also convertible (i.e., a privilege exists to convert the bonds to common stock at a future point). Other bonds are redeemable, allowing the company issuing the bonds to redeem them at specified points. The bond interest rate will reflect these various features. A lower interest rate may be required if a convertible feature exists, whereas a higher interest rate may be required with a redeemable feature.

Example: Elda, Inc., has issued a series of corporate bonds at a 7 percent interest rate. The bonds are for a period of 10 years and require quarterly payments of interest, with full payment of principal at maturity.

Elda also issues a series of 10-year bonds, but these bonds contain the privilege for Elda to redeem them at 24-month intervals (that is, two years after issue, four years after issue, and so on). Because Elda has the privilege of redeeming these bonds before the full 10-year maturity date, Elda will likely have to pay a somewhat higher interest rate (for example, 7.5 percent) on the bonds that contain the redeemable feature.

5.1.2 Mortgages

A mortgage is a security device allowing one to borrow money by pledging property as security. A mortgage has three characteristics:

1. The lender's interest in the property ends when the obligation is fully paid.
2. The lender has a right to foreclose on the mortgage should the debtor default.
3. The debtor has a right to redeem or regain the property.

Any form of property with marketable value can generally be mortgaged. The debtor need not have complete ownership, since any owned interest may be mortgaged. As a rule, mortgages should be recorded to prevent questions at a later date regarding the parties' intentions.

5.1.2.1 Points

With certain mortgages, a borrower must pay points when arranging the mortgage. Points are an additional cost to the borrower, and basically represent a fee paid for the privilege of obtaining the mortgage.

Points are normally represented as a percentage of the mortgage amount. For example, one point on a $50,000 loan would require the borrower to pay $500 at the time of executing the mortgage. Four points on a $100,000 loan would require the borrower to pay $4,000 at the time of executing the mortgage. Since points represent an additional cost to the borrower, they should be considered in calculating the effective interest rate of the mortgage.

5.1.2.2 Adjustable rate mortgages (ARMs)

Many mortgages offered today allow the interest rate to be adjusted over the mortgage term. These are known as *adjustable rate mortgages (ARMs)*. Under an ARM, the mortgage is executed for a certain time period—for example, fifteen years. However, the interest rate can change at certain terms throughout the mortgage, such as annually, every five years, or even in relation to various targeted interest rates, such as the prime rate.

The disadvantage of an ARM to the borrower is that the interest rate over the mortgage life is unknown, and certain risks are assumed in that the interest rate could rise significantly over the loan term. However, ARMs exist in several varieties, many of which have ceilings above which the rate cannot go or points beyond which the rates cannot rise within a given time period.

5.1.3 Common and preferred stock

Even though a stock sale is not generally a financing tool but rather an equity investment to raise funds, a brief mention is necessary. Generally, a common or preferred stock sale is a method of raising capital for a start-up business, thereby forming a basis for future borrowings. Rather than periodic interest charges, investors expect a dividend return or capital appreciation in the stock. The biggest disadvantage to obtaining funds through equity offerings is that interest payments are tax deductible whereas dividends are not.

> *Example:* Assume that Flowers, Inc., borrows $100,000 from the bank at an 8 percent interest rate. The $8,000 of interest expense paid annually by Flowers is deductible for tax purposes.
>
> Alternatively, if Flowers issued common or preferred stock and paid an equivalent dividend (8 percent) on the stock, the dividend payment would not be deductible by Flowers for tax purposes. So the disadvantage to Flowers in the equity offering is that the dividend payments are not tax deductible, whereas the interest payment on the debt would be deductible to Flowers for tax purposes.

5.1.3.1 Initial public offerings (IPOs)

Initial Public Offerings (IPOs) are issues from companies that first go public. When new shares are offered to the public, there is a spread between what the underwriters buy the stock from the issuing corporation for and the price at which the shares are offered to the public. This spread between the underwriting proceeds (the amount paid to the issuing corporation) and the price at which the shares are offered to the public covers various costs, including management costs for negotiating and managing the offering, underwriting fees for assuming the risk of buying the securities from the issuing corporation, and selling commissions.

Investing in IPOs tends to be a risky investment. Some issues appreciate materially very quickly, while other companies fail and the value of the stock decreases significantly. Shares of IPOs are often hard to purchase, as the managing underwriter reserves these shares for the best customers.

IPOs represent a method for a corporation to obtain capital, although significant costs are normally associated with bringing the stock to market. In addition to the management and underwriting costs previously discussed, significant professional fees, including legal and accounting fees, are normally associated with bringing an issue to market. Stringent SEC rules apply to new stock issues.

6. EMPLOYEE STOCK OWNERSHIP PLANS (ESOPs)

Another financing alternative available is employee stock ownership plans. This financing source may also serve to improve labor relations and reduce employee turnover. Because many plans allow favorable tax treatment under the Internal Revenue Code, many businesses now provide these programs. This discussion deals with each of the basic forms of ESOPs separately.

6.1 Nonleveraged ESOPs

Under a nonleveraged ESOP, a corporation must contribute shares of its own stock or cash to purchase outstanding shares. The contribution is then held in trust with the employees becoming the beneficiaries. The corporation is allowed a tax deduction equal to the fair market value of the shares contributed.

The trust must hold the contributed stock in individual accounts and may not distribute the stock until vesting requirements are met and there is a separation from employment. The employee is not taxed until the distribution is received.

The firm receives a tax deduction without decreasing its working capital. In addition, the company benefits from greater worker incentive, resulting in better productivity and loyalty, because the employees receive an interest in the company. The negative aspects of this arrangement include dilution of stock ownership as well as the initial expenditure of purchasing stock for the trust.

If stock rather than cash is contributed to the plan, the cash flow benefits can be substantial. For example, a contribution of stock produces the same tax deduction as does a cash contribution, but without the cash outflow.

Shareholders of privately held companies operating as C corporations may achieve nonrecognition of their gain through deferral upon sale of their shares to an ESOP. Immediately after the sale, the ESOP must own at least 30 percent of the outstanding securities, and the selling shareholder must purchase "qualified replacement property" within twelve months. For further information see the reference section at the end of this chapter and the section on ESOPs in the chapter of this manual titled Employee Retirement and Deferred Compensation Plans.

6.2 Leveraged ESOPs

The primary difference between a leveraged ESOP and a nonleveraged ESOP is that the leveraged ESOP may borrow funds to purchase stock of the sponsoring corporation. The trust may purchase shares in the corporation and have the corporation guarantee loans for the purchase. Also, the trust may make installment purchases from other shareholders.

Leveraged ESOPs have become a popular financing device for leveraged buyouts (LBOs). LBOs typically involve three levels of financing. A bank (or other financial institution) provides to the buyer a major portion of the acquisition price. The bank's position constitutes the top tier of the financing and is secured by the assets and, particularly, by the corporation's cash flow and earning power. Equity investors, looking for high annual returns, provide the bottom tier of the financing. In a predictable income and cash flow situation, equity investment will ordinarily be about 20 percent of the firm's value. The middle tier may be provided by notes taken back by the seller, by third parties willing to invest or lend on a subordinated basis, or by an ESOP.

Leveraged ESOPs must be invested in common stock. If there is more than one class of common stock, then the common stock owned by the ESOP must have the highest dividend and voting rights of all other classes of common stock. Leveraged ESOPs usually acquire a large block of stock at their inception, financed with an "exempt" loan (that is, a loan that is exempt from the general prohibition on borrowing by a tax-qualified plan imposed by IRC Sec. 4975). The stock is held as collateral while the company makes loan installment repayments. Shares are released in proportional allocations to employees' accounts as the loan is repaid. Appreciation on the collateralized shares, in effect, belongs to the employee-shareholders and not to the company. Thus, the possibility of using the appreciation as a tax deduction has been lost. Therefore, a strongly growing company might prefer to fund a nonleveraged ESOP each year by contributing its increasingly valuable shares and, consequently, earning larger tax deductions (up to the statutory limit).

Interest on the ESOP debt repayment is tax deductible and, in certain cases, principal payments are tax deductible under IRC Sec. 404(a)(9).

The company could also pay dividends to the ESOP. Dividends paid by a C corporation that are used to make loan payments on an exempt loan are tax deductible. Also, cash dividends paid to a participant are deductible by the employer and taxable to the employee, not as wages subject to payroll taxes, but as a dividend distribution. The ten percent early distribution penalty does not apply to the dividend distributions to an employee.

The company's assets and earning power are at risk for the ESOP debt repayment. Thus, default could place the company in bankruptcy. Privately held companies must give their employees (and their heirs) a *put,* which is the right to sell their stock to the company at its current value. (IRC Sec. 401(a)(28)(C) mandates an annual appraisal of the fair market value of closely held securities.) Growth of the company together with the aging of its labor force can create a "repurchase liability" for the puts that must be carefully monitored.

7. VENTURE CAPITALISTS

Although equity agreements are discussed in another chapter of this manual, venture capitalists merit mention here because they often provide funding where it may not otherwise be available. Most frequently, venture capitalists will look at small, high-growth-potential firms. Unfortunately, the cost of this type of financing, in terms of loss of control, is usually very high (to compensate for the risk involved). As a result, the option of involving venture capitalists should be considered only in circumstances where alternative sources are not preferable or possible. The company should also understand that venture capitalists are looking for a significant return on their investments within a relatively short time period (five to seven years), and this type of return can usually only be realized if the business is taken public. This financing type is advantageous because the company may grow rapidly rather than gradually with the additional investment.

Because venture capital is risky, investors will examine closely the company's attributes. In technically complex situations, a consultant may be hired to sort out the products and services marketed. The commonly reviewed attributes are

— The company's market size.

— The product's competitive condition.

— Production expense.

— Financial statements.

— The company's legal documents.

— Management's capability.

With regard to venture capital, corporate venture capital subsidiaries are another financing source. Typically, a large corporation sprouts a subsidiary company, thus cultivating future purchases and potentially becoming a new division of the corporation. This allows companies to gain openings into new technologies and markets and then to be assimilated into the corporation. Corporations may turn to this as a method to use excess space and surplus cash.

8. THE ECONOMICS OF REFINANCING

Once a financing decision has been made, the borrower should be advised that the decision is not necessarily final. For instance, if funds are necessary when interest rates are high, the borrower should be aware that a rate decrease may make refinancing less expensive than repayment according to the original agreement terms. This is why it is important, especially in times of high interest rates, to incorporate into the financing arrangement provisions that will keep the costs of refinancing down.

For example, assume a company obtains financing through a bond issue at a high interest rate and, subsequently, bond market interest rates decline. If the original bond issue includes a call provision, even with a redemption premium, refunding by issuing a second series of bonds at a lower interest rate to replace the earlier issue may significantly decrease the total expense of financing.

The interest rate is not the only factor to be considered in refinancing. Other issues to consider involve the costs of repaying the first financing source and of securing a second source, which includes the following:

— Are there any penalties for prepayment?
— Is prepayment possible under the agreement terms?
— What are the costs of securing a new financing source?
— Are there other hidden costs, including loss of the client's management time?

All the "extra" costs may make refinancing more expensive than it might appear at first. Therefore, when obtaining financing in times of high interest rates, the borrower should try to negotiate terms that will reduce the termination cost if interest rates decrease.

9. THE IMPORTANCE OF FINANCIAL STATEMENTS

Creditors often decide to provide financing based on the debtor's financial statements. In the case of a personal guarantee, the guarantor's financial statements will be examined. The accountant, as adviser, must understand fully the nature and use of financial statements that may need to be furnished to the creditors.

9.1 Procedure of Creditor Analysis

Creditors typically follow a procedure in business analysis that includes the following:

— An examination of the income tax returns, balance sheets, and income statements for the past three to five years
— A credit check, often done by a professional agency, on the business as well as any guarantors
— An examination of the collateral to serve as protection for the amount of funds loaned and, possibly, an outside appraisal
— A cash flow analysis for prior and, possibly, future years
— An analysis of the financial ratios of the business
— A check that the company is properly incorporated
— An indication of the company's management capabilities

The tax returns and financial statements are examined not only to get an overall picture of the business but also to uncover any recent developing trends. A credit check, on the other hand, determines the borrower's solvency. Similarly, a cash flow projection for future years helps assure the lender that the borrower will have enough cash on hand to repay the obligation. (Financial ratio analysis is discussed in the following subsection.) An assurance of proper incorporation safeguards the lender against fraudulent loans and is evidence of a proper business purpose. Because of their direct relationship on profitability, an understanding of management's capabilities is very useful.

9.2 Creditor Analysis of Financial Ratios

Financial ratio analysis allows a comparison of the company's financial strength with other comparable companies. Several software programs have been developed to facilitate the full analysis of various financial ratios. Reasons for analyzing ratios are discussed further in section 2.4.2 and in the Business Performance Measures chapter.

The ratios most commonly examined by creditors are liquidity ratios and financial position ratios.

9.2.1 The current ratio

The current ratio is the ratio of current assets to current liabilities. For example, if current assets amount to $500,000 and current liabilities are $100,000, the current ratio would be 5-to-1.

Examination of the current ratio helps to determine whether a company will be able to pay its current liabilities. This ratio shows the firm's short-term liquidity by disclosing the extent to which short-term creditors' claims can be matched to assets that may easily be converted to cash.

The "acceptable" current ratio to creditors varies according to the company, industry, and the season of the year, among other factors. For instance, in the industrial field, a 2-to-1 ratio is often thought of as being appropriate, while a 3-to-1 ratio may be necessary for a trade firm since there is a greater need for inventory and receivables. A company with a more rapid asset turnover will generally require a lower current ratio than one with a slow turnover.

9.2.2 Debt-to-total-assets ratio

The debt-to-assets ratio is determined by comparing all the debt to all the company's assets. This ratio represents the amount of total assets claimed by the owners over and above the amount necessary to totally repay the creditors. This ratio is used to help measure the soundness of the company.

Example: Lily, Inc., has total assets of $500,000 and total debt of $250,000. Lily's debt-to-total-assets ratio can be calculated as follows:

$$\text{Debt-to-total-assets ratio} = \frac{\text{Total debt}}{\text{Total assets}}$$

$$\text{Debt-to-total assets ratio} = \frac{\$250{,}000}{\$500{,}000} = .5$$

9.2.3 Debt-to-equity ratio

Another ratio used to calculate the firm's soundness is the debt-to-equity ratio, which may be arrived at by dividing total liabilities by total equity. The industry norm will vary directly in relation to the expected stability of the firm's earnings. For example, because many public utilities are safe companies with steady earnings, a debt-to-equity ratio of 60 to 70 percent may be considered acceptable. In industries in which earnings are less stable, a much lower debt-to-equity ratio will be necessary for creditor approval.

To calculate the debt-to-equity ratio, various adjustments for determining the total business debt may be required. For example, debt may include items such as deferred taxes and subordinated debt to the business owners, which may need to be removed from total indebtedness to allow proper calculation of the ratio.

Example: Lily, Inc., has total equity of $1,000,000 and total debt of $250,000. Lily's debt-to-equity ratio can be calculated as follows:

$$\text{Debt-to-equity ratio} = \frac{\text{Total debt}}{\text{Total equity}}$$

$$\text{Debt-to-equity ratio} = \frac{\$250{,}000}{\$1{,}000{,}000} = .25$$

9.2.4 Times-interest-earned ratio

Yet another measure of long-term solvency is the times-interest-earned ratio. This ratio is calculated by dividing net income before interest and income tax expense by the amount of interest expense. The ratio is used to assess the probability that the firm may default on the loan for failure to meet the required interest payments. This ratio is especially important to those seeking long-term credit, because interest payments must be made to these creditors from operations over a long period of time.

9.2.5 Quick ratio or acid-test ratio

The quick ratio is determined by taking the cash and equivalents plus net trade receivables and dividing by the amount of current liabilities. Often, this ratio should equal at least 1.0 or better. If there is a very high inventory-turnover rate, a lower quick ratio may be acceptable.

Example: Linc, Inc., has total current assets of $350,000, which includes $100,000 of inventory. The corporation also has current liabilities of $100,000.

The quick ratio is a measure of liquidity that does not include inventory in the current assets, defined as follows:

$$\text{Quick ratio} = \frac{\text{Current assets} - \text{inventory}}{\text{Current liabilities}}$$

$$\text{Quick ratio} = \frac{\$350{,}000 - \$100{,}000}{\$100{,}000} = 2.5$$

9.2.6 Inventory-turnover ratio

The inventory-turnover ratio is considered an important ratio because it shows how well the company uses the resources at its command. The inventory-turnover ratio equals total cost of sales divided by total inventory. A high inventory-turnover ratio will be evidence that the company does not hold excess inventory stock, and thus that it has better (higher) liquidity. On the other hand, the ratio can indicate an inventory shortage when demand is high. A low ratio implies poor liquidity, overstocking, inventory buildup, or obsolete inventory. Regardless of inventory level, the computation does not account for seasonal fluctuations that can affect the ratio analysis.

Example: Linc, Inc., has total cost of goods sold for the year of $2,000,000 and average inventory of $250,000. Linc's inventory turnover can be computed as follows:

$$\text{Inventory turnover} = \frac{\text{Cost of goods sold}}{\text{Average inventory}}$$

$$\text{Inventory turnover} = \frac{\$2{,}000{,}000}{\$250{,}000} = 8.0$$

9.2.7 Return on assets

Net income divided by total assets yields the company's return on assets. This formula reflects the earning power and effective use of all the company's resources. A heavily depreciated company or a large intangible asset amount can distort this ratio. Consequently, these points need to be considered during the analysis.

9.2.8 Net-income-to-sales ratio

Also called the profit margin ratio, the net-income-to-sales ratio helps measure the company's profitability prospects. Profitability ratios show how effectively management is running the company, and this particular ratio measures the level of protection against losses that might result from increased expenses or falling prices.

9.2.9 Cost-of-sales-to-payables ratio

The cost-of-sales-to-payables ratio indicates the number of times trade payables turn over during the year. If the ratio is high, the time between purchase and payment is shorter. If the ratio indicates a slow payable turnover compared to that of other industries, this may signify that the company has potential cash shortages and possible invoice disputes with suppliers having extended terms or deliberately increased trade credit. Therefore, if a company purchases on thirty-day terms, typical payable turnover will be thirty days.

9.2.10 Debt-to-net-worth ratio

Debt-to-net-worth ratio represents the amount of capital contributed by the owner set against that contributed by creditors. If the ratio is high, the creditor is acquiring the burden of risk. A low ratio gives the company the advantage to borrow in the future.

9.3 How Creditors Use Ratio Analysis

In a normal loan situation, a creditor may adopt the following credit analysis procedure: the current ratio to determine short-term solvency, the profit-margin ratio to determine the company's future prospects, and the debt-to-assets ratio to ensure that any credit extended is likely to be covered by assets. Accordingly, when applying for financing, a company should provide any information that might explain an unacceptable ratio and give the lender confidence that the ratio is not a matter of great concern.

Various sources of standard industry ratios exist, such as the Risk Management Association's (formerly the Robert Morris) *Annual Statement Studies* or Dun & Bradstreet's *Key Business Ratios.* With these sources, the ratio of a particular business can be compared to industry averages. In this manner, ratios can be determined to be unacceptable or out of line and, in such cases, the additional note of clarification should be added. More information is available at www.rmahq.org and at www.dnb.com.

10. THE FINANCING PROPOSAL PACKAGE

Once a proposed funding plan has been decided, the formal funding proposal package should be completed. This package will be submitted to the selected funding source.

Because the funding proposal package will contain information enabling the potential lender to make a decision, the information should be very specific and thorough. The information submitted should include

- Budgets and projections, including possible budgets from past periods and comparison of actual to budget.
- Repayment schedule, along with cash flow projections and other repayment provisions.
- Past earnings history and historical financial data, with a thorough explanation of any losses or unusual events in past years.
- Information about key management personnel, including, for example, age, experience, and education.

The financing proposal package should also include information on accounts receivable aging, documentation regarding receivable amounts of major customers, evidence of high-risk collection amounts, and any notes receivable. Also included should be inventory-related information, such as inventory aging, inventory turnover, price stability, and so forth. Market and appraised value of investments and fixed assets should be included, along with explanations of all liabilities.

Additionally, there should be clear specification of the collateral being offered, along with personal financial statements of all key personnel, if personal guarantee agreements are to be used.

It is important to provide the lender with as much useful information as possible, including information about any unfavorable items, so that the client can address such unfavorable items.

If a lending institution grants a loan, typically the lending policies will be somewhat formal. The loan agreement may specify the following items:

- Working capital must be maintained at a specified minimum amount.

— Audited or reviewed financial statements must be furnished at periodic intervals.

— Restrictions on items such as dividend payments, merger or consolidation agreements, prevention of any additional indebtedness, prevention of capital expenditures in excess of a specified amount, and prevention of officer loans.

It is extremely important to accurately determine financing requirements. The cash flow projections and net income projections that are completed for the proposal package should clearly indicate the maximum financing amount required. Extreme caution should be exercised against underestimating the amount of financing required. Businesses with insufficient financing may experience significant problems in cash flow and growth.

If stockholder or similar loans currently exist in the company, the bank may require such loans to be subordinated to the bank indebtedness. Similarly, the bank may restrict loans from a company to an officer, and may subordinate loans from the officer to the company.

11. INTEREST RATE SWAPS

The climate of historically low interest rates has led to a desire by borrowers to lock in fixed rates of interest, while banks are reluctant to enter into fixed rate loans. This tension between borrowers and lenders has led to the increased popularity of notional principal contracts, commonly referred to as "interest rate swaps." An interest rate swap involves an agreement between the borrower and a third party (swap party) to pay interest on a notional (that is, fictional) principal amount that tracks the principal amount of the underlying loan. For example, assume that the borrower desires to borrow $100,000 at a fixed rate of interest of 5 percent per year, repayable over 15 years. A bank may be unwilling to lend at a fixed rate for 15 years, but may be willing to lend the funds at an interest rate equal to the prime rate plus 2 percent. The borrower may be able to accomplish its desires by entering into an interest rate swap whereby the borrower will pay the swap party an amount equal to 5 percent on a notional principal amount of $100,000 (which will be adjusted to reflect principal payments on the underlying loan), and the swap party will pay the borrower an amount equal to prime plus 2 percent on the same notional amount. By entering into the interest rate swap, the borrower has assured itself of the funds necessary to pay prime plus 2 percent, but has fixed its interest rate cost at 5 percent.

12. COLLEGE FINANCIAL AID

The majority of the chapter on obtaining financing is devoted to business indebtedness. This section, however, is devoted to the non-business financing of college education for family members. With the rising cost of tuition, the ability of an individual to obtain either direct aid or student loans often determines where a student can attend college.

The federal government is the most significant provider of aid programs, although colleges, states, and private employers also provide tuition funding. Aid provided through the Direct Loan (DL) program comes directly from the U.S. government, while aid provided through the Federal Family Education Loan (FFEL) program comes from banks and other private lenders. This section focuses on the various types of federal aid available. More information on federal aid programs may be found at the Department of Education's Web site, www.ed.gov.

12.1 Federal Grant Programs

A federal Pell Grant, unlike a loan, does not need to be repaid. Pell Grants are awarded only to undergraduate students who have not earned bachelor's or professional degrees. In some cases, however, a student enrolled in a post-baccalaureate teaching certificate program might receive a Pell Grant. The maximum award for the 2006–2007 school year, along with the 2007–2008 school year, is $4,050. The minimum award is $400. Though Pell Grants are the primary source of federal aid for low income students, the value of the grant hasn't kept up with tuition inflation. According to the College Board's 2006 Trends in Student Aid report, Pell Grants covered only 33 percent of the average cost of tuition fees, room and board at four-year public colleges in 2005–2006, down from 42 percent in 2001–2002. Twenty years ago, the maximum Pell Grant covered nearly 60 percent of that cost.

Pell Grants are based not only on financial need, but also on the cost of attendance at a college. The student's expected family contribution (EFC) determines the amount of this entitlement program up to the maximum award. Pell Grants are considered a foundation of federal financial aid, to which aid from other federal and nonfederal sources might be added.

Federal Supplemental Educational Opportunity Grants (FSEOGs) are gift-aid for students with exceptional financial need. Pell Grant recipients with the lowest EFC qualify first for FSEOGs, which can be as much as $4,000 per student.

Federal Work-Study (FWS) awards are not entitlement payments. Rather, they compensate a qualifying student for part-time labor performed. FWS awards are at an hourly rate and are limited to the student's financial need.

12.2 Perkins Loans

A Federal Perkins Loan is a low-interest (5 percent) loan for both undergraduate and graduate students with exceptional financial need. Depending on financial need, the timing of a student's application, and the funding level of the school, a college may loan a student up to $4,000 annually using government funds with a maximum of $20,000 as an undergraduate. For a graduate student, this loan may be up to $6,000 a year (with a maximum of $40,000 including undergraduate loans). Repayment must begin within nine months of dropping below half-time enrollment status. Graduation or leaving school permanently also triggers repayment. Students are allowed up to ten years to repay the loan, and additional deferment possibilities exist.

12.3 Stafford Loans

Students who have unmet financial need after considering their EFC, Pell Grant, FSEOG, and other financial aid may obtain a subsidized Stafford Loan. Under a subsidized Federal Family Education Loan (FFEL) Stafford Loan, the government pays the interest during school, for the first six months after leaving school, and for any additional deferment periods. For Stafford Loans first disbursed between July 1, 1998 and June 30, 2006, the interest rate is adjusted annually, but will never exceed 8.25 percent. For all Stafford Loans first disbursed on or after July 1, 2006, the interest rate is fixed at 6.8 percent.

Unsubsidized Stafford Loans are not based on financial need. A student may obtain both a subsidized and an unsubsidized Stafford Loan in the same year. For dependent, undergraduate students, Stafford Loans are limited to—

— $2,625 for a first-year student.

— $3,500 for a student who has completed his or her first year.

— $5,500 per year if a student has completed at least two years and has a full year left in the course of study.

Independent undergraduate students (or dependents whose parents don't qualify for a parent loan [PLUS Loan; see section 12.4]) have higher borrowing limits under the Stafford Loan program, as follows:

- $6,625 for a first-year student
- $7,500 for a student who has completed his or her first year
- $10,500 per year if a student has completed at least two years and has a full year left in the course of study

12.4 Parent Loans for Undergraduate Students (PLUS Loans)

Parents who do not have an adverse credit rating may obtain a PLUS Loan to meet financial need. The yearly limit on a PLUS Loan is the cost of attendance less any other financial aid obtained. The interest rate is adjusted annually and may never exceed 9 percent. Interest is charged from the date of disbursement until the loan is repaid. Generally, repayment begins within sixty days of the final loan disbursement for the year. There is no deferral under this program.

12.5 Application for Financial Aid

Each of the above federal programs is based on a student's financial need. For the majority of colleges and universities, one application form covers the entire financial aid process. The Free Application for Federal Student Aid (FAFSA) is used by all schools to determine a student's expected family contribution (EFC).

Some institutions rely on Financial Aid Profile (PROFILE), an alternative application which is also referred to as the "institutional method."

FAFSA should be filed by all students at the beginning of each calendar year. Since many aid programs are disbursed on a first-come, first-served basis, early application ensures the best financial award. Further filing deadline information can be found on the FAFSA Web site.

FAFSA on the Web is an interactive Web page where one may complete the FAFSA online and submit the data over the Internet. The Web site is found at www.fafsa.ed.gov.

12.6 Expected Family Contribution (EFC)

The information submitted on a FAFSA is used to calculate the amount that the family is expected to contribute towards the cost of higher education. All accredited colleges use a standard federal formula (FM) to determine how federal funds are used to cover a student's cost of attendance. Certain private colleges use an institutional method (IM) to determine how the institution's own funds are awarded. The IM is more restrictive and considers the value of the family's residence, farm, and siblings' assets, which are not considered under the FM.

The EFC is composed of four essential elements: (1) parents' contribution from income, (2) parents' contribution from assets, (3) student's contribution from income, and (4) student's contribution from assets.

Parents' contribution from income is assessed at a maximum 47-percent rate. The starting point is parents' adjusted gross income (AGI) plus untaxed income and benefits. From this is subtracted a living allowance, federal income taxes, Social Security taxes, state taxes, and employment expense allowance.

Parents' contribution from assets is assessed at a 5.64-percent rate. Nonassessable assets include annuities, life insurance, retirement accounts, personal items, family farms, custodial Section 529 Plans owned by the parents, prepaid tuition plans and Coverdell Education Savings Accounts. An asset protection allowance is deducted, increasing with the age of the older parent. Graduated rates apply to the net worth of businesses and investment farm assets, which are not fully included until they exceed $430,000.

Student's contribution from income is assessed at a 50-percent rate. The starting point is the student's AGI plus untaxed income and benefits. From this are subtracted federal income taxes, Social Security taxes, and state taxes. A standard income protection allowance is also subtracted.

Student's contribution from assets is assessed at a 35-percent rate. All assets of the student are included in this calculation. Effective July 1, 2007, the student asset conversion rate will change from 35 percent to 20 percent.

The following table represents an outline of the federal formula for calculating the EFC:

(See table on page 50.1)

Expected Family Contribution (EFC)
College Financial Aid

(1)	(2)		(3)		(4)
Parents' AGI + untaxed income and benefits	– Living allowance Federal income taxes Social Security taxes State taxes Employment expense allowance	×	22%–47%	=	Parents' contribution from income
Parents' assets	– Asset protection allowance	×	5.64%	=	Parents' contribution from assets
Student's AGI + untaxed income and benefits	– Federal income taxes State taxes Social Security Income protection allowance	×	50%	=	Student's contribution from income
Student's assets	– Nothing	×	35%[1]	=	Student's contribution from assets
					Expected family contribution

[1]Effective July 1, 2007, the student asset conversion rate will change from 35 percent to 20 percent.

Other factors also affect the computation of the EFC, including household information (for example, whether parents are married, divorced, or separated; widowed or single), along with information on the number in household (for example, the number of people in the student's household supported by the parents and the number of the

(Text continued on page 51)

people in the household who will be enrolled in college in the same year as the student).

Example: If the Smith family had only one child (Suzie) in college, assume that Suzie's financial need would be $7,000. However, if brother Leo decides to enroll in college during the same year, the EFC is divided by two, and Suzie's financial need would increase to $11,000, as follows:

	Family Members in College	
	Suzie	*Suzie and Leo*
Cost of attendance	$15,000	$15,000
Less: EFC	(8,000)	(4,000)
Suzie's financial needs	$ 7,000	$11,000

Because the computation of the EFC is directly related to the income and asset amounts of the parents and child, various strategies to limit these amounts when completing the FAFSA form may be appropriate.

Example: If Suzie was applying for financial aid and had funds in a savings account, she may want to expend a portion of the funds for needed college supplies before completing the FAFSA application. As an example, Suzie might purchase the computer she needs for college, calculators and other tools, and necessary books and supplies. These purchases would reduce the savings account amount that is accessible for financial aid, resulting in a lower EFC amount for Suzie and a greater amount of financial aid.

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Business Valuation

BUSINESS VALUATION

1. INTRODUCTION

A business valuation is an opinion of the estimated value of an ownership interest in a company at a specific point in time. Business valuations are conducted for many purposes. A number of the purposes are discussed in section 3 of this chapter, including the sales and purchases of business enterprises, gift and estate taxes, divorce, valuing minority interests, and litigation. The accountant performing a business valuation must keep the following factors in mind:

— The *exact date* of the valuation

— The *purpose* of the valuation

— *What is being valued* (meaning, 100 percent of the stock of the company, a minority interest in the company, or a majority interest in the company)

— The *standard of value* (for example, fair market value, or fair value)

— The *methods* that are most appropriate, given the above

Business valuation is subjective and therefore by no means an exact science. Outside factors, such as market forces or limited salability, may affect a valuation to the extent that several different valuation methods will each yield different, yet entirely appropriate, results. Internal factors, such as the company's products and how the firm's future prospects fit into its industry, also affect the valuation. (For example, consider how differently a company would be perceived if it produced slide rules rather than electronic calculators.)

Unique facts and circumstances of each valuation determine the most appropriate, objective valuation methods to be used. Actual transactions in the company's stock are important, as are actual transactions in comparable companies (referred to as guideline companies). Conclusions need to be based on an unbiased, objective review of the facts and circumstances.

1.1 Scope

This chapter provides a basic understanding of the factors pertinent to performing an accurate business valuation and can serve as background on and a guide to valuation methods and techniques. This chapter describes—

— The purposes for which valuations are performed.

— The fundamental concepts of valuation.

— An overview of some methods and techniques of valuation and the subjective factors that affect the validity of each method.

— The standards and guidelines for valuing businesses as established by professional organizations.

CAUTION: Software is available to assist in performing valuations and preparing valuation reports. Great care should be exercised that the method used and the result of such programs are appropriate to the circumstances of the assignment and in keeping with business valuation standards.

Also, one must understand exactly how the software calculates values and must agree with each and every facet of such calculations in order for the appraiser to rely on its conclusions. In general, the appraiser should do the calculations and not rely on a "canned" approach.

1.2 Duty to Be Independent

It is important for the accountant to understand his or her role in performing a business valuation. The client may want the appraiser to advocate a position favorable to the client—in a divorce, for example. Nevertheless, the appraiser has a duty like that of an accountant in an audit—to be independent. The appraiser should look at the valuation questions from the point of view of a willing buyer and from the point of view of a willing seller, and then use judgment to reach an independent opinion. Once he or she has reached an opinion, it is his or her duty to advocate that opinion and to support it. See Section 11.5 for more information.

Under the Public Company Accounting Reform and an Investor Protection Act of 2002 (Sarbanes-Oxley Act), auditors of public companies under the jurisdiction of the Securities and Exchange Commission (SEC) are prohibited from rendering appraisal or valuation services to such clients. The General Accounting Office (GAO) has also imposed strict independence standards on auditors of entities subject to "single audit" reporting standards.

2. DEFINITIONS

The following definitions are used throughout this chapter and are listed here for easy reference. However, the reader is encouraged to consider the definitions within the context of the applicable discussions. The terms marked with an asterisk (*) are as defined by the American Society of Appraisers' (ASA's) Business Valuation Standard I, which provides uniform definitions of terminology used by professional business appraisers who are members of the ASA and is fast becoming the industry standard. (For more information on this organization, see section 12 of this chapter.)

***Appraisal.** The act or process of determining value. It is synonymous with valuation.
***Appraisal approach.** A general way of determining value using one or more specific appraisal methods (for example, asset-based approach, market approach, income approach).
***Appraisal method.** Within approaches, a specific way to determine value.
***Business appraiser.** A person who, by education, training, and experience, is qualified to perform an appraisal of a business enterprise and/or its intangible assets.
***Capitalization rate.** Any divisor (usually expressed as a percentage) that is used to convert income into value.
Closely held corporations. Corporations owned by a relatively small number of shareholders. The limited number of shareholders implies that the stock is not publicly traded in a free and active market (Rev. Rul. 59-60).
***Discount rate.** A rate of return used to convert a monetary sum, payable or receivable in the future, into present value.
Fair market value. Price for which property would change hands between a willing buyer and a willing seller if the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts (Rev. Rul. 59-60).
Going concern value. Value that takes into account the fact that a collection of assets in an operating business is worth more than the sum of the replacement value of each asset. Intangible elements of value in a business enterprise result from factors such as having a trained work force and an operational plant, as well as the licenses, systems, and procedures necessary to operate as a business enterprise.
***Goodwill.** That intangible asset that arises as a result of name, reputation, customer patronage, location, products, and similar factors that have not been separately identified and/or valued but which generate economic benefits.
Liquidation value. Value that would be obtained for an asset or group of assets if they are sold separately.
***Marketability discount.** An amount or percentage deducted from an equity interest to reflect lack of marketability.
***Minority discount.** A discount for lack of control applicable to an ownership position less than 50 percent of the voting interest in an enterprise.

Opportunity cost. Return that would be realized on the next best alternative whose rate of return is known.

3. VALUATION PURPOSES

The appraiser needs to understand the purpose of the valuation, as this can influence the valuation process and the relative weight afforded various alternatives.

In *Understanding Business Valuation* (2d ed), by Gary R. Trugman (see the Suggested References section at the end of this chapter), the author identifies a variety of reasons for performing business valuation engagements, including the following:

- Mergers, acquisitions, reorganizations, spin-offs, liquidations, and bankruptcy
- Allocation of purchase price
- Estate, gift, and income taxes
- Marital dissolution
- Employee stock ownership plans (ESOPs)
- Buy-sell agreements
- Stockholder disputes
- Financing
- Ad valorem taxes
- Incentive stock option considerations
- Initial public offerings
- Damages litigation
- Insurance claims
- Charitable contributions
- Eminent domain actions
- Fairness opinions

3.1 Sales and Purchases

The valuation report may serve as a valuable negotiating tool in justifying a proposed bid or asking price. The proponent of the report will be able to provide objective data urging the other party to reconsider the price and substitute another that is more "appropriate and reasonable."

In forced sales, a valuation can help avoid misunderstandings of how the sale or purchase price was determined. A written report enables the parties to understand the specific factors that contributed to the price. In addition, a clearly written, well-documented valuation report may preclude claims of an unfair price.

The valuation report may also guide the buyer and seller in determining the wisdom of the proposed purchase or sale by providing more concrete information about the business being appraised, including its future prospects.

3.2 Gift and Estate Taxes

A professional valuation may be required in determining gift or estate taxes, particularly where the deceased was key to the operations of the business. In this situation, the business value may properly be discounted to take into account the owner dependency of the business. For instance, a professional manager may be needed to continue the business, lest the entity be valued as if it is to be liquidated. The compensation paid to such a manager may be different than that of the owner. Life insurance proceeds must also be considered.

Valuations for gift purposes may differ because the owner is still present. However, consideration must be given to minority interests as well as to future prospects for obtaining a controlling interest through stock options or other means.

In disputes involving the Internal Revenue Service (IRS), the valuation issue may become moot because the tax differential may not exceed valuation and legal fees. If a contest is anticipated, it is often advisable to prepare a written valuation report and submit it to the IRS with the return. Courts tend to rely more heavily on properly prepared valuation reports prepared prior to filing the tax return than on reports prepared years later after the IRS has contested the return. Refer to section 8 for additional information on rules provided by the IRS through revenue rulings addressing valuations for gift or estate tax purposes.

3.3 Divorce

In valuations involving divorce, the effect of the divorce on the business must be considered. Depending upon state law, the valuation may be adversely affected if a number of the business assets must be sold or if one spouse no longer contributes to the operation of the business.

If one of the spouses has left the operation of the business, the effect on goodwill may be even more difficult to determine than in the case of valuation for estate tax. The contention that the departing spouse provided substantial value to the business may be challenged by the other spouse. An independent valuation requires the appraiser to be especially careful not to compromise professional standards of objectivity and professional judgment.

If the business remains intact, standard valuation methods and procedures are sufficient. If, however, some of the assets must be sold, the appraiser will have to evaluate not only the effects of the decrease in assets but also the decrease in earnings and the effect on goodwill as a result of the contraction of operations.

Case law in the state of jurisdiction will have an important impact on the valuation process. Such state law may dictate the valuation process for professional goodwill and other intangibles. It may also restrict the recognition of deferred tax liabilities for highly appreciated assets. In some jurisdictions, liability for income taxes may be considered only where the future payment of such taxes is either imminent or not subject to tax-avoidance techniques such as like-kind exchanges or estate basis step-up. See also Section 5.5.1 regarding tax considerations.

3.4 Valuing Minority Interests

In several circumstances, it may be necessary to obtain an independent value of minority interests. Examples include buyout of dissenting minority shareholders, valuation of such interest at divorce or death, and valuation related to estate or gift taxes.

Minority interests in closely held corporations are often difficult to sell because they lack the ability to control corporate policy and dividends, and thus may lack marketability. The courts have long recognized that such a discount exists, making minority stock interests in a closely held corporation less valuable than the proportionate share of the whole enterprise. Courts have allowed minority discounts even though an individual's shares combined with those of family members constitute majority control (Rev. Rul. 93–12).

In addition, Revenue Ruling 59-60 acknowledges that a discount for blocks of shares may properly be applied as follows:

> The size of the block itself is a relevant factor to be considered. Although it is true that a minority interest in a nonpublic corporation's stock is more difficult to sell than a similar block of publicly traded stock, the amount of the minority interest discount is a factual question. It is a consideration which involves a sound evaluation of all the factors applicable to the particular case.

A review of court cases indicates that discounts for minority interests from 15 percent to 25 percent are common, although discounts often reach 50 percent and more. In addition, other types of discounts may be available. See section 6 for further discussion of such discounts.

3.5 Litigation

Expert valuations of closely held businesses are becoming increasingly important in various kinds of litigation. Common situations in which a valuation may be required in litigation include divorce, insurance claims, lost profits, and compensatory damage cases. Support can be provided to an attorney who is deciding whether to proceed with a case. A valuation may also be necessary if the appraiser is to testify as an expert witness.

The business appraiser may sometimes be required to testify in a court of law and to prepare various exhibits for submission to the courts. The appraiser should be sufficiently familiar with business valuation techniques and the specific reason for the particular valuation to provide the courts with accurate professional testimony. Exhibits summarizing valuation calculations may be submitted as evidentiary material in legal proceedings. The appraiser should closely coordinate all efforts with the attorney representing their mutual client, yet maintain the independence and integrity of the appraisal. A written valuation report covering all pertinent information and detailing the underlying assumptions, analysis, rationale, and conclusions of the valuation procedures is an especially important communication and may be required under professional standards.

In circumstances that include litigation, it is important to know the purpose of the valuation, to work closely with the attorney, and to be prepared with a complete report. Remember that the laws differ by jurisdiction. Thus, it is critical to know the definition of value in the particular jurisdiction and the key case law interpreting the standards of value. It may also be helpful to investigate prior court cases that are similar to the situation at hand. Additional guidance in this area is available in the American Institute of Certified Public Accountants' (AICPA's) Management Consulting Services Technical Consulting Practice Aid No. 7, *Litigation Services.*

3.5.1 Federal rules for expert witnesses

The Federal Rules of Civil Procedure apply in federal court unless the local jurisdiction opts out of certain provisions. The rule amendments effective December 1, 1993, are the most sweeping changes since the

(Text continued on page 11)

Rules were first adopted in 1938. Business appraisers who may be called to testify as expert witnesses are required by these Rules to provide a written report under most circumstances. In addition to the report, expert witnesses must furnish the following supplemental information:

— A list of the cases in which the expert witness testified either by deposition or testimony in the prior four years
— Disclosure of the compensation being paid to the expert witness for study and testimony
— A list of all publications authored by the expert witness in the preceding ten years without regard to relevancy

An appraiser who will provide expert testimony should meet these requirements unless the attorney involved explicitly directs the expert witness that those Rules do not apply in the particular jurisdiction where the matter is pending.

4. IMPORTANT VALUATION CONCEPTS

Valuation is based on the highest and best use of an asset. The same business can have different values for different purposes. For example, a business may be valued at one level for divorce purposes and at another for dissenting shareholder cases. The following subsections provide a basis to determine if certain values are more appropriate and therefore more applicable to the valuation process.

4.1 Corporate Life Cycle

Businesses are much like people. They have an inception. They have a nurturing stage during which they cannot support themselves. They may have a period of rapid development similar to adolescence. They experience maturity, decline, and, perhaps, even death. The business life cycle, though, can be changed by bringing in new management, new products, or new financing.

An important consideration in valuing a business is to identify as closely as possible where the company is in the corporate life cycle. In adolescence, for example, the company is growing so quickly that it runs out of working capital. The inventory is not enough, the receivables are not enough, the company struggles, and growth is not always smooth. Earnings tend to be good, but cash flow is a problem. By comparison, a company in decline is not growing. Rather, its sales are decreasing, and earnings may be dropping. The cash flow is very good, however, because inventories are being liquidated and receivables are being liquidated. Because the company is mature, the assets are generally paid for and there is little leverage.

As a buyer, which would you prefer to invest in—a company that is growing and, in so doing, struggling to meet its cash flow requirements, or a company that is declining, losing market share, and has a limited future? Keep in mind that, by buying a company past its peak and in a declining stage, it is possible to downsize—that is, to liquidate a number of the assets—and generate almost as much total profit with a fraction of the total assets.

4.2 Management

Inherent in any business appraisal is an assessment of the quality of management. Experienced, competent, imaginative management will recognize and address problems. Inexperienced, unimaginative management can turn a good company into a poor investment quickly. The quality of top management is important in the long run. The quality of second-line management is also important in the long run. Is there a clear management succession scheme? Is there a key person in the company, the loss of whom would be significant? Is that key person the owner or an inventor-type who develops the new products—and what happens to the company in the absence of new product development?

If the appraiser determines that the company relies on one person or a very few key people, there are at least two ways to incorporate that circumstance into a business valuation calculation. The appraiser can adjust upward the discount rate or capitalization rate used in the calculations of value under certain valuation methods to recognize the risk to the company of the loss of a key person. How to determine an appropriate discount rate and capitalization rate is reviewed in subsection 4.5. Another option is to calculate the value of the company ignoring the key person risk and then apply a separate, special discount for that risk. The key person discount is discussed in subsection 6.1.3.

4.3 Liquidation Value v. Going Concern Value

Liquidation value is the amount that could be realized if the company's assets were sold separately. For example, if the owner of a restaurant were to sell the inventory and equipment, the proceeds from such a sale would be the liquidation value of the business. Orderly liquidation is the sale of assets over a reasonable period with an attempt to get the best price for each asset. Forced liquidation is the sale of assets as quickly as possible, frequently all at one time, at auction.

In contrast, going concern value is the amount that could be realized if the business entity, as a viable operating entity, were sold as a whole. In the preceding example, this would be the amount realized for the sale of the entire restaurant. If this amount exceeds that which could be obtained from the assets separately, the difference is the amount attributable to the going concern separate from its tangible assets—that is, intangible value.

The willing seller/willing buyer concept suggests that no seller would accept a liquidation value if the business has been highly profitable and, thus, the value under an earnings approach is higher. Conversely, no seller would accept an earnings approach value if the liquidation value is substantially higher. A buyer may be willing to pay almost liquidation value if the buyer believes he or she can sell off a number of assets and maintain a profitable business with the assets that remain.

4.4 Book Value v. Market Value

Use of the book value of assets as a basis for valuation can be very misleading. Because book value is determined on the basis of historical accounting cost and certain assets are depreciated, depleted, or amortized according to generally accepted accounting principles (GAAP) or current tax legislation, there is often a wide variation between the current book value of an asset and its market value. Accountants, therefore, make no representation that the current book value of an asset is equal to the current market value of an asset. Nevertheless, book value is important to determine the seller's income tax ramifications. Book value is also important as a starting point if the approach to valuation is weighted heavily toward asset values.

4.5 Discount Rate v. Capitalization Rate

An often confusing issue in business valuation is the discount rate and the capitalization rate used in various calculations of value. The discount rate is a rate of return used to convert future expectations of either earnings or cash flows to a present value. The discount rate is similar to the opportunity cost in that it measures the return required to induce a potential investor to invest in a company.

A capitalization rate converts a particular stream of earnings or cash flows into value. Mathematically, the capitalization rate is equal to the discount rate minus growth. Using a capitalization rate is appropriate only if the subject company's growth is expected to be at a constant rate. If growth is not expected to be constant, the appraiser should use a valuation method that utilizes a discount rate.

4.5.1 Discount rate

The calculation of the appropriate discount rate requires consistency and judgment. Under appropriate circumstances, an appraiser might discount the earnings either pretax or after tax. Under other circumstances, discounting the earnings before interest and taxes may be appropriate. Under still others, earnings before interest, depreciation, and taxes may be discounted. At least in theory, one should discount the net cash flow—that is, the after-tax earnings, plus noncash expenses, depreciation and amortization, less capital expenditures, less principal payments, plus new principal borrowing.

It is possible to calculate a discount rate in a step-by-step process. A company's discount rate is composed of a number of identifiable risk (or return) factors that, when added together, result in the total return that a prudent buyer would demand from an investment in the company. The discount rate can be built up in this process, as follows:

1. A risk-free rate of return (the return an investor could obtain from a low-risk, safe investment) is determined for the valuation date. This risk-free rate is assumed to be approximately equal to the yield to maturity of long-term bonds (U.S. Treasury bonds or tax-free bonds, in some cases).
2. To this risk-free rate is added a risk premium that the average equity investor will demand above this risk-free rate. Ibbotson Associates has published information in the *Stocks, Bonds, Bills and Inflation* yearbooks regarding actual premiums since 1926.
3. Depending on the circumstances, a small stock risk premium, which the average investor will demand above the rate required on larger companies, may also be added to this rate. Ibbotson Associates' yearbooks include information on actual small stock premiums paid. Ibbotson determines this risk premium based on the weighted average return earned by the smallest 20 percent of all companies listed on the New York Stock Exchange, plus American Stock Exchange companies and Over the Counter Exchange companies of similar size.

4. Finally, an additional increment is added for risk associated with the particular company being valued. Some of the risk may be offset by the company's strengths.

How to arrive at the discount rate through the build-up process is summarized in the following example:

Risk-free rate (a composite long-term U.S. Treasury bond rate, as of the valuation date)		6.34%	
Equity risk premium		7.30%	
Small stock premium		5.20%	
Company specific risk premium		3.00%	
	Discount rate	21.84%	
	Rounded		22.00%

4.5.2 Capitalization rate

Once a discount rate has been determined, calculating the capitalization rate seems a simple subtraction problem. However, complex considerations affect the determination of a capitalization rate.

When the expected growth rate of an earnings stream is constant, the capitalization rate will be the reciprocal of the price-to-earnings (P/E) ratio. For example, if the P/E ratio is 5, then the capitalization rate is 20 percent.

However, in most instances, the expected growth rate of an earnings stream will not be constant but will instead be affected by factors such as interest-rate changes, expected changes in the business, and other economic conditions. If growth is not expected to be constant, conversion of the estimate of future earnings to a present value by using a discount rate is a more appropriate valuation method.

If an earnings history is the basis for calculating value (see subsection 5.2), a capitalization rate can be used to convert the historical earnings to present value. As noted earlier, the capitalization rate is the discount rate minus growth. Subtracting a growth factor is appropriate because the discount rate is normally applied to estimates that include future growth, but actual historical earnings do not include future growth. If comparable companies are used in the valuation process, the price-to-weighted-average-earnings ratio of the similar companies over the historical period (usually five years), may be used to arrive at an appropriate capitalization rate. The capitalization rate is the reciprocal of this ratio.

Section 6 of Rev. Rul. 59-60 discusses capitalization rates and admits that "a determination of the proper capitalization rate presents one of the most difficult problems in valuation." Although Rev. Rul. 59-60 does not present a standard formula for capitalization rates, it does list some of the more important factors to be considered in deciding the capitalization rate in a particular case, the same factors considered in determining the discount rate, as follows:

— The risk

— The nature of the business

— The stability or instability of earnings

In addition to these factors, the riskless rate of return (such as that of U.S. government securities) should be considered, along with the rate the company pays to borrow money. Shareholders take a greater risk than the bank and are entitled to a greater return.

Business risk considers the relative importance of management as well as several other factors such as the condition of the economy, and the uncertainty of the sources of supply, product quality, skilled labor.

Managerial skills may be measured by comparing a company's past performance with that of similar businesses. In older businesses with strong historical earnings and less risk, the P/E ratio generally will be higher and the capitalization rate, therefore, lower.

In contrast, businesses that are established but that require a great deal of managerial ability because of the instability of the market in which they compete would have a lower P/E ratio than those businesses requiring fewer managerial skills and, therefore, a higher capitalization rate.

In small businesses that truly rely on one key manager as the key component of earnings, the capitalization rate may equal 100 percent. Therefore, the value will be approximately equal to the earnings of a single year because the earnings are almost entirely dependent upon the skill of the manager and are subject to the company's ability to retain this person.

(Text continued on page 17)

5. COMMON METHODS OF VALUATION

Several important valuation methods are discussed below; however, space does not permit a comprehensive list of all possible valuation methods.

In circumstances where a binding, contractual agreement specifying a particular valuation method exists, the agreement would dictate the valuation method to be used, for example, a buy–sell agreement may indicate a fixed price, a formula price, or a specific capitalization factor. In addition, a valuation method based on recent arm's-length sales may take precedence over other valuation methods if the sales were made under appropriate circumstances.

Otherwise, a combination of the methods discussed below may be the best way to reach a valuation conclusion. In the absence of a binding contractual agreement and/or recent prior sale, the guideline company valuation method may provide the most appropriate valuation. Other methods become appropriate, should the guideline company valuation method not be applicable. Appendix 4 contains a comprehensive case study of each of the following valuation methods (see also the *Accountant's Business Manual Toolkit CD-ROM*).

5.1 Guideline Company Valuation Method

In valuing the stock of closely held companies, the market values of stocks of comparable publicly held companies (and privately held companies if enough information is available) are relevant factors for providing guidance on the value of the subject company. Such comparable companies are called guideline companies. Conclusions about the financial condition of a company can also be drawn by comparing its operating results with those of guideline companies.

To be truly comparable to the subject company, a guideline company should be engaged in the same or a similar line of business. Its size, capital structure, and trend of sales and earnings should be similar. To reflect the public market attitude, a guideline company's stock should be actively traded in a free and active market, whether on an exchange or over the counter.

The guideline company valuation method is perhaps most appropriate for larger companies that compete with publicly traded companies. The first step in this method is the selection of a group of publicly traded companies similar to the subject company. The accuracy of the results of this valuation method depends on finding truly comparable companies.

5.1.1 Selecting guideline companies

An appraiser will rarely find a company that is exactly the same as the subject company in all respects. The best the appraiser can usually hope for is to find a number of public companies that are similar to the subject company in many respects. The appraiser must exercise a great deal of judgment in determining which companies are similar enough to be used as guideline companies. Reasonable, informed appraisers exercising their professional judgment may reach different conclusions about which specific companies should be used as guideline companies.

Industry similarity should always be a primary criterion in selecting guideline companies, but appraisers differ in their judgments as to how this criterion should be applied. For example, a number of appraisers include the company's customers; customers may be in a different industry, but they and the subject company face the same economic and industry influences. Degree of diversification, similarity of products and markets, degree of vertical integration, economic and regional influences, and the maturity of the business are all factors to consider in judging whether the companies are actually in the same industry.

Among the other criteria used in determining comparability are size, historical trend and growth prospects, financial risk, operating risk, management depth, and dividend paying capacity.

If no guideline companies can be found, the other valuation methods discussed in this chapter should be considered.

5.1.2 Using the guideline company method

If an acceptable group of comparable, publicly held companies has been found, the various P/E ratios, dividend payout ratios, and market value-to-book value ratios should be calculated; other ratios may also be used, but these three are usual. Consider the results of these calculations. Is a simple average appropriate? Perhaps the median (the middle value ranking the ratios high to low) should be the main consideration. Perhaps a particular company's ratios are so out of line that the company should be ignored. Are some of the guideline companies very comparable and others less so? Excellent judgment is needed at this point.

Next, each ratio should be applied to the subject company to arrive at an implied market price derived in the context of each ratio. What adjustments then need to be made?

After arriving at the implied market price derived by the relevant ratios as adjusted, the relative importance of each ratio or factor must be considered and the results of applying each ratio weighted accordingly. In *Central Trust v. U.S.*, (305 F. 2d 393(1962), 62-2 USTC 12,092), it was determined that earnings should be weighted at 50 percent because the company was a manufacturer with a consistent dividends and earnings record. The court divided the remaining 50 percent between the dividend yield and book value factors.

Examples of the guideline company valuation method are presented in *Guide to Business Valuations* by Jay E. Fishman, Shannon P. Pratt, J. Clifford Griffith, and D. Keith Wilson, and in *Valuing A Business* (4th ed.), by Shannon P. Pratt, et al. (See Suggested References at the end of this chapter.)

5.2 Capitalization of Earnings Method

In the capitalization of earnings valuation method, company earnings (or cash flows), adjusted for unusual or nonrecurring items, are converted to value by applying an appropriate capitalization rate. Since this method may be based on earnings or cash flows, it is sometimes called the capitalization of economic income method. Asset values are not considered under this method.

In some cases, projected future earnings may be used; however, often a three-to-five-year earnings history is used, with more weight apportioned to the most current earnings. For example, the most current year may receive a weight of 5 if a five-year history is used, a weight of 4 for the preceding year, and so on. This weighting stresses the importance of current trends in reaching a realistic valuation.

The capitalization of earnings method can be illustrated as follows:

Year	*20X5*	*20X4*	*20X3*	*20X2*	*20X1*
Weight adjusted after-tax earnings	5 $70,000	4 $40,000	3 $ 45,000	2 $30,000	1 $90,000
×	5/15	4/15	3/15	2/15	1/15
	$23,333	$10,667	$ 9,000	$ 4,000	$ 6,000
Five-year weighted average earnings					$ 53,000
Capitalization rate					÷15%
Value of business before discounts and premiums					$353,333

5.3 Capitalization of Excess Earnings Method

Capitalization of excess earnings is similar to the capitalization of earnings method in that earnings, adjusted for unusual or nonrecurring items, are capitalized on the basis of a five-year earnings history. Normal expected earnings are composed of two parts. The first part is the fair return the company should earn on the tangible assets. The second part is any earnings in *excess* of a fair return on tangible assets, which must be a return on *intangible* assets. Therefore, the *excess* earnings are capitalized at an appropriate rate (higher than the rate of return for tangible assets because intangible assets are at greater risk of loss in the future). The value of the intangible assets plus the value of the tangible assets (net of liabilities) is the value of the equity.

The capitalization of excess earnings method can be illustrated as follows.

Net tangible assets at valuation date (equals tangibles and identifiable intangibles minus liabilities, all at fair market value)		$100,000
Weighted average of five-year earnings (after deducting extraordinary items and discontinued operations)	$ 15,000	
Less: average industry rate on net tangible assets for the size of the company involved	− $ 10,000	
Excess earnings	$ 5,000	
Capitalization rate (determined from industry data)	÷ 20%	
Value assigned to unidentifiable intangibles (goodwill)		$ 25,000
Value of the business before discounts or premiums		$125,000

The capitalization of excess earnings method should be followed only if no other methods apply.

5.4 Dividend Capacity Method

The dividend capacity valuation method is of questionable usefulness for the closely held business since dividends and salaries are both controlled by the owner. In fact, the minimization of dividends is typical for smaller businesses. However, as the method's name implies, it is the dividend capacity (the amount of earnings that could be distributed) that is important—not the actual dividends that have been paid. Because it is difficult to gather objective information of this nature for a closely held business, this method is seldom used.

5.5 Adjusted Net Assets Method

The adjusted net assets valuation method is frequently used for valuing real estate and other investment companies or businesses to be liquidated by utilizing itemized appraisals of the company's assets. This method of determining the business value is arrived at by subtracting the fair market value of the liabilities from the fair market value of the assets. An adjustment is also made for unrecorded intangible assets such as goodwill, if they can be sold. This method produces a static valuation and is difficult to use because of the substantial actual time and cost that may be needed to carry out an asset-by-asset evaluation.

This method may be valuable as a check on other methods because it attempts to find the cost of reproducing the business enterprises. It also may identify those items that do not contribute to current earnings or profitability. A discussion of procedures for valuing selected items is found in section 9 of this chapter. The adjusted net assets method is frequently used as part of an analysis of the value of a business in a partial liquidation, whereby some of the assets are sold to reduce the size of the company to a level that is justified by the remaining earnings.

5.5.1 Tax effect

When using a net asset method, business appraisers (and courts) may disagree on the appropriate considerations to be given to tax consequences. For example, if the appraiser determines that the fair market value of a plant exceeds its book value by a substantial amount, he or she would substitute the fair market value of the plant for its book value in preparing an adjusted balance sheet. What about the tax consequences of selling the plant for the new, adjusted fair market value price? In a number of states, in the instance of divorce, for example, if the plant is not going to be sold in the near future, the courts may ignore the income tax effect as being speculative as to 1) whether or not there ever would be a tax, and 2) the amount of tax that would be incurred at the future disposition date.

Some appraisers believe that assets are valued "as if" put up for sale, without assuming that a sale will occur. Since there is no sale, no taxes will be incurred on any gains on asset sales (or benefits from losses on those sales), and no tax adjustments are needed because gains and losses on asset sales and the related tax expense are recognized in the ongoing net income amounts used in other going-concern valuation methods. Thus, they believe that it would be inconsistent to provide for tax effects on the appraisal adjustments.

Other appraisers believe that taxes generally should be provided for the difference between the market values of net assets and their tax basis. Since enactment of the Tax Reform Act of 1986, many sales involving C corporations have been structured as sales of stock, with the buyer retaining the seller's old basis. That means the buyer does not receive the additional tax deductions associated with stepping up the basis in appreciated assets acquired in the purchase. Since the buyer's tax deductions are reduced, the total benefits from purchasing the company are reduced. Likewise, if the corporation sells assets rather than the owner selling stock, the corporation will have to pay taxes, thus reducing the net proceeds. Calculating tax effects of the net asset value adjustments recognizes these costs.

The IRS's position on this issue appears in Technical Advice Memorandum (TAM) 9150001. This TAM considered the issue of whether or not an estate is entitled to discount the net asset value of a Subchapter C real estate holding corporation for estate tax purposes in order to reflect the capital gains taxes that would be incurred if the corporation were liquidated. The effect of the conclusion expressed in the TAM is that an individual would pay the same price to purchase the real estate directly as to purchase 100 percent of the stock of a corporation that owned the real estate (the corporation having a very low basis in the real estate).

Earlier tax court cases declined to recognize a discount for unrealized capital gains based on the ability of the corporation, under the doctrine of General Utilities, to liquidate and distribute property to its shareholders without recognizing built-in gain, thus circumventing double taxation. More recent decisions in *Eisenberg v. Commissioner* and *Davis v. Commissioner* recognize that the tax-favorable options ended with the Tax Reform Act of 1986 and capital gain taxes were permitted as part of the discount for lack of marketability.

The question for the appraiser to consider, then, is this: If there is no way for the company to avoid paying income tax at the corporate level under the appropriate appraisal method being used, then should that deferred tax be considered in determining the net asset value? If the taxes could be avoided by appropriate planning, then the appraiser would not consider taxes that would not have to be paid.

CAUTION: A minority shareholder may not be able to force the company to take actions. Thus, the appraiser needs to consider whether a method that assumes some actions at the corporation level, such as the sale of assets, is appropriately used in appraising a minority interest in a closely held business.

5.6 Discounted Future Earnings Method

The discounted future earnings valuation method is used to determine whether a business's price can be recovered through future earnings.

In discussing future amounts, the appraiser must be able to calculate not only the amount of the expected future earnings but also the appropriate discount rate.

Theoretically, the most reliable method for determining the fair market value of a business is to determine the future benefits and discount those benefits to a present value. The experienced practitioner realizes that it is difficult under the best of circumstances to predict one or two years accurately, let alone five years, ten years, or even into perpetuity. Further, the calculation of the appropriate discount rate requires a clear assessment of the risks of the accuracy of the projections, as well as market influences and alternative investments available to a buyer. Thus, while the theory is clear, its application is quite difficult and is subject to differences of opinion. Factors that influence the reliability of the projections include the following: How the projections are prepared, how successful the company has been historically in meeting its projections (meaning, how accurate were past projections), how volatile the business is, and the effect of relatively small errors in the projections relative to the value.

5.6.1 Earnings forecast

The preparation of an earnings forecast usually involves preparation of a five-to-ten-year forecast of operations. Although these earnings forecasts are not exact, they provide some insight into expected future earnings. Although business people regularly consider optimistic, pessimistic, and most likely scenarios, an accountant who does so may be in violation of certain AICPA pronouncements. (See subsection 11.2.)

It has been suggested that the element of risk inherent in using such projections may be reduced by providing for a weighted estimated earnings figure. For example,

$$\text{Weighted estimated earning} = \frac{a + 3m + b}{5}$$

Where:
a = the most optimistic estimate
m = the most likely estimate
b = the most pessimistic estimate

There are two basic ways to address a higher degree of risk. One is to reduce the earnings forecast to indicate that a greater risk factor is present. The preferred treatment, however, is to increase the discount rate to reflect the greater risk.

6. APPLYING DISCOUNTS

6.1 Discounts for Size of Interest, Key Person

As noted earlier in this chapter, various discounts may be pertinent that affect the final conclusion of value.

6.1.1 Discount for minority interest

A minority interest in a closely held business is worth much less than its proportionate share of the whole company because of the absence of control. The holder of a minority interest cannot elect a majority of the board of directors and, therefore, cannot compel the payment of dividends, force the sale of the company or its assets, dictate management policies, or choose top management. A minority shareholder cannot ensure his or her own position as an officer or even as an employee.

Empirical evidence quantifying the discount for minority interest is provided by extensive studies of control premiums in acquisitions of public companies and the implied minority discount. Statistics on these acquisitions are published annually in *Mergerstat Review.* These statistics indicate that average implied minority interest discounts ranged from 26 percent to 34 percent during the period 1980 through 1992. These statistics are based on market prices during the five business days prior to the merger announcement. Studies have shown that stocks have some tendency to rise in anticipation of such announcements, starting considerably more than five days prior to the announcement. Therefore, the *Mergerstat Review* statistics may understate the discount for minority interest.

Mergerstat also publishes studies of control premiums and implied minority discounts in public companies in the *Control Premium Study* (formerly the *HLHZ Premium for Control Study*). Mergerstat analyzes the prices of a target company's stock before the acquisition date and attempts to select a price that is unaffected by preannouncement speculation about the proposed transaction. Mergerstat's analyses covering 1980 through 2000 indicate an average implied minority discount ranging from 21 percent to 31 percent.

To determine the appropriate minority discount to apply in a valuation, the appraiser looks at the degree of control or lack of it in the particular company. Based on experience and knowledge and grounded in the results of empirical studies, the appraiser arrives at an appropriate discount for minority interest from the pro rata value per share of the entire enterprise.

NOTE: If the value per share is derived from public market guideline companies, that data already reflects minority interests, thus no additional discount is appropriate.

6.1.2 Discount for lack of marketability

A discount for lack of marketability may also be appropriate because a minority interest in a closely held business does not enjoy the ready market of an actively traded, publicly held security. Marketability addresses the liquidity of the investment or how quickly the investment can be converted to cash.

Empirical evidence quantifying the discount for lack of marketability is provided by numerous studies. Shannon P. Pratt summarizes these studies in his book, *Valuing a Business* (4th ed., 2000). One approach to quantifying the discount for lack of marketability is to compare prices of restricted stock of publicly traded companies with prices of unrestricted stock of the same company at the same time. The only difference between the restricted stock and unrestricted stock in these studies is the lack of a public market for the restricted stock. Therefore, the difference in price between restricted and unrestricted stock is one way to measure the discount for lack of marketability. Pratt summarizes several independent studies of several hundred transactions from the late 1960s to early 1990s. Average discounts observed in these studies ranged from 23 percent to 45 percent.

Another approach to quantifying the discount for lack of marketability is to study the stock sales of closely held companies, which then become publicly held companies. Stock prices immediately before the announcement of the intent to offer stock on public markets are compared with subsequent prices on public markets (with certain adjustments for market conditions at the different times). A series of studies by John D. Emory covering periods from 1980 to 1993 and a series of studies by Willamette Management Associates (1975–1992) utilized this approach. Evidence from these studies covered hundreds of transactions. The average discounts observed in these studies ranged from 40 percent to 63 percent. Current restrictions on the sale of securities are somewhat less stringent than the restrictions in force at the time of the earliest of these studies.

To determine the appropriate marketability discount to apply in a valuation, the appraiser looks at factors that affect the marketability of the stock such as buy–sell agreements, dividend paying history, and anticipated cash flow needs. Based on experience and knowledge and grounded in empirical evidence, the appraiser arrives at an appropriate discount for lack of marketability.

6.1.3 Key person discount

The degree to which the company's success depends on the efforts of a single individual (often the majority owner) dictates the magnitude of the key person discount. Having safeguards in place that protect the company reduces the magnitude of the key person discount.

Key person risk may be considered within a discount rate or capitalization rate (as noted in subsection 4.5) or as a separate discount applied to the value of the company. Generally, this risk of loss can be attributed to one of three possibilities: (1) death, (2) disability, or (3) leaving the company (which may further include competing against the company). Life insurance can be purchased that reduces the risk of loss due to death. Employment contracts that include noncompete agreements may be used to reduce the risk of voluntary leaving. Additional management support may be a way to reduce all three levels of risk.

A company that carries sufficient life insurance on a key person and has a noncompete agreement with the key person has less risk of loss of the key person and, therefore, a lower discount than would be applied to the value of a company without those contractual advantages. By considering a separate discount for the risk of loss of a key person, the appraiser can be more analytical and reach more objective conclusions.

6.1.4 Successive discounts

The order in which discounts are taken is important because it affects the results. Key person discounts and other discounts that reflect the whole company should be taken first. This is consistent with either taking a discount or adjusting the discount rate for the whole company. The conclusion arrived at for the value of the entire company after the key person discount or other similar discounts is called the enterprise value. That is the value for 100 percent of the enterprise.

Next, when appropriate, a minority discount should be taken. This discount reduces the pro rata value per share of the enterprise value to get to a value per share on a block of stock constituting a minority interest. This is consistent with the conclusion reached using a guideline company market approach as the public market is made up of many minority blocks of stock, generally without any one individual or group owning absolute control. Sometimes, for identification purposes, appraisers refer to the total number of shares outstanding times the value per share for minority blocks of stock as the aggregate minority value. Note that when valuing a control position in a closely held company, if the appraiser has used guideline companies to reach a value per share, that share value is typically considered to reflect a minority interest. To move from the minority interest value per share to a control position, the appraiser often adds a control premium to the aggregate minority value per share to describe the control position.

After determining the minority value per share, it may also be necessary to take a discount due to lack of free marketability. Such a discount is particularly appropriate if the conclusions reached about the company were based on alternative investments that provide liquidity. These might include guideline company methods which value on the basis of publicly held company stocks, or discount rates that consider U.S. Treasury bills or a diversified portfolio of common stocks as a part of a calculation of the discount rate.

It is not appropriate to merely add the discounts and then apply the sum to the pro rata enterprise value per share. Taking the appropriate discounts consecutively leads to a different conclusion than adding them together and applying them. For example, consecutively applying a 25-percent discount for minority interest and a 25-percent discount for lack of marketability yields a different result than that achieved by applying a 50-percent total.

7. REACHING CONCLUSIONS

Each of the various valuation methods calculates a conclusion. How does the appraiser reach an opinion of the fair market value given these various indications of value?

7.1 Examining Valuation Results

One helpful step is to organize the various methods used and the results of each method in a summary chart. The three major headings of asset approaches, earnings or cash flow approaches, and market approaches give an array of value conclusions that shows immediately whether or not the valuation methods produced similar results. If the value conclusions fall in a relatively tight range within an approach and among approaches, the appraiser can be confident that the final conclusion is within the range. If, however, there is a wide disparity within each of the approaches, the appraiser should decide which methods are a better representation of the value of the subject company, considering the influences that may have skewed the result of each method. Was there an error in the calculations? Were there inconsistent assumptions? Are the differences caused by the nature of the business or some economic event?

Also consider the following questions. What value would a willing seller demand? What value would a willing buyer accept? Which methods best achieve the purpose of the appraisal?

7.2 Weighting Valuation Results

Sometimes the approaches and/or methods are weighted to arrive at a final conclusion of value. For example,

Earnings approach	=	50%
Market approach	=	25%
Adjusted asset method	=	25%

If the range of value is minimal, the appraiser can be confident of the conclusion reached by weighting (even though different appraisers may reach slightly different conclusions). If the range of values is wide, however, a mere averaging or weighting may be less reliable than choosing one or a few methods that make the most sense and relying on their results to indicate a final conclusion.

7.3 Matching Valuation Methods to the Business

The nature of the business may dictate which valuation approaches will produce the most reliable results. Generally, service businesses are best valued on the basis of earnings or cash flow. For businesses with a heavy asset base, such as grocery stores or manufacturers, asset approaches and, particularly, adjusted assets methods may lend themselves better. Large-sized businesses that compete with and are similar to publicly held companies are best valued by market approaches and, particularly, guideline company methods.

8. THE INTERNAL REVENUE SERVICE APPROACH

Treasury Regulations 20.2031-1(b) and 25.2512-1 define "fair market value": "The value of property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts." Although this definition has been generally accepted, it may not be appropriate in all situations. A number of factors and methods must be weighed in performing a valuation that may ultimately involve the IRS. It is important to tailor the valuation report to the standards the IRS has set forth. A brief summary of selected IRS standards follows. (Appendix 8 on the *Accountant's Business Manual Toolkit CD-ROM* contains a summary of IRS Revenue Rulings cited as well.) Additional revenue rulings pertinent to business valuation include Revenue Ruling 77-287 and Revenue Ruling 80-213, Valuation of Restricted Securities; Revenue Ruling 81-253, Family Attribution (re: Minority interest discounts); Revenue Ruling 83-120, Valuation of Preferred Stock; and Revenue Ruling 93-12, Related Party Minority Interest Discounts.

8.1 Revenue Ruling 59-60—IRS Business Valuation Principles/Valuing Closely Held Stock

In this ruling, the IRS provided a detailed consideration of many factors it feels are relevant to the valuation of closely held stock. The reader is advised to read and review Revenue Ruling 59-60. This ruling has also been relied on as a source of authority in numerous valuation cases not involving the IRS. For informational purposes, the key points of Revenue Ruling 59-60 are summarized below.

8.1.1 Purpose

The purpose of this ruling was to outline the factors the IRS believes should be considered in valuing shares of closely held corporations specifically for gift and estate tax purposes. Then, in 1965, through Rev. Rul. 65-192 and 65-193, the Treasury Department announced that these same factors would be extended to all types of business interests for income tax purposes. The IRS went on to list certain fundamental factors that should be examined.

8.1.2 Background

The second section of Revenue Ruling 59-60 discusses the definitions of fair market value and closely held corporations. This section also explains that the valuations (for gift and estate tax purposes) must be made subject to the applicable sections of the Internal Revenue Code (IRC) and the estate and gift tax regulations.

8.1.3 Approach

The IRS contends that a determination of fair market value is a question of fact and that no single formula is applicable to all valuation cases. This ruling section also discusses the fact that the fair market value of stocks will fluctuate with general economic conditions, so the appraiser must exercise judgment as to the risks the corporation will face. Finally, the section states that, in many instances, the price at which publicly held companies in the same or a similar line of business are trading will be the best measure of value.

8.1.4 Key provisions

Rev. Rul. 59-60 contains a list of some of the factors the IRS considers fundamental to valuations:

— The nature of the business and the history of the enterprise from its inception

— The economic outlook in general and the condition and outlook of the specific industry in particular

— The book value of the stock and the financial condition of the business

— The earning capacity of the company

— The dividend-paying capacity of the company

— Whether or not the enterprise has goodwill or other intangible value

(Text continued on page 31)

— Sales of stock and the size of blocks of stock to be valued
— The stock market price of corporations engaged in the same or a similar line of business having their stocks actively traded on a free and open market

Each of these factors is discussed by the ruling in some detail. The analysis of each of these factors involved a method that in effect combined several of the other tests. The practitioner must be knowledgeable about each of these factors since they have been stressed by the IRS in this ruling.

Rev. Rul. 59-60 specifically discourages averaging factors. "No useful purpose is derived by taking an average of several factors (for example, book value, capitalized earnings, and capitalized dividends) and basing the valuation on the results."

The courts, however, have moved away from this IRS position and seem to support weighting the various factors. When weighting is used, the weight to be accorded to each factor depends upon the nature of the company's business. For example, earnings should be a primary consideration when valuing companies that sell products or services, but asset values will be given the greatest weight when valuing investment or holding companies. (A brief discussion of the treatment of capitalization rates under this ruling appears in subsection 4.5.2.)

Rev. Rul. 59-60(8) also states that in the case of a restrictive agreement, an option price, for example—although a factor to be considered—will not determine fair market value for gift tax purposes. The IRS recognizes that these agreements have often been used to avoid gift and estate taxes by trying to pass the decedent's shares for less than adequate value.

8.1.5 Summary

Rev. Rul. 59-60 does not provide a specific formula by which the IRS will measure valuations. It does, however, provide guidelines as to what factors should be assessed in a valuation report and provides some guidance about when those factors may be applicable.

8.2 Revenue Procedure 66-49 and Revenue Procedure 96-15—Donated Property

The IRS states that Rev. Proc. 66-49 is used as a guideline for all persons making "appraisals of donated property for federal income tax purposes, under Sec. 170 of the Internal Revenue Code." This procedure also states that, although the cost or actual selling price of an item within a time period surrounding the valuation date may be the best evidence of its fair market value, the sale must have been an arm's-length transaction.

This revenue procedure stresses the importance of expert opinion and the appraisal report. According to the requirements of this procedure, the appraisal report should contain

— A summary of the appraiser's qualifications.
— A statement of the value and the appraiser's definition of the value obtained.
— The basis on which the appraisal was made.
— The date of the appraisal and the signature of the appraiser.
— The date the property was valued.

This revenue procedure also outlines the method for reviewing appraisals. The burden is on the taxpayer for supporting the fair market value listed on the tax return. The IRS will not issue advance rulings on valuations and, if the taxpayer's appraisal is not accepted, the IRS may make its own determination of fair market value (made through an independent appraiser employed by the IRS).

In 1996, the IRS released Rev. Proc. 96-15, informing taxpayers how to complete an application for a statement of value from the IRS to substantiate the value of donated art for income, estate, or gift tax purposes. The revenue procedure generally applies to items that have been appraised at $50,000 or more, with an effective date of requests submitted after January 15, 1996. Statements may also be issued for items appraised at less than $50,000, if the statement request includes a request for appraisal review for at least one item appraised at $50,000 or more (subject to IRS determination that such a request is in the best interest of tax policy).

8.3 Revenue Ruling 65-192—Intangible Assets

The stated purpose of this ruling is to furnish information and guidance concerning the usage of methods for valuing intangible assets. Basically, it states that the formula method (meaning, the capitalization of excess earnings) of valuing intangibles, as delineated in Appeals and Revenue Memorandum (ARM) 34, is not "conclusive of the existence and value of goodwill" if better evidence is available.

This ruling goes on to state that the methods and procedures outlined in Rev. Rul. 59-60 are also applicable to intangible asset valuations for income and other tax purposes and that the formula method set forth in ARM 34 may be used only if other alternatives are not available.

8.4 Revenue Ruling 68-609—The "Formula" Method

Rev. Rul. 68-609 comprehensively sets forth the IRS position regarding the valuation of goodwill.

An example of the formula follows:

(Text continued on page 33)

1. Value of tangible assets		$1,000,000
Value of goodwill		
a. Fair return on tangible assets		
Value of tangible assets	$1,000,000	
Reasonable return (for example, 8 percent in low-risk or 10 percent or more in high-risk businesses or the industry average)	8%	
Computed return on assets	$ 80,000	
b. Compute "excess" earnings		
Average earnings per year	$ 100,000	
Computed return per above	80,000	
Excess earnings attributable to intangible assets	$ 20,000	
c. Capitalize excess earnings		
Excess earnings	$ 20,000	
Capitalization rate for intangibles (for example, 15 percent on low-risk to 30 percent on high-risk businesses; use industry average)	÷ 15%	
Value of goodwill		$ 133,333
Total value of business		$1,133,333

There is significant weakness and limited use of the excess earnings/formula method as applied to valuations of closely held businesses. Any appraisal relying heavily on this valuation method should be cognizant of the number of criticisms that can be raised to discredit it. The most obvious flaws relate to arbitrary rates of return and the unclear industry standard for rate of return.

The formula method will not be used in determining the fair market value of intangibles if a better basis is available for making the determination, such as testimony of the presence or absence of goodwill.

9. VALUATION OF SELECTED ITEMS

The following procedures are recommended in valuing selected items.

9.1 Cash

A common technique for the valuation of cash assets is to reconcile the bank statements and confirm the amount and account.

9.2 Accounts Receivable

Methods vary from using a five-year weighted average of bad debts in determining a percentage to reduce current receivables, to performing individual analyses of each receivable to determine collections.

9.3 Inventory

Inventory is normally valued at its replacement cost, according to the entity's records. Generally, the LIFO (last-in first-out) method should be used. Entities using FIFO (first-in first-out) should adjust to the LIFO method. However, circumstances may warrant that if inventory turns more than once a month, use of FIFO may be acceptable without any adjustment.

In valuing inventory, supplies must be included if they are a material item rather than considered an expense. Hidden reserves should also be accounted for. Obsolete and slow-moving inventory items should be identified and valued at their net realizable value.

9.4 Investment Securities

The current value of investment securities may be obtained from a broker or by checking *The Wall Street Journal* or *The New York Times,* among other sources.

9.5 Insurance

If existing insurance policies will not be continued, the short cancellation rate often provides the best value. The remaining prepaid portion of the last premium paid should otherwise be used.

9.6 Life Insurance Policies

This valuation amount will be the cash surrender value of the policy itself, less any policy loans. Interest on policy loans is often paid in advance, a fact that also should be considered.

9.7 Prepaid Expenses

The components of the prepaid expenses should be valued. The most common examples are rent, office supplies, taxes, and insurance. There may be valuable prepaid expenses that do not show up on a balance sheet because they were charged directly to expenses.

9.8 Equipment

Usually the suppliers of the business entity deal with both new and used equipment and are able to provide figures that represent what the company could obtain in a fair market transaction for the asset, less any moving and reinstallation costs. Our technology is growing very fast, so a written estimate provides the best objective evidence.

9.9 Real Estate

A real estate appraisal by an appraisal specialist should be used. An appropriate appraisal may be obtained by combining and then averaging the appraisals of several local realtors.

When appraising real estate, the following three approaches are normally acceptable:

— *The cost approach.* The appraiser estimates the current cost to reproduce or replace the existing structure, deducts accumulated depreciation, and adds the value of the land.

— *Sales comparison approach.* The appraiser compares similar properties that have been sold recently, while making price adjustments based on elements of comparison.

— *Income approach.* Where there is income-producing property, the appraiser capitalizes a single year's income expectancy or an average of several years income expectancy that reflects a return on investment.

9.10 Intangibles

Intangibles considered for valuation should include covenants not to compete, employment agreements, patents, customer lists, trademarks, copyrights, franchise values, trade secrets, business plans, employee training programs, research and development, and developed computer software.

Patents and copyrights may be valued by taking the discounted value of future royalties, using an appropriate rate as of the valuation date.

These intangibles as well as all the other factors mentioned in this section may be considered part of goodwill. It is important to keep these factors in mind when performing a valuation and to determine whether they will be valued separately or included in goodwill.

9.10.1 Measuring goodwill impairment

The Financial Accounting Standards Board (FASB) issued FASB Statement No. 142, *Goodwill and Other Intangible Assets,* in 2001, superseding APB Opinion No. 17. The new statement addresses financial accounting and reporting for acquired goodwill and other intangible assets. It also provides guidance on how goodwill should be accounted for subsequent to initial recognition.

Goodwill is not to be amortized. Instead, it shall be tested for impairment at a level of reporting referred to as a reporting unit. The first step of the goodwill impairment test compares the fair value of a reporting unit with its carrying amount, including goodwill. The second step of an impairment test compares the implied fair value of the reporting unit goodwill with the carrying amount of that goodwill. Goodwill is written down by the difference, but is never restored in the event fair value is higher. In estimating the fair value of a reporting unit, a valuation technique based on multiples of earnings or revenue or a similar performance measure may be used if that technique is consistent with the objective of measuring fair value.

FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets,* provides additional guidance on calculating the impairment of long-lived assets other than goodwill and other intangibles.

9.11 Leases

A lease is considered to have value when the lessee can retain the lease for an amount less than the lessor could obtain from a new tenant.

9.12 Liabilities

Long-term debt may be present-valued, using the current prime rate or actual borrowing rate. Current debt may be valued at face value. Pension liabilities may be valued by finding the present value of the accrued benefits. This is based on the assumption that the plan will be terminated at the valuation date.

Contingencies should generally be included only if they meet the conditions of FASB Statement No. 5, *Accounting for Contingencies,* paragraph 1, under which an estimated loss from a contingency should be considered if certain considerations are met.

Although contingencies may not be measured if they don't meet the criteria of FASB Statement No. 5, buyers may still reduce the value by increasing the required rate of return due to the increased risk.

Deferred tax should be treated in a manner similar to long-term debt if the buyer will ultimately be responsible for this tax. Any future payments that will be due as a result of present operations should be present-valued using the company's borrowing rate. Consideration should also be given to any potential taxes upon liquidation of a corporation.

9.13 Liens

If the company has any of its assets pledged, such facts should be noted.

10. SPECIAL VALUATION CONSIDERATIONS

10.1 Valuing Employee Stock Ownership Plans

The Tax Reform Act of 1986 included provisions dealing specifically with Employee Stock Ownership Plans (ESOPs). On May 17, 1988, the Department of Labor issued proposed regulations defining the "adequate consideration" limitation on the amount an ESOP can pay for securities. The "Proposed Regulation Relating to the Definition of Adequate Consideration," published in the *Federal Register* of May 17, 1988, also specifically addresses the valuation of securities held by ESOPs. Basically, the provisions and regulations guide ESOP fiduciaries in fulfilling their statutory duties even though the regulations have never been formally adopted.

The Department of Labor requires fiduciaries to purchase ESOP assets for not more than adequate consideration, defined as fair market value determined in good faith. Good faith is defined as applying sound business principles of evaluation and conducting a prudent investigation of the circumstances prevailing at the time of the valuation. IRS provisions are included by reference as well.

A key point of the regulations is that the appraiser must be *independent.* An independent appraiser is defined as a qualified appraiser, that is, one who holds himself or herself out to the public as an appraiser qualified to make appraisals of the type of property being valued. The appraiser is not considered qualified as to the specific property if the donor of the assets had knowledge of facts which would cause a reasonable person to expect the appraiser to overstate the value of the property being appraised.

In most respects, valuing the assets held by an ESOP is no different from other valuation assignments. One facet that is more typical of the ESOP, however, is the *put* option. This is the legal requirement that an ESOP participant who receives a distribution of stock in a closely held company be given an option to sell the stock to the ESOP and alternatively to the employer company. The put option ultimately creates a company liability to repurchase the stock that must be considered when analyzing the financial condition of the company.

Leveraged ESOPs are much more complex and are beyond the scope of this chapter.

10.2 Valuing Professional Practices

A large portion of the value of a professional practice, such as a medical, dental, legal, engineering, architectural, or accounting practice, may lie in the goodwill associated with the practice. Goodwill includes professional goodwill that is transferable and personal goodwill that is not transferable. Goodwill encompasses professional qualifications, personal reputation, the practitioner's skill, retention of clients, and anticipated future earnings, and can be affected by the practitioner's age, work habits, and health.

The courts have recognized a variety of methods for valuing professional goodwill, including the capitalization of earnings method and the capitalization of excess earnings method, both of which have been reviewed in this chapter. As with other valuation assignments, the existence of a contractual agreement, such as a buy–sell agreement, specifying a value or valuation method would take precedence in determining value for certain purposes. Outside of such circumstances, the best valuation method is a recent offer to purchase the practice.

Particular complications in valuing professional practices arise when the valuation is performed in connection with a divorce. Viewing goodwill as marital property focuses attention on how to "divide and distribute" this intangible asset. Several potential valuation methods take into consideration future earnings, which can be viewed as proposing that postdivorce income be distributed as part of the marital assets. Several courts have looked unfavorably on that concept.

11. AICPA GUIDANCE

The practitioner should have a thorough understanding of the valuation methods discussed and referenced in this chapter while keeping abreast of changing alternatives and methods.

The AICPA has launched a dedicated Web site (www.aicpa.org/BVFLS) for its members who specialize in Business Valuation (BV) and Forensic & Litigation Services (FLS). The site provides resources, tools, professional guidance, and additional benefits for those enrolled in the membership section or holding an ABV accreditation.

In addition to understanding the valuation process, it is important to follow related AICPA guidelines applicable from the initial engagement through reporting on the valuation and obtaining representation letters (see appendix 1, also on the *Accountant's Business Manual Toolkit CD-ROM,* for illustrative letters).

These guidelines have grown in recent years. Sufficient time should be devoted to becoming familiar with these guidelines. The following is a summary of some of the AICPA guidelines.

11.1 Statement on Standards for Consulting Services (SSCS) No. 1, *Consulting Services: Definitions and Standards*

In 1992, the AICPA issued guidelines for the conduct of a practitioner providing consulting services. Consulting services may include consultations, advisory services, implementation services, transaction services, staff and other support services, and product services. Valuation services fall into the category of transaction services, in which the practitioner's function is to provide services related to a specific client transaction, generally with a third party.

SSCS No. 1, *Consulting Services: Definitions and Standards,* discusses, among other topics, professional competence, due professional care, planning and supervision, having sufficient relevant data, serving the client interest, understanding with client, and communication of results.

SSCS No. 1 also references the standards established under Rule 202 of the AICPA Code of Professional Conduct. The practitioner should be familiar with these standards before accepting an engagement involving business valuations.

11.2 *Guide for Prospective Financial Information*

This guide, published by the AICPA in 1997, supersedes the AICPA *Guide for Prospective Financial Statements.* It presents recommended procedures to be followed when an accountant is associated with prospective financial information.

The purpose of this guide is to provide guidelines for the preparation and presentation of financial forecasts and projections (referred to as prospective financial statements).

Prospective financial statements are defined as statements that present financial position, results of operations, and cash flows. Statements that cover periods that have expired are not prospective financial statements; therefore, pro forma statements that demonstrate the effect on historical financial statements based on hypothetical future transactions are not considered prospective financial statements. Any statement that meets the definition of a prospective financial statement will be considered one even if the statement is referred to as a forecast, projection, feasibility study, breakeven analysis, or budget.

Among other items, the guide covers the following:

- Types of prospective financial information and its uses
- Responsibility for prospective financial information
- Preparation guidelines
- Presentation guidelines
- Illustrative prospective financial statements
- Guidelines for accountants who provide services on prospective financial statements
- Compilation procedures
- Examination procedures
- Illustrative engagement and representation letters for compilations and examinations
- Accountants' reports
- Various other topics such as agreed-upon procedures, internal-use-only statements, partial presentations, SEC policy on projections, and IRS regulations regarding tax shelter opinions.

11.3 Statement on Standards for Attestation Engagements (SSAE) No. 10, *Attestation Standards: Revision and Recodification*

This section sets forth standards and provides guidance to practitioners who are engaged to issue or do issue examination, compilation, or agreed-upon procedures reports on prospective financial statements. Valuation reports often include prospective financial statements for purposes of projecting future cash flows or income.

A presentation of prospective financial information that excludes one or more of the items required for prospective financial statements under the minimum presentation guidelines, are not ordinarily appropriate for general use. Accordingly, partial presentations should be restricted for use by specified parties who will be negotiating directly with the responsible party.

11.4 MCS Small Business Consulting Services Practice Aid No. 93-3, *Conducting a Valuation of a Closely Held Business*

Another source available to practitioners is MCS Small Business Consulting Services Practice Aid 93-3.

It provides information on several different methods that may be used in valuing a business, as well as examples of the application of these methods. According to the practice aid, accountants should be proficient in completing business valuation engagements by having an in-depth knowledge of finance, economics, and security analysis and an understanding of appraisal principles and methods. The practitioner should have appropriate education to possess the competency required to accept a business valuation engagement.

The practice aid provides a list of additional publications that may be useful in preparing business valuations. It also recommends the use of engagement and management representation letters (see Appendix 1 for sample letters).

11.5 Ethics Interpretation 101-3

Rules issued in September 2003 by the Professional Ethics Executive Committee define what constitutes impaired independence when a CPA performs nonattest services for an attest client. The rules apply for services performed after 2004.

Independence would be impaired if a CPA performs an appraisal, valuation, or actuarial service for an attest client where the results of the service would be material to the financial statements and the appraisal, valuation, or actuarial service involves a significant degree of subjectivity.

Valuations performed in connection with, for example, employee stock ownership plans, business combinations, or appraisals of assets or liabilities generally involve a significant degree of subjectivity. Accordingly, if these services produce results that are material to the financial statements, independence would be impaired. However, valuation of a client's pension or postemployment benefit liabilities generally would not impair independence, nor would such services for nonfinancial statement purposes, such as tax planning or compliance, estate and gift taxation, and divorce proceedings.

11.6 Accreditation in Business Valuation

The AICPA has developed an accreditation program for CPAs to display their expertise in this area. The Accredited in Business Valuation (ABV) designation may be earned by AICPA members in good standing who hold an unrevoked CPA certificate or license. A candidate must successfully complete an ABV Examination and provide evidence of ten business valuation engagements that demonstrate substantial experience and competence.

To maintain the ABV credentials, the individual must complete sixty hours of related CPE every three years and show substantial involvement in five business valuation engagements during that same time period. The experience requirement is intended to identify CPAs with expertise and experience, not those who are considering entering this field.

The AICPA also offers a Certificate of Educational Achievement (CEA) program in business valuations. This program is an educational offering that currently consists of eight modules providing an orderly, methodical approach to learning business valuation. It is education only, not an accreditation, and, as such, may not be used as a professional designation.

12. OTHER PROFESSIONAL GUIDANCE

Several professional organizations have published standards which govern the ethics, nature, and process of business valuations. These standards are essential reading for anyone performing, reviewing, or using business valuations. As the appraisal profession advances, the standards have been modified to reflect the "state of the art." Following are the primary documents produced by professional business valuation-related organizations.

12.1 Uniform Standards of Professional Appraisal Practice

The Appraisal Standards Board of The Appraisal Foundation develops, publishes, interprets, and amends the *Uniform Standards of Professional*

Appraisal Practice (USPAP) on behalf of appraisers and users of appraisal services. The original Standards were jointly developed by representatives of nine professional appraisal organizations, eight of which were real estate appraisal related. Although the bulk of *USPAP* focuses on real estate and personal property appraisals, Standard 9 and Standard 10 speak directly to business valuation.

A copy of *USPAP* is available for a fee from:

The Appraisal Foundation
1029 Vermont Avenue, NW
Suite 900
Washington, D.C. 20005-3517
(202) 347-7722
(800) 348-2831
FAX: (202) 347-7727
www.appraisalfoundation.org

12.2 Principles of Appraisal Practice and Code of Ethics of the American Society of Appraisers

The American Society of Appraisers, a multidisciplinary organization of real estate, machinery and equipment, personal property, business valuation, and technical valuation specialists, offers education and professional accreditation. The *Principles of Appraisal Practice and Code of Ethics* provide authoritative guidelines covering all classes of property and setting forth accepted appraisal procedures and appropriate, professional conduct.

12.3 Business Valuation Standards of the American Society of Appraisers

The Business Valuation Committee of the American Society of Appraisers has adopted *Business Valuation Standards,* which provides minimum criteria to be followed by business appraisers in the valuation of businesses, business ownership interests, or securities. As of this writing, eight Standards have been approved by the American Society of Appraisers, Board of Governors. The Standards address proper terminology, performance requirements, and specific approaches to and procedures for performing valuations. Both the *Principles of Appraisal Practice and Code of Ethics,* as well as the *Business Valuation Standards* are available free of charge from:

American Society of Appraisers
555 Herndon Parkway
Suite 125
Herndon, VA 20170
(703) 478-2228
(800) 272-8258
FAX: (703) 742-8471
www.appraisers.org

Upon adoption, the Standards are also posted on the Business Valuation Committee's Web site at www.bvappraisers.org.

12.4 Publications of the Institute of Business Appraisers

This professional organization also publishes a code of ethics, its *Standards of Business Appraisal Practice*, and standards related to report writing. The Institute of Business Appraisers also awards a professional designation. Information is available from:

The Institute of Business Appraisers, Inc.
P.O. Box 17410
Plantation, Florida 33318
(954) 584-1144
FAX: (954) 584-1184
www.go-iba.org

12.5 National Association of Certified Valuation Analysts

National Association of Certified Valuation Analysts (NACVA) is a professional organization that supports the business valuation and litigation consulting disciplines within the CPA, financial advisory, and investment banking communities. NACVA offers training and certification programs, along with marketing tools, software programs, reference materials, and customized databases to its members. Certification programs include Certified Valuation Analyst (CVA), Accredited Valuation Analyst (AVA), Certified Forensic Financial Analyst (CFFA), and Certified Fraud Deterrence Analyst (CFD). Information is available from:

National Association of Certified Valuation Analysts
1111 Brickyard Road, Suite 200
Salt Lake City, UT 84106-5401
(801) 486-0600
FAX: (801) 486-7500
www.nacva.com

12.6 Publications of the Canadian Institute of Chartered Business Valuators

This professional organization also offers professional accreditation and publishes a code of ethics which designates the general content of a valuation report and other professional requirements. Information is available from:

Canadian Institute of Chartered Business Valuators
277 Wellington Street West,
Fifth Floor
Toronto, Ontario M5V 3H2
(416) 204-3396
FAX: (416) 977-8585
www.cicbv.ca

13. RESEARCH SOURCES

Research is vital to any appraisal assignment because it provides an understanding of a company's business environment. Research helps the appraiser understand the effect of the economy on the industry and the company as well as the investment community's attitude toward the industry. This understanding allows the appraiser to make an informed judgment about the risks a company faces and the kind of return an informed investor would require based on these risks.

13.1 Data Sources

There are innumerable sources of information pertinent to business valuation research. The ones you use will most likely be those most readily available to you, either in your own library or a public or college library near you, or via a computer link. Preparing a checklist of those sources for your own use with each appraisal is an effective means of keeping track of the research sources that should be and have been used.

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As computer technology has advanced, the methods for storing and retrieving data have advanced. The business appraiser can take advantage of on-line access to information from periodicals, stock data, company annual reports, and much more—although there is a cost to doing so. You must have the proper computer equipment and pay the charges associated with being on-line. You will have to investigate and decide for yourself if this kind of access would be cost-effective.

Appendix 3, exhibit A provides a checklist of sources of information to use in conducting your independent company, industry, and economic research. Information about specific publications that have proved useful to business appraisers as of this writing appears in appendix 3, exhibit B.

13.2 Researching the Economy (National and Local)

Information about the general economy should include the status of key indicators of economic health—for example, consumer spending, strength of manufacturing, productivity, retail sales, unemployment rates, residential and commercial construction, loan demand, the trade deficit, and agricultural conditions. An examination of interest rates is important; you should know, as of the valuation date, the prime rate, treasury bill rates, and municipal bond rates. Such general information is available from a variety of periodicals and government publications.

Regional and local economy information may also be available from government agencies and from periodicals. Local chambers of commerce or economic development groups often publish literature detailing the economy of their area.

The industry information you gather will likely also have references to the economy's effect on the industry.

13.3 Researching the Industry

13.3.1 Identifying the NAICS code

A key to finding information in a wide variety of sources is the company's North American Industry Classification Code (NAICS) code, defined in the United States Office of Management and Budget (OMB) publication *NAICS Manual.* The company's tax return shows its NAICS code (though you should verify that this is the correct one according to the latest version of the coding system), or you can determine what code is appropriate by knowing the company's business description and finding a matching code description in the manual or in other sources set up by NAICS codes (for example, Risk Management Association's *RMA Annual Statement Studies* and *F&S Predicasts Index*). A number of companies may have more than one line of business; therefore, you will identify more than one NAICS code and research, accordingly. See Appendix 3 for detailed information on NAICS industry groupings.

13.3.2 Surveying the industry

There are a number of types of industry information that could be acquired. Foremost is to determine how an industry is affected by changes in the economy and whether the industry has any control over those changes (for example, by using alternative sources of raw materials or by undertaking lobbying efforts).

You should also determine where the industry is in its life cycle. This influences the competitive environment. In an emerging high-growth industry, for example, companies are able to maintain high profit margins. In a mature or declining industry, profit margins come under pressure as companies compete on the basis of price. Competition is also affected by the number of companies in the industry and the degree of market dominance enjoyed by the largest companies. Emerging products are another area to research because they may indicate the future direction of an industry.

The annual reports and especially SEC Forms 10-K of publicly held companies are helpful, not only for their financial information but also for their comments on trends in, and the state of, the industry. To identify public companies, use *Moody's Company Data on CD-ROM,* the blue pages from Volume T–Z of *Standard & Poor's Standard Corporation Descriptions,* which list public companies by NAICS code, or a similar source. Call the public companies directly to have several years of annual reports and 10-Ks mailed to you at no cost, or use a computer database information service for this.

The aforementioned *United States Industrial Outlook and Industry Surveys* present good overviews of a number of industries. *Value Line Investment Survey* includes both company reports and industry overviews. A variety of indexes to periodicals exist which can be used to locate articles in magazines and newspapers on the industry and companies in the industry.

13.3.3 Collecting industry financial data

Industry financial ratios are another useful tool for assessing a company's financial position relative to other companies in its industry. Although there are several sources presenting such industry norms, you must be careful to note the date of the information. The publication date typically lags by six months to three years. Get as close to your valuation date as you can. These sources include *RMA Annual Statement Studies, Financial Studies of the Small Business, Dun and Bradstreet's Industry Norms and Key Business Ratios,* and *The Almanac of Business and Industry Ratios.* Remember that trade associations may also make such data available.

13.3.4 Companies in the industry

In addition to the aforementioned *Moody's Company Data on CD-ROM* and *Standard & Poor's Standard Corporations Descriptions* list of public companies by NAICS code, other sources can yield lists of public and private companies in the industry. *Standard & Poor's Register of Corporations,* Volume 3, is a list by NAICS code of public and private companies. *Market Share Reporter, Ward's Business Directory of U.S. Private and Public Companies, Manufacturing USA,* and *Service Industries USA* all show the leading companies in a specific NAICS code. Information on the companies, once they are identified, is also fairly easy to find, often in the same sources which provided the list of companies by NAICS code or by industry name.

13.3.5 Merger and acquisition data

Information on mergers and acquisitions may be detailed enough to use a recent acquisition as a proxy for valuing your subject company if the acquired company is a close match. You may be able to obtain a proxy statement or purchase agreement from the acquisition to get the details. It is more likely, however, that you will find only sketchy coverage in the public literature, and your primary interest will be to see the degree of merger and acquisition activity in the industry. Use indexes to find articles in newspapers and magazines, check the periodical *Mergers & Acquisitions,* or use computer databases to find merger and acquisition information.

Some detailed information appears in the Transaction Roster in *Merrill Lynch's Mergerstat Review.* This annual publication is also a source of compiled and averaged price/earnings ratios and premiums paid in actual transactions by industry and by year, though the number of transactions on which the data is based may be few.

13.4 Researching Guideline Companies

Information on guideline companies may be used in several valuation methods to arrive at an indication of value for your subject company. Conclusions about the financial condition of a company can also be drawn by comparing its operating results with those of guideline companies.

Your research into companies in the industry will lead you to identifying a list of possible guideline companies. Also consider the companies named by management as your subject company's competitors.

Although the research you do on companies in the industry may be rather general and summarizing, your research on guideline companies must be specific and detailed. You will need to gather these kinds of information for each possible guideline company:

- The business description, as of the valuation date; this can come from any of a number of sources—for example, *Standard & Poor's Register of Corporations, Standard & Poor's Standard Corporation Descriptions* company report, *Moody's Manuals* company report, *Value Line Investment Survey* company report.
- Stock price as of the valuation date; this is available from the *Wall Street Journal* or other periodicals, the *Daily Stock Price Record, Standard & Poor's Security Owner's Stock Guide,* among other sources; you may also find additional, useful data in such sources—for example, the Stock Guide also shows institutional holdings, trading volume, the high, low, and last sale or bid, price/earnings ratio, and other financial information.

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- Details of the company's financial condition; the best source is the company's annual report and Form 10-K, plus its Forms 10-Q, which provide quarterly updates; financial details are also available in such sources as *Moody's Company Data on CD-ROM, Moody's Manuals* company reports, *Standard & Poor's Standard Corporation Descriptions* company reports, *Standard & Poor's Stock Reports, Value Line Investment Survey* company reports, and reports from brokerage houses; company information filed with the SEC is also available from various databases such as Disclosure, Inc., who will send a printed company report (even on short notice) for a fee.

14. REPORT WRITING

All readers of this chapter may not be members of the American Society of Appraisers (ASA) and all appraisals may not be subject to the Standards of the Appraisal Foundation. Nevertheless, these two organizations have gained enough stature in the appraisal profession that the failure to follow their standards may subject the appraiser to the significant criticism that he or she has departed from professional standards. We recommend that all appraisers and all appraisals meet the standards of these two organizations.

14.1 Are Written Reports Always Required?

As a general rule, a written appraisal report is preferred. The formal report is a comprehensive written document that allows the appraiser to explain in detail the analysis, the methods, and other considerations used in reaching conclusions. (See section 14.2 for details on the content of a report.) Other formats include a summarization of data in a letter of conclusion, or an oral presentation. Such appraisal formats are permitted if requested by your client.

14.2 Components of a Written Report

There are a number of standard components that generally should be included in a full written report. A number of these are required; others are recommended. The components are derived from the standards set by various professional appraisal organizations, the Uniform Standards of Professional Appraisal Practice, and the requirements of Internal Revenue Ruling 59-60. The format of the report, however, is for the most part a matter of style. A summary of the necessary components and their purpose follows.

14.2.1 The nature and scope of the assignment

The nature and scope of the assignment are typically identified in either a cover letter, or in the opening section of the report. Information pertaining to the assignment such as the identity of the client, a description of the stock being appraised, the company name, the effective date of valuation, and the extent of the appraisal assignment should be included. Also, perhaps in a following paragraph, give a brief description of the company, including its incorporation status and industry. You can also include a summary of the valuations methods used and indicate the final estimate of value in a cover letter (required). The format for the report is flexible and can be tailored to your individual style.

14.2.2 Assumptions and limiting conditions

A statement regarding the assumptions and limiting conditions that affected the analyses, opinions, and conclusions contained in the report is required. The Uniform Standards of Professional Appraisal Practice (USPAP) specifies the contents of these statements. You can include the assumptions and limiting conditions in the body of the report or as an exhibit referenced within the body of the report. You may use USPAP's suggested wording or your own. The USPAP standards are available at www.appraisalfoundation.org.

14.2.3 Definition of value

The applicable standard of value should be identified and defined in the report. There are various kinds of standard value, the most frequently used and accepted standard of value is *fair market value.* The fair market value definition is commonly used by courts, valuation consultants, and the Internal Revenue Service. The definition of fair market value as it appears in this author's reports follows:

> The standard of value to be determined is fair market value. Fair market value is defined as ". . . the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts." (Internal Revenue Service Revenue Ruling 59-60, 1959-1, CB 237)

Other standards of value include fair value, orderly liquidation value, forced liquidation value, and book value.

14.2.4 Sources of information

This section should highlight the primary sources of information used and reference an exhibit detailing sources. Identify the individuals interviewed and any facilities visited, including the dates of such interviews and field trips. You may also want to disclose the primary sources used in gathering data for the economy and industry and to specify the source of the financial information (for example, audited financial statements, internal financial statements, tax returns).

14.2.5 Economy

Revenue Ruling 59-60 requires that consideration be given to general economic conditions. A concise but sufficiently in-depth summary of economic conditions as of the valuation date on national, regional, and local level may be important. You should identify any significant economic factors that may have an impact on the company and explain how they affect the valuation being performed.

You might begin the summary with a paragraph discussing the importance of considering the economic outlook in connection with the valuation, followed by the economic analysis. The national economy should include a discussion of economic indicators such as real gross national product (GNP) or gross domestic product (GDP), interest rates, housing and construction, employment, income, and consumer spending. The summary should also contain information relating to important economic issues at or around the date of the valuation. Also, discuss how these economic considerations influence the valuation.

In addition to discussing the national economy, it is typically important to provide economic information concerning the region or regions in which a company operates. The regional economic outlook can sometimes be as or more important than the national outlook. A specific city or county can be more important than a region. The economic climate in a city or county can differ substantially from other areas of the state or the state as whole.

14.2.6 Industry

It is important to obtain a general understanding of the industry or industries in which the company operates and to understand the company's position in relation to the rest of the industry. You may want to include information concerning the life cycle of the industry, trends as of the date of valuation and prospects for the future. You may want to include information on the industries' products and services and what might affect its growth, and any information concerning supply and demand. You should discuss how the company fits into the industry, its size relative to its competitors, its strengths and weaknesses, and any special niches it may fill. You should also explore the industry of the customers of your client, particularly if a few customers make up the majority of sales or operate primarily in one market segment.

14.2.7 Company

Your written report should discuss in some detail the company and its operations. In order to obtain knowledge of the company's operations, you should submit a request for documents with your proposal letter. The information requested should include but not be limited to financial information such as annual financial statements, tax returns, depreciation schedules, sales and profits by product line, inventory, and order backlogs. Other information requested should include information regarding product and market information, information on management and personnel, and corporate documents and information such as articles of incorporation, bylaws, and corporate minutes.

After you have received and reviewed the requested documents and information, it may be necessary to conduct a field interview. An on-site visit and interview at the company may not always be necessary depending on the circumstances of the appraisal and your knowledge of the company and its operations. However, a field interview can give you insight beyond that obtained from the documents and information provided to you. A field interview allows you to see firsthand the company's operations and the condition of its facilities. In addition, face-to-face discussions with management personnel can bring new information to light. If you plan to conduct a field trip, you should review all documents and information previously sent and then prepare a list of questions. The questions should be designed to help obtain specific information that was either unclear, not included in the information already received, or came about after having reviewed such information.

Following is a list of information that may be obtained from the company and included in your written report:

History of the business

- Legal status and ownership of the business
- Date the business was founded and its founders
- Changes in legal status or ownership
- Significant changes in product lines
- Changes in geographical locations
- Any acquisitions or divestitures

Operations

- Products and services offered
- Proprietary products
- Market areas served
- Suppliers
- Customers
- Competition
- Sales organization and planning
- Advertising and promotion
- Research and development
- Labor, benefits, and employee relations
- Regulatory climate

Plant and equipment

- Brief descriptions of land and buildings
- Location, dates purchased or built
- Manufacturing processes and capacity
- Condition of the facilities and equipment
- Terms of any major leases

Management

- Directors and officers, and their responsibilities
- Employment contracts
- Management compensation
- Key employee insurance
- Union membership and contract status
- Stock options or bonus arrangements
- Pension or profit-sharing programs

Stock ownership

- Classes of stock
- Stock ownership
- Prior transactions in stock
- Stock restrictions
- Buy–sell agreements

14.2.8 Financial analysis

The financial analysis section should include discussions of the company's financial condition, its profitability and earning capacity, dividend-paying capacity, tangible assets, and goodwill or any other intangible asset values. Consideration should be given to the company's historical financial information, its current position, and prospects for the future as indicated by the financial information. Include a discussion on historical trends and what you expect the future financial results will be.

Explain any adjustments that you made to the financial statements. Examples of cases in which adjustments to the company's earnings may be appropriate include excessive salaries, discontinued operations, cash method of accounting, and the expensing of certain repairs and improvements.

The company's historical financial data may be presented in the financial analysis section or included as an exhibit or addendum to the report. Typically, balance sheets and income statements for the current year and prior four years are analyzed. Common size statements, trend and ratio analysis, and comparative industry data may also be included. Focus on historical growth profit rates compared to other companies within the industry. Also, make a comparison of the financial information to the guideline companies you selected (if any).

14.2.9 Major considerations

List the key factors that influenced you in reaching your conclusions. Focus on the factors that tended to increase the value and other factors that tended to decrease the value. Discuss their relative importance as well.

14.2.10 Valuation methods and calculations

Discuss in general terms the various valuation methods that you considered most relevant and the general conclusions reached by each of these valuation methods. It may also be appropriate to discuss why certain methods were not used. Explain your final conclusion of value and the major factors that influenced that conclusion.

14.2.11 Conclusion

Restate the final conclusion to clearly summarize your opinion. This final statement should include a statement of a specific opinion of value or a range of values and should parallel the appraisal assignment statement with which you opened the report.

14.2.12 Signature and inclusion of dissenting opinion(s)

The user of the appraisal report is entitled to assume that you and/or others signing the report are responsible for the findings contained therein. Therefore, you, as the appraiser, are responsible for the appraisal report, whether prepared by you or by others under your supervision. The completed report must be signed either by you individually or by you as an officer of your corporation. If you are preparing the appraisal jointly with other appraisers, all involved must sign the report. Should one of the parties disagree with all or part of the conclusion, the dissenting opinion must be included as part of the report.

14.2.13 Exhibits and appendixes

Exhibits supporting a point being made may appear in the body of the report or as an attachment to the report. In addition to the exhibits mentioned previously, include exhibits summarizing the company's financial statements and the various financial ratios. Exhibits may also illustrate valuation calculations.

Appendixes contain pertinent information that supports the appraisal but is not vital to understanding the appraisal conclusion. You will want to include your resume and qualifications as an appraiser, and the resume and qualifications of any other appraiser involved, as an appendix.

14.3 Presentation

It is a good idea to number pages consecutively and to bind the report. This prevents the danger that a few pages may be copied and used without the whole report. Use graphs that help explain a point but do not overuse them.

14.3.1 Quality of the writing

The report may be the only way a reader has to judge the quality of your work. Spend the time to correct spelling errors, grammatical errors, and incomplete sentences. Reread and revise the report to make it concise.

14.4 Who Gets Copies?

Limit the number of copies given to the client to a number appropriate for the intended purpose, generally six or less. A client who wants thirty-five copies for a gift tax valuation probably intends to use the report for some other purposes as well.

14.5 Examples of Valuation Reports

Examples of valuation reports are presented in *Guide to Business Valuations* by Jay E. Fishman, Shannon P. Pratt, J. Clifford Griffith, and D. Keith Wilson, and in *Valuing A Business,* 4th edition, by Shannon P. Pratt et al. (see Suggested References). See the *Toolkit CD-ROM* for samples of an informal valuation report as well as a calculation of value report.

14.6 Valuation Software Tools

A number of vendors have developed software tools to assist in building a business valuation analysis and report. Two popular business valuation software tools from Wiley ValuSource are available at www.cpa2biz.com. *Value Express Software* is a complete business valuation, deal structuring, and report-writing system. This software is designed to assist with a range of projects, including benchmark appraisals, business purchases and sales, buy-sell agreements, lender or creditor requests, estate planning, business planning, performance evaluation, and IRS and SEC appraisals.

ValuSource Pro Software is designed to provide the detail needed for litigation services. The program enables the user to customize a chart of accounts, weigh different valuation conclusions, enter historical information on an annual, quarterly, or monthly basis, enter an unlimited number of periods of historical financial statements, analyze financial statement percentages and ratios and compare to standards within the same industry, and compute growth rates of balance sheet and income statement accounts.

PPC's Business Valuation Specialist software is designed to interface with the guidance in *PPC's Guide to Business Valuations.* Features include the ability to automatically annualize partial year income statements and balance sheets, models to develop projected financial statements, options to prepare monthly projections for the first two years of the projection period, a report builder, and the ability to electronically import data from RMA's *Annual Statement Studies, Done Deals, BIZCOMPS,* and selected *Mergerstat* information. More information is available at www.ppcnet.com.

When using valuation software, one must never substitute predefined software formulae in lieu of professional judgment. Perhaps the most frequent error made in preparing business valuations is relying on capitalization and discount rates without understanding how these factors are developed.

15. CONSIDERATIONS IN MERGERS AND ACQUISITIONS

15.1 Perspective of Buyer and Seller

It is not unusual for sellers to have inflated expectations of what their company might be worth. In some cases, sellers set their offering price based on bygone "glory days" and fail to consider their company's inability to adapt and remain profitable in a changing world. Conversely, a seller who is under great compulsion to sell may never realize a company's true value in the marketplace. An independent business appraisal that presumes no compulsion to buy or sell is essential to get a seller's expectations squarely grounded.

Buyers need to determine the reasonableness of any offer to sell. Their emphasis is nearly always on discounted cash flow to determine if the target business can provide a profitable return on investment.

15.2 Effect of Buy-Sell Agreements

Buy-sell agreements, or shareholders' agreements, are executed in closely held companies which have at least two owners and do not have an established market for its shares. They are generally created prior to any unforeseen circumstances that would cause an owner to divest and are invoked upon the occurrence of certain events. These are typically death or functional disability of an owner, retirement or voluntary departure from the company, or termination.

Pre-existing agreements between owners often contain certain valuation terms which are not necessarily indicative of fair market value. This is done either to provide a lack of incentive for an owner to sell out or because some aspects of the business could be subject to wide differences of opinion on fair value. Agreeing in advance to a specific valuation methodology retains simplicity and avoids potential litigation between the parties.

In any business valuation for the purpose of transferring ownership between existing owners, the initial inquiry needs to be about the existence of a buy-sell agreement. The contractual terms included in that agreement always supersede any generally accepted valuation methods. For these reasons, a buy-sell valuation can rarely be used to value the business for other purposes, such as an arms-length sale to a third party.

For example, a buy-sell agreement might specifically exclude goodwill from the valuation, or tie certain inventory valuations to a published commodity index. When a buy-sell agreement is invoked due to the death of an owner, the valuation formula should specify whether life insurance proceeds received by the company are included or excluded.

In some cases, the owners agree annually in advance of a triggering event what overall value to affix to the business for the coming year. This is typically found in the minutes of shareholder or director meetings, although the buy-sell agreement itself may contain this on an addendum which is updated periodically.

15.3 Mergers and Stock for Stock Exchanges

Mergers may reorganize companies under common control, such as merging together brother-sister companies, or they may be acquisitive, such as forcing out minority shareholders to take full ownership of a company. Understanding the ownership structure of merging companies and any existing cross-ownership is critically important in such valuations.

To calculate the number of shares to exchange, begin by valuing each company using generally accepted business valuation methods. Once the total valuation of each company has been determined, divide these by the number of outstanding shares to arrive at a per share valuation for each company.

Stock exchange ratios are typically determined by dividing the per share value of the acquirer company by the per share value of the target company. The resulting ratio gives the number of acquirer shares to issue in exchange for each share of the target.

Fractional shares are typically converted to a cash payment in lieu of stock. This technique is sometimes used to force out minority shareholders where the stock exchange ratio results in a conversion to less than a full share of the acquirer.

As a reality check, the total market value received by a target shareholder is determined by the number of acquirer shares received multiplied by the acquirer per share value. Comparing this total value to the original market value of the target shares held will prove whether a stock for stock exchange is equitable.

A similar approach is needed when assets are contributed to a corporation in exchange for stock. This is particularly important when multiple proprietors wish to pool assets in a newly formed corporation. When the contributors own 80 percent or more of all classes of stock immediately after the transfer, the transaction qualifies under Internal Revenue Code Sec. 351 for tax-free treatment. The relative valuation of each asset contribution determines the ratio of stock received in exchange.

SUGGESTED REFERENCES

Abrams, Jay B. *How to Value Your Business and Increase Its Potential.* New York: McGraw-Hill, 2005.

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Gabehart, Scott, and Richard J. Brinkley. *The Business Valuation Book.* New York: AMACOM Books, 2002. Includes CD-ROM.

Gough, Leo. *Valuation.* Hoboken, N.J.: John Wiley & Sons, Inc., 2002. Available as an E-book.

Hawkins, George B., and Michael A. Paschal. *CCH Business Valuation Guide.* Riverwoods, Ill.: CCH, Inc., 1998. Loose-leaf. Annual update.

Hitchner, James, ed. *Financial Valuation: Applications and Models.* Hoboken, N.J.: John Wiley & Sons, Inc., 2003. Available as an E-book.

Horn, Thomas W. *Unlocking the Value of Your Business: How to Increase It, Measure It and Negotiate It a Sale Price.* Fort Collins, Colo.: Charter Oak Press, 1999.

Kleeman, Robert E., et al. *The Handbook for Divorce Valuations.* Hoboken, N.J.: John Wiley & Sons, Inc., 1999. Available as an E-book.

McKinsey & Company, Inc., *Valuation: Measuring and Managing the Value of Companies.* 4th ed. Hoboken, N.J.: John Wiley & Sons, Inc., 2005.

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Pratt, Shannon P., and David Laro. *Business Valuation and Taxes: Procedure, Law and Perspective.* Hoboken, N.J.: John Wiley & Sons, Inc., 2005.

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Pratt, Shannon P., et al. *Valuing a Business.* 4th ed. New York: McGraw-Hill Trade, 2001. Available as an E-book.

Pratt, Shannon P., et al. *Valuing Small Businesses and Professional Practices.* 3d ed. New York: McGraw-Hill Trade, 1998.

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West, Thomas L. and Jeffrey D. Jones, eds. *Handbook of Business Valuation.* 2d ed. Hoboken, N.J.: John Wiley & Sons, Inc., 1999.

Yegge, Wilbur M. *A Basic Guide for Valuing a Company.* 2d ed. Hoboken, N.J.: John Wiley & Sons, Inc., 2001. Available as an E-book.

The following resources provide composite industry information for use in a business valuation. The directory noted below lists information on professional business valuation specialists.

American Society of Appraisers. *Directory of Professional Appraisers.* 2003 ed. Washington, D.C. Annual. www.appraisers.org.

Financial Research Associates. *Financial Studies of the Small Business.* Winter Haven, Fla.: Financial Research Associates. Annual. www.frafssb.com.

Ibbotson Associates, Inc. *Stocks, Bonds, Bills, and Inflation Yearbook* and *Stocks, Bonds, Bills, and Inflation Valuation Edition Yearbook.* Chicago: Ibbotson Associates, Inc. Annual editions. www.ibbotson.com.

RMA—The Risk Management Association (formerly Robert Morris Associates). *RMA Annual Statement Studies.* Philadelphia: Robert Morris Associates. Annual. www.rmahg.org.

Troy, Leo. *Almanac of Business and Industrial Financial Ratios.* 2005 ed. Riverwoods, Ill.: CCH, Inc., 2005. Annual. Includes CD-ROM.

(Text continued on page 57)

APPENDIX 1: Illustrative Letters

Sample Valuation Engagement Letter

Date

Ms. Irma Prescott, President
Enterprises, Ltd.
1503 Poplar Street
Anytown, USA 00000

RE: Valuation of common stock

Dear Ms. Prescott:

At your request, Smith Corporation will perform an appraisal of the fair market value of 100 percent of the common stock of Enterprises, Ltd., for the purpose of assisting you in pending litigation matters. We will also provide such other financial and accounting assistance as you may direct.

The appraisal will include the review of the information requested in Exhibit A to this letter, other necessary research and investigation, interviews with key personnel, analyses of the financial and tax records, and a review of both the tangible and intangible assets owned by the business. The appraisal will be conducted under the limiting conditions set forth in Exhibit B to this letter. An opinion of value will be determined after consideration of all the pertinent facts available.

We will provide a report presenting our findings of fact and conclusions of value. We have no responsibility to update our valuation report for events and circumstances occurring after the issuance date.

We generally perform appraisals in four phases. Phase one consists of a review of the information requested and our own independent research. Phase two consists of visiting company facilities and interviewing management. Phase three consists of additional analysis and reaching our conclusions. Phase four consists of the preparation of a letter of conclusion. Approximately three weeks after the receipt of the information requested in Exhibit A, we would be in a position to visit company facilities and interview management. Approximately three weeks thereafter, we would be in a position to communicate our conclusions to you. Our fee is not contingent on the value determined by this engagement.

The fee for the appraisal is estimated to be between \$______ and \$______, based on charges for appraiser and staff time and efforts ranging from $____ to $____ per hour, plus direct out-of-pocket expenses. We do require a $______ retainer to begin our work. Deposition and/or court testimony, should they be required, would involve additional time and, therefore, additional expense.

We will invoice monthly for professional fees, based on our standard rates and expenses, with payment due in thirty (30) days from the invoice date. We will require payment of all professional fees and expenses incurred to date prior to offering deposition testimony or any written opinions. Further, we will require payment of incurred and estimated professional fees and expenses through completion of our assistance before offering testimony at trial. (Law firm) will be responsible for payment of professional fees and expenses. Payment of our professional fees and expenses is not contingent on our findings or on the outcome of the action.

Documents, records, papers, transcripts, and information provided will be maintained on a confidential basis. Documents, records, papers, and transcripts will be returned or destroyed upon completion of our assistance at your direction and in accordance with professional business valuation standards. You will be asked to sign a representation letter at the conclusion of our engagement acknowledging management's responsibility for the information provided us.

If you wish to engage our services, please sign the enclosed copy of this letter acknowledging our understanding and return with the information requested in the attached exhibit. I look forward to hearing from you at your earliest convenience.

Sincerely,

SMITH CORPORATION

John D. Smith
President

Accepted:

____

EXHIBIT A

Please furnish the following information as of ______, the valuation date.

1. Financial information
   a. Annual financial statements for the last ten years
   b. Monthly financial statements for the last two years plus the current year to date
   c. Tax returns for the last five years
   d. Detailed depreciation schedules
   e. Any financial budgets and/or projections
   f. List of affiliated companies, partnerships, or proprietorships and their financial statements for the last five years
   g. Sales and profits by product line
   h. Other management reports
   i. Plans for capital expenditures
   j. An accounts receivable aging schedule
   k. A breakdown of inventory
   l. List of order backlog
   m. List of contingent liabilities

2. Product and market information
   a. Sales forecasts by product line and division
   b. Sales brochures, price lists, and advertising copy
   c. List of major competitors and their locations
   d. List of major customers including sales to each for prior five years
   e. List of major suppliers including amount of purchases in each of the last five years
   f. Samples of trade publications regularly received by the company
   g. Names of trade associations to which the company or officers belong
   h. Newspaper or magazine articles regarding the company, its products, services, or key employees

3. Personnel information
   a. List of current officers and directors, including background, experience, age, and compensation including all company paid benefits
   b. List of other key management personnel, including job title, background, experience, responsibilities, compensation, and age of each
   c. Schedule of all insurance policies owned by the company including the name of the insurance company, the property insured,

policy number, effective date, annual premium, and a copy of the face page of all major insurance policies

d. Organization chart
e. Summary of pension and profit-sharing plans
f. Employee handbook

4. Other corporation information
   a. Articles of Incorporation and Bylaws
   b. Minutes of shareholders' and board of directors' meetings for the last ten years
   c. Major contracts and other agreements, including loan agreements, buy-sell or other shareholder agreements, employment agreements, franchise agreements, leases, and so on
   d. Current stockholder list and list of any transactions in company stock since inception
   e. Description of physical facilities
   f. Previous appraisals of real estate, personal property, or the business
   g. Previous offers to purchase company assets or stock
   h. List of matters currently pending before any government agency
   i. Any CPA or other consultant's reports regarding the company

EXHIBIT B

Limiting Conditions

The appraisal will be conducted under the following limiting conditions:

1) The appraisal will consider all elements pertaining to the valuation of closely held businesses per Internal Revenue Service Revenue Ruling 59–60.

2) The appraisal will be conducted in accordance with the *Uniform Standards of Professional Appraisal Practice* of The Appraisal Foundation.

3) All estimates of value will be based upon the facts and data obtained during the investigation, some of which may be representations of management.

4) The appraiser has no past, present, or anticipated financial interest in the entity to be appraised or in any affiliate thereof. The appraiser has no personal interest in or bias toward any parties involved. The appraiser's compensation for the appraisal is not contingent upon the values or the conclusions reported, nor upon an action or event resulting from the analyses, opinions, or conclusions in, or the use of, the appraisal report.

5) The conclusions to be reported are for the purpose and use established between the client and Smith Corporation. No further use of these conclusions is authorized.

6) At the client's direction and in the interest of saving both time and expense, we may furnish a summary letter of conclusion rather than a fully detailed report.

Sample Valuation Report Cover Letter

Appraisers may differ on what constitutes an appropriate report format. Some advocate the use of a cover letter, called a "transmittal letter," to accompany the report. Others set up the report so that a transmittal letter is unnecessary. Regardless of the format of the report, it must be a clear communication, not misleading, and meet the guidelines established by professional organizations.

John Smith, CPA
12 Third Avenue
Anytown, USA 00000

Date

Ms. Irma Prescott, President
Enterprises, Ltd.
1503 Poplar Street
Anytown, USA 00000

Dear Ms. Prescott:

I have prepared a valuation report of Enterprises, Ltd. as of December 31, 200X. I have made my valuation in accordance with the combination method. I performed review procedures on certain data necessary for the preparation of the valuation, namely, earnings-per-share data, normal industry earnings-per-share data, and net tangible asset data at the date of valuation.

I have based the valuation of Enterprises, Ltd. on the most probable quantitative valuation. The range presented for the valuation considers certain general factors normally used in the process. I take no responsibility for updating this report to reflect events and circumstances occurring after the date of the valuation. During the valuation process, the management of Enterprises, Ltd. compiled data on earnings per share and net tangible assets at the date of valuation. After performing limited analytical review procedures on the data, I used it in preparing the valuation report.

Had I performed additional procedures or performed an examination of the underlying financial statements of Enterprises, Ltd. in accordance with generally accepted auditing standards, significant matters that would alter the amounts used in the preparation of the valuation might have come to my attention.

The cash flow forecast, designated as an appendix to this report, is not an integral part of this valuation. Its inclusion and my report on it provide information that may be useful to your management in deciding whether to acquire the business under consideration.

Sincerely,

John Smith, CPA

Sample Representation Letter for a Business Valuation Engagement

Company Letterhead
Enterprises, Ltd.
10 Fourth Avenue
Anytown, USA 00000

Date

John Smith, CPA
12 Third Avenue
Anytown, USA 00000

Dear Mr. Smith:

In connection with your valuation of Enterprises, Ltd. as of December 31, 200X, we confirm the following representations made to you during your valuation:

1. All information that we believe is relevant to your valuation and all information requested has been made available to you.

2. The five years of income tax returns are exact and complete copies of returns submitted to the IRS.

3. The financial statements submitted to you for the year ended December 31, 200X, present the financial position, results of operations, and changes in financial position of Enterprises, Ltd. in conformity with generally accepted accounting principles as promulgated by the authoritative literature.

4. The financial statements noted in paragraph #3 disclose all commitments or contingent liabilities, including those arising from litigation, claims, and assessments.

5. We have advised you of all actions taken at meetings of the stockholders, directors, and directors' committees that might affect the valuation.

6. The acquisition of a new business interest or the disposition of existing segments or product lines is not currently being negotiated.

7. There would be no guarantees of profitability by either the corporation or the shareholders if the corporation were sold.

8. The valuation report will serve as a basis for arriving at a valuation for the sale of Enterprises, Ltd. Furthermore, the distribution of the report is restricted to the internal use of Enterprises, Ltd., and accordingly, will not be distributed to outside parties.

9. We represent that the information about the company presented in the preliminary draft of your valuation report, a copy of which is attached, is accurate and complete.

Sincerely,

____

Name, Title
Enterprises, Ltd.

Date: ________________________

APPENDIX 2: Valuation Checklist

The following is a sample checklist to aid in preparing a business valuation.

		Done By	*Date*	*Comments*
1.	Determine reason for valuation.			
2.	Existing client? Is independence compromised based on reason for valuation?			
3.	New client? Determine if engagement is acceptable and complete appropriate new client registration forms.			
4.	Obtain engagement letter. (See sample in Appendix 1.)			
5.	Determine system for keeping client informed of progress.			
6.	Determine date of valuation.			
7.	Determine valuation approaches that may be used and communicate same to client. (This may be a part of the engagement letter.)			
8.	Obtain knowledge and history of the business being valued.			
9.	Determine if business has any preexisting agreements that may affect, control, or set the value.			
10.	Determine if outside sources exist to aid in the valuation (for example, IRS Revenue Rulings, AICPA Practice Aids, court cases, guideline companies, sales).			
11.	Determine if any future events may impact the value of the business.			
12.	Determine method of valuation.			
13.	Determine if an appraisal of any assets will be required and hire qualified appraiser.			
14.	Gather and compile company information.			
15.	Be sure workpapers are documented and organized for future reference.			
16.	Document sources of information relied upon in preparing valuation.			
17.	Test valuation for reasonableness and determine if more than one method may be required.			
18.	Review procedures and documentation to be sure appropriate guidelines have been followed.			

	Done By	*Date*	*Comments*
19. Prepare representation letter. (See sample in Appendix 1.)	______	____	________
20. Prepare report cover letter (see sample in Appendix 1) along with necessary disclosures.	______	____	________

APPENDIX 3: Research Checklist and Sources

This sample research checklist should be modified to reflect library resources in the individual appraiser's community. As an individual appraiser increases the size of his or her personal library of valuation sources, it is important to use these sources first because, of course, they are readily available. Examples of information that are recommended for an office library are labeled "Office" in the sample checklist.

Also, note that the sources listed in the *left* column of the checklist are those that are usually *most useful* and that sources in the right column can be considered ancillary.

EXHIBIT A: Research Checklist*

COMPANY NAME: ______________________________

VALUATION DATE(S): ______________________________

SIC: ______________________________

Date completed/Source

_____ *Standard Industrial Classification Manual*
_____ per company tax returns
_____ per *RMA Annual Statement Studies*
_____ per *Predicasts F&S Index*

COMPANY HISTORY, OPERATIONS, PERSONNEL

_____ Material supplied by company
_____ Company Web site
_____ Local yellow pages (especially ads)
_____ Local law library—state statute under which company incorporated

_____ Local and regional newspapers
_____ *Business Record*
_____ Other newspapers

____
_____ Other periodicals

____
_____ (State) business directory
_____ (State) manufacturers register
_____ (State) directory of manufacturers
_____ *Thomas Register of American Manufacturers*
_____ *S&P's Register of Corporations*
_____ *Million Dollar Directory*
_____ *Ward's Business Directory of U.S. Private and Public Companies*

INDUSTRY INFORMATION

Lists of guideline companies/competitors

_____ Competitors supplied by company
_____ Public companies by NAICS from Volume T–Z, *Standard Corporation Descriptions*
_____ Public companies by NAICS
_____ *Moody's Company Data on CD-ROM*
_____ *Manufacturing USA*
_____ *Service Industries USA*
_____ Public companies, *Value Line*

_____ Public and private companies, *S&P's Register*, vol. 3
_____ Local companies, (state) business directory
_____ Local companies, (state) manufacturers register
_____ Local companies, (state) directory of manufacturers
_____ Public companies, *Directory of Corporate Affiliations*

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*left column—sources usually most useful
right column—additional sources

_____ Local companies by subject heading, local yellow pages

_____ Public & private companies by product manufactured, *Thomas Register*, Vol. 1–15

_____ Public & private companies by NAICS or geography, *Million Dollar Directory*

_____ Public companies (from *Moody's Industrial Manual*)

_____ *Ward's Business Directory of U.S. Private and Public Companies*

_____ *MacRae's Blue Book*

Information on companies

_____ *S&P's Register*, Volume 1

_____ S&P Stock Reports

_____ *Value Line Investment Survey*

_____ *Moody's Company Data* on CD-ROM

_____ *Standard Corporation Descriptions*

_____ *S&P's Security Owner's Stock Guide*

_____ S&P's *Earnings Guide*

_____ Annual reports, Form 10-K Form 10-Q, Form 8-K

_____ Atlas/map—company location, competitors' locations

_____ *Moody's Manuals*

_____ *Directory of Corporate Affiliations*

_____ *Value Line Selection & Opinion*, Stock Highlights

_____ InfoTrac Company Profiles (on computer with *Magazine Index*)

_____ *SEC Filing Companies*

_____ *Million Dollar Directory*, Vol. 1–3

_____ *Thomas Register*, Company Profiles

_____ *Predicasts F&S Index*, vol. 2

_____ Other articles in periodicals (see Indexes)

_____ *Daily Stock Price Record*

_____ S&P *OTC Profiles*

_____ S&P *Stock Yearbook*

_____ *Moody's Handbook of Common Stocks*

_____ *Moody's Handbook of OTC Stocks*

_____ *Ward's Business Directory of U.S. Private and Public Companies*

_____ *NASDAQ Fact Book*

_____ *MacRae's Blue Book*

_____ *Hoover's Handbook of American Business*

Industry financial data

_____ *RMA Annual Statement Studies*

_____ *Financial Studies of the Small Business*

_____ Trade association data

_____ *Industry Norms & Key Business Ratios*

_____ S&P's *Analysts Handbook*

_____ *Almanac of Business & Industrial Financial Ratios*

Information on status, trends, future of the industry

_____ Office files by industry

_____ *U.S. Industrial Outlook*

_____ S&P's *Industry Surveys*

_____ *Credit Considerations* (RMA)

_____ *Lending to Different Industries*

_____ *Value Line Investment Survey*

_____ Trade association info (*Encyclopedia of Associations*)

_____ *Manufacturing USA*

_____ *Service Industries USA*

_____ *Market Share Reporter*

_____ *Mergerstat Review*

_____ *Mergers & Acquisitions*

_____ Articles in periodicals (see Indexes)

_____ *Inside U.S. Business*

_____ *Small Business Sourcebook*

_____ Government documents

_____ *Industry Analysts in the Federal Government*

_____ *Sources of State Information on Corporations*

_____ *Mergers & Acquisitions Sourcebook*

_____ (State) Commerce

_____ *Statistical Abstract of the U.S.*

_____ *Dow Jones-Irwin Business and Investment Almanac*

Information on the economy/demographics

- ______ Office files
- ______ Chemical Banking Corp. *Financial Digest*
- ______ *Federal Reserve Statistical Release*—financial markets
- ______ *Federal Reserve Bulletin*—financial markets charts
- ______ *Value Line Selection & Opinion*
- ______ *fedgazette* National Economic Summary
- ______ *Sales & Marketing Management* Survey of Buying Power
- ______ *Editor & Publisher Market Guide*
- ______ *Community Quick Reference*
- ______ *Sourcebook of ZIP Code Demographics*
- ______ *Sourcebook of County Demographics*
- ______ *The Lifestyle ZIP Code Analyst*
- ______ *Economic Indicators Handbook*
- ______ *Markets of the U.S. for Business Planners*
- ______ Local Chamber of Commerce (call for information)
- ______ Government documents

____

- ______ *State and Metropolitan Area Data Book*
- ______ *County and City Data Book*
- ______ *Grant Thornton Manufacturing Climates Study*
- ______ *Statistical Abstract of the U.S.*
- ______ Federal Reserve publications (see separate list)
- ______ Statistical Profile of (State)
- ______ *A Five-year Economic Development Plan* (State)
- ______ (State) Economy: Dimensions of Change
- ______ (State) Economy: Growth & Diversification
- ______ (State) Economic Trends Report
- ______ Vital Statistics of (State)
- ______ (State) Retail Sales & Use Tax Report
- ______ *Economic Developments*
- ______ *Economic Indicators* (regional)
- ______ *Economic Report of the President*

INDIVIDUAL INDUSTRY INFORMATION

Agriculture

- ______ Office files
- ______ *Agricultural Outlook*
- ______ *Facts on State Agriculture*
- ______ *State Agricultural Statistics*
- ______ *A Glossary of Food & Ag Policy Terms*
- ______ *Agricultural Letter*
- ______ *Ag Credit Conditions Survey*
- ______ *FAPRI U.S. & World Agricultural Outlook*
- ______ *FAPRI 10-yr. International Ag Outlook*
- ______ (State) Dept. of Agriculture (call for information, especially Statistics Division)
- ______ Federal Reserve publications (see separate list)
- ______ *National Food Review*
- ______ *Feedstuffs* Reference Issue
- ______ *Biological & Agricultural Index*

Banking

- ______ *Sheshunoff (Bank Report)* report on subject bank
- ______ Office files
- ______ Swords *The Banking Company Report*
- ______ *Polk's Bank Directory*
- ______ Federal Reserve publications (see separate list)
- ______ State bank directory
- ______ *Moody's Manual*—Banking & Finance

Food industry

_____ Office files
_____ *Thomas Food Industry Register*

Health care

_____ Office files (medical)
_____ *Dun's Guide to Healthcare Companies*
_____ *Cumulative Index to Nursing & Allied Health Literature*
_____ State library medical indexes
_____ State library medical periodicals
_____ *Med Line* on compact disk

Insurance

_____ Office files
_____ *Best's Insurance Reports*
_____ *Insurance Periodicals Index*
_____ *Insurance Almanac*
_____ *Insurance Facts*

Utilities

_____ Office files
_____ *Gas Facts,* American Gas Assoc.
_____ Other AGA publications
_____ *Public Utilities Fortnightly*
_____ Other articles in periodicals (see Indexes)
_____ *Moody's Manual*—Public Utility

Wholesalers/Distributors

_____ *American Wholesalers and Distributors Directory*

INDEXES TO PERIODICALS

_____ *Predicasts F&S Index*
_____ *Business Periodicals Index*
_____ *Wilson Business Abstracts* on CD-ROM (includes *Business Periodicals Index*)
_____ Local or regional newspaper index
_____ *SRI*
_____ *Academic Index* (on computer)
_____ *Wall Street Journal/Barron's Index*
_____ *New York Times Index*
_____ *PAIS Bulletin*
_____ *Applied Science & Technology Index*
_____ *Magazine Index* (on computer)
_____ *Readers' Guide to Periodical Literature*
_____ *ASI*
_____ Harfax *Guide to Industry Special Issues*
_____ *Social Sciences Index* on compact disc
_____ *Business Publications Index and Abstracts*
_____ other indexes

FEDERAL RESERVE PUBLICATIONS

In addition to those already shown

_____ *Economic Perspectives*/FRB Chicago

_____ *Federal Reserve Bulletin*

_____ *National Economic Trends*/ FRB St. (city)

_____ *Monetary Trends*/ FRB St. (city)

_____ *Fedgazette*/FRB (city)

_____ *Review*/FRB (city)

_____ *Quarterly Review*/FRB (city)

_____ *Economic Review*/FRB KC

_____ *District Economic Conditions*/ FRB Mpls

_____ *Business*/FRB (city)

_____ FRB (city)

OTHER REFERENCES

_____ Encyclopedia—Information on state economy, cities, industry; primarily use local library copy

_____ Brokerage company reports—Call for industry and company information

_____ *Federal Fast Finder*

_____ *Census Catalog & Guide*

EXHIBIT B: Business Valuation Research Sources

AICPA Business Valuation and Forensic & Litigation Services Community—AICPA's Business Valuation and Forensic & Litigation Services Center (http://bvfls.aicpa.org/) is designed to provide CPAs a vast array of resources, tools, and information about Business Valuation and Forensic & Litigation Services (BVFLS) in one convenient location. The Resources section of the site is designed to provide one of the most comprehensive sources of professional guidance and tools available today in the field. The site contains significant information on the following areas of practice: Antifraud/Forensic Accounting, Litigation Services, Business Valuation, Economic Damages, Bankruptcy, Family Law, Practice Management, Analytical Guidance, Fair Value for Financial Reporting, Laws, Rules, Standards, and Other Guidance. See http://bvfls.aicpa.org/Resources/.

ASI (American Statistics Index)—A comprehensive guide to all statistical material published by the U.S. government, including the executive branch, Congress, and federal agencies, as well as materials published by other independent bodies; identifies sources and provides detailed subject indexing with abstracts giving specific page locations for data and tables in publications issued from 1960 through the present; is also part of a searchable database called LexisNexis Statistical (formerly Statistical Universe), available at web.lexis-nexis.com/statuniv

American Wholesalers and Distributors Directory, Gale Group—Lists more than 27,000 large and small wholesalers and distributors in the United States and Puerto Rico searchable by product line, North American Industrial Classification (NAICS) code, geographic index, or alphabetic index; www.gale.com/

Annual and Quarterly SEC Filings—Online access to required Securities and Exchange Commission (SEC) filings on all U.S. public companies covering critical business, financial, and competitive details of their activities; www.edgar-online.com

Best's Insurance Reports—A.M. Best's in-depth analysis of more than 6,000 companies for the latest five-year period on property and casualty, life and health, and non-U.S. companies; www.ambest.com

Census Bureau Data, U.S. Census Bureau—Online databases, interactive software, and publications covering a broad range of demographic and economic data; www.census.gov

Comptroller of the Currency—OCC Web site with information on national bank charters, regulations, and supervision, including links to all federal reserve banks, independent bank-rating services, the National Credit Union Administration, the Office of Thrift Supervision, and government regulations; www.occ.treas.gov/Sites.htm

Daily Stock Price Record—Reprints the high, low, and closing prices of stocks traded on the major exchanges, reported in fractional form, including the National Association of Securities Dealers Automated Quotation (NASDAQ) bid and ask prices for mutual funds; other Web sites with historical stock prices for all major exchanges: chart.yahoo.com/d/, www.finweb.com/ (formerly FinancialWeb), www.siliconinvestor.com

D&B Industry Norms and Key Business Ratios—A benchmarking tool enabling one to compare the financial performance of a single company against the average financial performance of its entire industry; presents key financial measures and business ratios based on profitability, efficiency and solvency; http://www.dnb.com/

Financial Studies of the Small Business, Financial Research Associates—Benchmarking information for small businesses under $1 million capitalization; includes historical financial statements and financial ratios, including data such as labor, advertising expense, travel, rent, insurance, officer/executive compensation, depreciation, and interest expense as a percentage of sales; www.frafssb.com

Hoover's Online: The Business Network—Proprietary company and industry information providing a business-oriented perspective on topics important to the business community; arguably, the Web's most comprehensive source of business information; www.hoovers.com

Ibbotson Stocks, Bonds, Bills and Inflation Yearbook, Ibbotson Associates—A history of the returns of capital markets in the United States from 1926 to the present, useful for developing premium and discount calculations in business valuations; www.ibbotson.com

IRS Corporate Ratios, ValueNomics—A standalone Windows program for analyzing and customizing Internal Revenue Service (IRS) corporate tax return data, as well as view typical percentages derived from industry financial statements and performance ratios; program allows comparison of a business with industry norms (generated from nearly four million corporate tax returns) based on the same industry and asset size, to determine areas of competitive advantage and disadvantage; www.valuenomics.com

Manufacturing USA, Gale Group—Statistics on nearly 500 manufacturing industries drawn from federal and business sources; www.galegroup.com

Moody's Handbook of Common Stocks—Company profiles, NYSE, ASE, annual

Moody's Handbook of OTC Stocks—Company profiles; annual *Moody's Handbooks*

Moody's Manuals (Banking and Finance, Industrial, OTC Industrial, Public Utility, Transportation, International, OTC Unlisted)—Company profiles, information from annual reports; annual; blue-pages inserts with stock and bond, public utility, and other market data; separate master index to all volumes; http://www.moodys.com/

RMA Annual Statement Studies—Industry information categorized by company size, including historical financial statements and financial ratios; individual reports available for sale online at www.rmahq.com

Service Industries USA, Gale Group—Compiles difficult to use federal economic information graphically for more than 150 service sector industries and more than 4,500 companies and organizations; www.galegroup.com

S&P Economic Insight—Web-based service publishing economic analysis and forecast data that is event-driven and Web current; www.standardandpoors.com/

S&P Global Industry Insight—A Web-based information platform integrating a broad array of industry news, research information, analysis, and forecasts with functional tools to produce more effective decision making worldwide; www.standardandpoors.com/

The Valuations Group—Leading provider of independent third-party valuations of limited partnerships and other illiquid securities to bank and trust companies, brokerage firms, attorneys, accountants, consultants and private investors; www.valuationsgroup.com

Valuation Resources for Business Appraisers—Business valuation resources including valuation publications, industry resources, economic data, public company information, mergers and acquisitions data, legal and tax resources; www.valuationresources.com

Value Line Investment Survey—One of the most widely used independent investment information services in the world; encyclopedic in breadth of coverage, covering some 1,700-equity issues and 94 industries, updated quarterly; covers about 135 stocks in seven or eight industries, weekly; www.valueline.com/products.html

Wall Street Journal—Interactive version available online along with *Barron's Online*; www.wsj.com/

Industry-Specific Information
Following are industry resources, arranged by the North American Industry Classification System (NAICS) codes, available from industry trade associations.

Accommodation, Food Services, and Drinking Places
722000 Restaurants—National Restaurant Association; www.restaurant.org
721110 Hotels and Motels—HVS International; www.hvs-intl.com
721211 Recreational Vehicle Parks and Campsites—National Association of RV Parks and Campgrounds; www.gocampingamerica.com

Administrative and Support Services; Waste Management and Remediation Services
561440 Collection Agencies—American Collectors Association; www.collector.com
561700 Building Cleaning and Maintenance Services—Building Services Contractors Association International; www.bscai.org
561730 Landscape and Lawncare Services—Associated Landscape Contractors of America; www.alca.org. On January 1, 2005, the Associated Landscape Contractors of America (ALCA) and the Professional Lawn Care Association of America (PLCAA) joined forces to become the Professional Landcare Network (PLANET).

Arts, Entertainment, and Recreation
713930 Marinas—National Marine Manufacturers Association, Inc.; www.nmma.org
713940 Physical Fitness/Health Club/Racquet Club Facilities—International Health, Racquet, and Sports Club Association; www.ihrsa.org
713910 Golf Courses—National Golf Foundation; www.ngf.org

Construction
233320 General Construction Contractors—Construction Financial Management Association; www.cfma.org
233210 Residential Construction/Remodeling Contractors—National Association of Home Builders; www.nahb.com
234110 Highway and Street Construction Contractors—American Road & Transportation Builders Association; www.artba-hq.org
235110 Plumbing, Heating, And Air Conditioning—Air Conditioning Contractors of America; www.acca.org
235310 Electrical Contractors—National Electric Contractors Association; www.ecmag.com

Finance and Insurance
524210 Insurance Agents—Independent Insurance Agents of America; www.iiaa.org

Health Care and Social Assistance
621110 Physicians—American Medical Association; www.ama-assn.org
621210 Dentists/Dental Specialists—American Dental Association; www.ada.org
621310 Chiropractors—American Chiropractic Association; www.amerchiro.org
621320 Optometrists—American Optometric Association; www.aoanet.org
621391 Podiatrists—American Podiatric Medical Association; www.apma.org
623110 Nursing Homes/Assisted Living—The National Center for Assisted Living; www.ahca.org

Information
513110 Radio and Television Broadcasting Stations—National Association of Broadcasters; www.nab.org
511210 Software Companies—Software & Information Industry Association; www.siia.net
514191 Internet Companies—Association of Information technology Professionals.; www.aitp.org

Manufacturing
315000 Apparel/Clothing/Garment Manufacturing—The American Apparel & Footwear Association (www.apparelandfootwear.org) was formed in August 2000 through the merger of two highly regarded trade associations: the American Apparel and Manufacturers Association (AAMA) and Footwear Industries of America (FIA). AAFA is the national trade association representing apparel, footwear, and other sewn products companies, which compete in the global marketplace. See also www.apparelsearch.com.
321000 Lumber and Dimensional Wood Products—Woodworking Machinery Industry Association; www.wmia.org
321911 Window and Door Manufacturers—Window and Door Manufacturers Association; www.wdma.com
337110 Wood Kitchen Cabinets—Kitchen Cabinet Manufacturers Association; www.kcma.org
337000 Furniture Manufacturing—American Furniture Manufacturers Association; http://www.ahfa.us/, See also http://www.furnitureresellers.com/associations.html.
337200 Store Fixture Manufacturers—National Association of Store Fixture Manufacturers; www.nasfm.org

322200 Cardboard/Paperboard Containers and Boxes Manufacturers—Fibre Box Association; www.fibrebox.org
323100 Commercial Printers—Printing Industries of America (PIA); The PIA web site (www.gain.net) has become part of the Graphic Arts Information Network (GAIN), the new web portal of PIA/GATF.
326100 Plastics Products Manufacturers—The Society of the Plastics Industry; www.plasticsindustry.org
331000 Metal Fabricators—Precision Metalforming Association; http://www.pma.org.
331520 Die Casting Manufacturers—North American Die Casting Association; www.diecasting.org
333111 Farm Machinery and Equipment Manufacturers—Farm Equipment Manufacturers Association; www.farmequip.org
333120 Construction Machinery and Equipment Manufacturers—Construction Industry Manufacturers Association; http://www.aem.org/. The Equipment Manufacturers Institute (EMI) and Construction Industry Manufacturers Association (CIMA) have consolidated the CIMA-EMI associations. The combined group is now called the Association of Equipment Manufacturers (AEM). See also www.fiatech.org/resources/industry.htm.
333512 Machine Tool Manufacturers—The Association for Manufacturing Technology; www.mfgtech.org
333514 Tool & Die/Machine Shops—National Tooling & Manufacturing Association; www.ntma.org
333515 Cutting Tools—United States Cutting Tool Institute; www.uscti.com/
333293 Printing Machinery and Equipment Manufacturers—National Printing Equipment Association; www.npes.org
336211 Truck Equipment Manufacturers and Distributors—National Truck Equipment Association; www.ntea.com
339920 Sporting Goods Manufacturers—Sporting Goods Manufacturers Association; www.sgma.com/

Other Services
812331 Uniform and Linen Rental Service—Textile Rental Services Association; www.trsa.org
812210 Funeral Homes—National Funeral Directors Association; www.nfda.org

Professional, Scientific, and Technical Services
541940 Veterinary Services—American Veterinary Medical Association; www.avma.org
541810 Advertising Agencies—American Association of Advertising Agencies, Inc.; www.aaaa.org
541850 Outdoor Advertising Services—Outdoor Advertising Association of America; www.oaaa.org
541110 Attorneys—American Bar Association; www.abanet.org
541310 Architectural Services—American Institute of Architects; www.e-architect.com
541210 Accounting, Auditing, and Bookkeeping Services—American Institute of Certified Public Accountants, www.aicpa.org; National Society of Accountants, www.nsacct.org
541820 Public Relations Agencies—Council of Public Relations Firms; www.prfirms.org
339116 Dental Laboratories—National Association of Dental Laboratories; www.nadl.org

Real Estate, Rental and Leasing
531310 Property Management/Operators—Urban Land Institute; www.uli.org
531210 Real Estate Agents and Brokers—National Association of Realtors; www.realtor.com
532000 Equipment and Tool Rental Stores—American Rental Association; www.ararental.org
532420 Equipment Leasing Companies—Equipment Leasing and Finance Foundation; www.elaonline.com. The Equipment Leasing Association has changed its name to the Equipment Leasing and Finance Association (ELFA).

Retail Trade
444000 Building Materials/Hardware/Home Center Stores—National Retail Hardware Association; www.nrha.org
445120 Convenience Stores—National Association of Convenience Stores; www.cstorecentral.com
445110 Grocery Stores/Supermarkets—Food Marketing Institute; www.fmi.org

441100 Automobile Dealers—National Automobile Dealers Association; www.nada.org
441222 Boat Dealers—National Marine Manufacturers Association, Inc.; www.nmma.org
441210 Recreational Vehicle Dealers—Recreation Vehicle Industry Association; www.rvia.com
448210 Shoe Stores—National Shoe Retailers Association; www.nsra.org
442110 Furniture and Appliance Stores—National Home Furnishings Association; www.nhfa.org/. See also http://www.hfia.com.
446110 Retail Pharmacies—National Community Pharmacists Association; www.ncpanet.org
453210 Office Products Distributors—Business Products Industry Association; www.bpia.org. See also http://www.enxmag.com/indassoc.html.
451110 Bicycle Stores—National Bicycle Dealers Association; www.nbda.com
451110 Sporting Goods Stores—National Sporting Goods Association; www.nsga.org
448310 Jewelry Stores—Jewelers of America, Inc.; www.jewelers.org.
443130 Photographic Equipment and Supply Stores—Photo Marketing Association International; www.pmai.org
454110 Catalog/Mail Order Companies—The Direct Marketing Association; www.the-dma.org
454210 Vending Machine Operators—National Automatic Merchandising Association; store.vending.org

Transportation and Warehousing
484120 Trucking Companies—American Trucking Associations; www.trucking.org

Wholesale Trade
441300 Motor Vehicle Parts, Supplies, Tools, and Equipment Distributors—Automotive Service Industry Association; http://www.aftermarket.org
421450 Medical Equipment and Supplies Distributors—Health Industry Distributors Association; www.hida.org
421510 Metal Service Centers and Distributors—Steel Service Center Institute; www.ssci.org
421610 Electrical Supplies Distributors—National Association of Electrical Distributors; www.naed.org
421720 Plumbing and Heating Supplies Distributors—American Supply Association; www.asa.net
421730 Heating and Air Conditioning Equipment Distributors—North American Heating, Refrigeration, and Air Conditioning Wholesalers Association; http://www.leonessex.com/links.html. See also http://lib.linnbenton.edu.
421820 Farm and Garden Machinery and Equipment Distributors—North American Equipment Dealers Association; www.naeda.com
421830 Machine Tool Distributors—American Machine Tool Distributors Association; www.amtda.org
422100 Printing Machinery and Equipment Distributors—National Printing Equipment Association; www.npes.org
421840 Industrial Equipment and Supplies Distributors—Industrial Distribution Association; www.ida-assoc.org
421850 Cleaning and Maintenance Supplies Distributors—International Sanitary Supply Association; www.issa.com
421860 Truck Equipment Distributors—National Truck Equipment Association; www.ntea.com
422130 Paper and Packaging Distributors—National Paper Trade Association; www.gonpta.com
422210 Drug Wholesalers—National Wholesale Druggists' Association; www.nwda.org
422410 Food Distributors/Wholesalers/Brokers—Food Distributors International; www.fdi.org. See also http://www.ifdaonline.org/
422720 Fuel Distributors—Petroleum Marketers Association of America; pmaa.org
422810 Beer Distributors—National Beer Wholesalers Association; www.nbwa.org

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APPENDIX 4: Sample Company Business Valuation

See the discussion in Section 5 on how to apply these valuation methods.

Guideline Company Method

Comparable Public Company	*P/E Ratio*	*Dividend Yield*	*Market/Book*
National Convenience Stores	14.2	2.7%	1.8
Burrito & Big Gulp Stores	16.7	2.0	1.7
By-way Convenience Stores	10.5	0	1.5
Eat 'n Get Gas Stores	10.8	0	3.3
One Stop Shops	8.0	3.1	2.4
Median	10.8	2.0	1.8
Mean	12.0	1.6	2.1

Using professional judgment, it is determined that the *median* value is most appropriate.

Target company valuation based on comparative company ratios:

Target company adjusted earnings	\$ 343,867 × P/E ratio 10.8	= \$3,713,764
Target company dividend pay-out	\$ 60,000 ÷ Dividend yield 2.0%	= \$3,000,000
Target company adjusted book value	\$2,171,000 × Market/book 1.8	= \$3,907,800

Weighting:

P/E ratio valuation	\$3,713,764 × 50% =	\$1,856,882	
Dividend yield valuation	3,000,000 × 25% =	750,000	
BV valuation	3,907,800 × 25% =	976,950	
Value of business before discounts or premiums			\$3,583,832

Capitalization of Earnings Method

Prior year	*20× 5*	*20× 4*	*20× 3*	*20× 2*	*20× 1*
Weighting	5	4	3	2	1
Adjusted after-tax earnings	\$323,000	\$397,000	\$344,000	\$318,000	\$287,000
Factor	5/15	4/15	3/15	2/15	1/15
	\$107,667	\$105,867	\$ 68,800	\$ 42,400	\$ 19,133

Five year weighted average earnings	$ 343,867
Capitalization rate	÷ 12%
Value of business before discounts and premiums	$2,865,558

Capitalization of Excess Earnings

Fair market value of net tangible assets at valuation date		$2,906,000
Weighted average of five years earnings	$343,867	
Less average industry rate of return on net tangible assets (9% × $2,906,000)	(261,540)	
Excess earnings	82,327	
Capitalization rate for excess earnings	÷ 25%	
Capitalized value of intangibles		329,308
Value of business before discounts or premiums		$3,235,308

Adjusted Net Assets Method

Assets	*Book Value*	*Adjust to Market*	*Market Value*	
Cash	$79,000	—	$79,000	
Receivables	16,000	(2,000)	14,000	
Inventories	752,000	33,000	785,000	
Prepaids	66,000	—	66,000	
Buildings and equipment	12,109,000	1,100,000	13,209,000	
Intangibles	400,000	(400,000)	—	
Total assets	$13,422,000	731,000	$14,153,000	
Liabilities				
Trade payables	$690,000	—	$690,000	
Accrued expenses	27,000	(4,000)	23,000	
Operating debt	984,000	—	984,000	
Long-term debt	9,550,000	—	9,550,000	
Total liabilities	$11,251,000	(4,000)	$11,247,000	
Adjusted net assets	$ 2,171,000	735,000	$ 2,906,000	
Value of business before discounts or premiums				$ 2,906,000

Discounted Future Earnings Method

Future Year	*20 × 1*	*20 × 2*	*20 × 3*	*20 × 4*	*20 × 5*
Optimistic	$410,000	$451,000	$496,000	$545,000	$600,000
Most likely	365,000	401,000	441,000	486,000	532,000
Pessimistic	339,000	356,000	374,000	393,000	412,000

$$\text{Weighted estimated earnings} = \frac{O + 3M + P}{5}$$

Weighted earnings	$369,000	$402,000	$439,000	$479,000	$522,000
21% PV factors	.82645	.68301	.56447	.46651	.38554
Present value	$304,960	$274,570	$247,802	$223,458	$201,252

Present value of future earnings		$1,252,042	
Terminal value—end of 5 years			
Year 5 earnings	$ 522,000		
Normal growth	5%		
Future year earnings	548,100		
Capitalization rate (21% – 5%)	16%		
Terminal value	3,425,625		
PV factor	.38554		
Present value of terminal value		1,320,715	
Value of business before discounts or premiums			$2,572,757

Weighting of Valuation Methods

Method	*Value*	*Weighting*	*Composite*
Comparable companies	$3,583,832	× 10% =	$358,383
Capitalization of earnings	2,865,558	× 25% =	716,390
Capitalization of excess earnings	3,235,308	× 25% =	808,827
Adjusted net assets	2,906,000	× 10% =	290,600
Discounted future earnings	2,572,757	× 30% =	771,827

Total value of business before premiums or discounts	$2,946,027
Number of shares outstanding	20,000
Pro rata value per share	$147.30
Less minority discount ($147.30 × 20%)	(29.46)
	117.84
Less lack of marketability discount ($117.84 × 15%)	(17.68)
Value per share	$100.16
Total shares in block being valued	7,000
Value of shares	$ 701,120

Investment Vehicles

INVESTMENT VEHICLES

See also CD Toolkit for updates, links and additional resources.

1. INTRODUCTION

1.1 Debt Instruments and Equity Instruments

Investment vehicles can take the form of any asset that is held to provide an income stream or growth appreciation over a period of time. Although physical custody of an asset usually occurs with investments in collectibles, real estate, or commodities, most investments are held *on paper* in the form of instruments.

Investment instruments held on paper ease the transferability of title and establishment of clear obligation or ownership. The majority of such investments can be classified as debt or equity instruments.

Debt instruments represent obligations of one party to another for borrowed funds. Not only do government and corporate bonds fall into this broad classification, but also bank savings accounts and certificates of deposit (CDs).

Equity instruments represent ownership or potential ownership interest in assets. Capital stock, representing ownership of a corporation, is viewed as a typical equity instrument. However, ownership of commodities such as precious metals or agricultural products can also be held on paper through equity instruments.

1.2 Risk and Return

The difference between investment vehicles is often most pronounced when it relates to risk and return on investment. The proper investment objective is to achieve the greatest return on an investment while minimizing risk of loss. One characteristic of investments, however, is that the potential return tends to rise as the level of risk increases.

A stockholder in a publicly traded company bears the inherent risk that lower corporate earnings will lower the stock's price or dividend yield. On the other hand, the prospect of improved corporate earnings provides a shareholder with the opportunity for significant gain. Companies in new or emerging markets tend to have greater stock price volatility, thereby adding to the risk factor.

Fixed-income securities, such as bonds, generally entail significantly lower risk if held to maturity. The greatest risk is that of default. However, bonds traded prior to maturity face additional risks from ever-changing interest-rate markets. In a rising interest-rate environment, a bondholder faces risks of not receiving the entire investment if a bond is sold prematurely.

The level of return and amount of risk that given investors will accept depends on their goals and constraints. An investor with significant disposable income is likely to have constraints very different from those of someone who has less available for investment. Similarly, the investor with young children, a home mortgage, and an automobile will likely have different goals than a retired person free of debt.

To manage risk, portfolio theory suggests that an investor's first decision should focus on the allocation of investments between equities, cash or cash equivalents, and fixed-income securities. (Real estate can be added as a fourth class, if desired.) The relative mix between these investment classes—called *asset allocation decisions*—is determined by an analysis of such factors as age, years to retirement, goals, tolerance for risk, present wealth, and financial responsibilities. Of these, risk tolerance assessment is the most important factor. Age, however, can be a meaningful general indicator because investors often have similar goals, responsibilities and future earning years within the same stages of life.

The table of investment allocation percentages that follows presents illustrative investment allocations for a conservative investor with a $100,000 portfolio. Exhibit 1, page 7, shows a risk-return ladder and exhibit 2, page 8, shows an investment allocation pyramid.

INVESTMENT ALLOCATION PERCENTAGES BASED ON AGE

Age	*Liquid Investments* %	*Income-Producing Investments* %	*Growth-Oriented Investments* %
20 years	10–70*	10–20	10–50
30 years	10–20	10–20	70–80
40 years	10–15	10–20	70–85
50 years	10–15	15–25	60–75
Retirement	15–20	40–60	20–40

*The large spread reflects the fact that some people will be saving to buy a home, and others will have already bought one or do not intend to buy one.

A few concepts are common to all investment allocation alternatives:

— *Market risk.* Market risk is the risk of price fluctuations resulting from market conditions that tend to affect all securities of a particular kind. For example, the prices of most common stocks are affected by trends such as bull or bear markets. Sudden political turmoil, negative economic news, or the overheating of a bull market can cause sharp price *corrections* across entire financial markets. Market risk may also cause the price of certain investments, such as closed-end mutual funds, master limited partnerships, or certain insurance products, to vary from the value of their underlying assets.

Exhibit 1

The Risk-Return Ladder

INCREASED POTENTIAL FOR RETURN
DECREASED SAFETY OF INVESTMENT

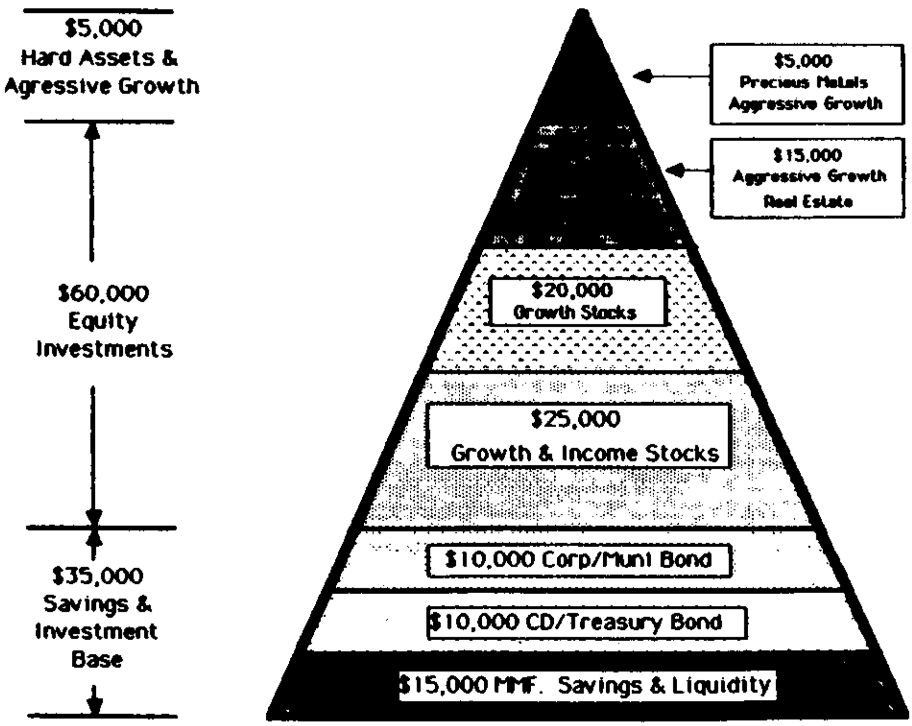
- Exploratory Drilling
- Precious Metals and Stones
- Undeveloped Land
- Real Estate
- Options
- Oil & Gas Income
- Common Stocks
- Growth Mutual Funds
- Convertible Bonds
- Variable Life Insurance
- Variable Annuities
- Municipal Bonds
- Government Bonds
- Fixed Annuities
- Personal Residence
- Money Market Funds
- Treasury Bills
- Savings Certificates
- Guaranteed Life Ins.
- Series EE & HH Bonds
- Passbook Savings
- Cash & Checking Accts.

INCREASED SAFETY OF INVESTMENT
DECREASED POTENTIAL OF RETURN

Robert T. LeClair, *A Consumer's Guide to Investing for Financial Independence*. Adapted with permission. Longman Financial Services Institute, Vernon, CT.

Exhibit 2

$100,000 Pyramid for Conservative Investor



William G. Droms, "Investment Risk and the Individual Investor," in *Asset Allocation for the Individual Investor,* The Institute of Chartered Financial Analysts. Homewood, Ill.: Dow Jones-Irwin, 1987. Used with permission.

— *Business risk.* Business risk is the risk that the company or venture will have management or business problems. The possibility that the price of XYZ Utility Co. stock will fall if its nuclear facility is closed, or that the price of ABC Manufacturing Co. stock will fall if its product becomes obsolete because of technological advances, are examples of business risks. Occasionally, negative developments within a competitor's business can send sympathetic shock waves throughout a particular industry even though the development may have no direct impact on the company's operation.

— *Interest rate risk.* Interest rate risk results from increases and decreases in investment prices caused by changes in interest rate levels. Stocks, real estate, and especially bonds are interest-rate sensitive.

— *Purchasing power risk.* Investors suffer from purchasing power risk if the total return on their investments is less than the rate of inflation. All investments, but especially long-term fixed income securities, are subject to purchasing power risk. This presents a dilemma for ultraconservative investors with a strong aversion to market risk. By accepting low guarantee yields, such investors may, in fact, be guaranteeing a loss to inflation.

1.3 Investment Considerations

The types of investments an investor is likely to choose depend on specific goals, needs, interests, experience, and financial resources. The ultimate objective of investors is to maximize return and minimize risk. Beyond risk aversion, the considerations an investor will have are likely to be as unique as each investor:

— *Safety.* If an investor desires safety of the dollar, conservative investments are advisable. Blue-chip stocks, high-rated bonds, and other relatively low-risk investments are appropriate. Safety also requires careful analysis and attention to economic and industry trends, since many relatively safe investments are still subject to market risk, business risk, and interest-rate risk. Diversification in a number of investments that differ by industry, geography, and maturity, such as through money market or mutual funds, can reduce an investor's risk.

— *Liquidity.* If an investor desires liquidity and easy access to funds, short-term, easily accessible investments are advisable. Money market funds, short-term certificates of deposit, and savings accounts would be appropriate investments. Liquidity should not be confused with safety. For example, an aggressive mutual fund may be highly risky, but with telephone transfer and redemption privileges, it may be quite liquid.

— *Income or Growth.* Income-oriented investments are geared to produce current income through dividends or interest. Growth-oriented investments usually have lower current yield, but offer greater potential for appreciation in principal value.

— *Tax advantages.* Tax-advantaged investments provide a method of converting dollars that would otherwise be paid in taxes into additional net worth for the investor. This is done by taking advantage of statutory provisions that partially or completely exempt certain types of income or defer reporting it until some future time, thereby allowing the investor to use the funds currently.

— *Future security.* The investor interested in securing the future for a family may do well to purchase investments that provide for a return far into the future. Life insurance provides both death benefits and investment features. Annuities, pensions, and retirement accounts provide both favored tax status and retirement security. Long-term government securities can be purchased to provide for later educational needs of children. Trust funds divert income and also provide financial protection for children.

— *Inflation hedge.* Potential hedges against inflation and defensive investments in times of uncertainty are tangible investments such as gold, silver, and precious gems and coins. Investors in this category must watch the market for these investments carefully; the market tends to be extremely volatile and extremely risky.

1.4 The Tax Impact

The Jobs and Growth Tax Relief Reconciliation Act of 2003 (the 2003 Act), signed into law on May 28, 2003, has a number of provisions that will make certain investments more attractive from a tax standpoint from other investments until year 2009. The Tax Increase Prevention and Reconciliation Act of 2005 extended the tax breaks through 2010. The pertinent provisions of the 2003 and 2005 Acts are as follows:

— From 2003–2010, capital gains and dividends will be taxed at 15 percent for taxpayers in the 25-percent or higher tax bracket.

— From 2003–2007, capital gains and dividends will be taxed at 5 percent for taypayers in the 10- to 15-percent tax bracket.

— From 2008–2010, taxpayers in the 10- and 15-percent bracket will pay no tax on capital gains or dividends.

— In 2011, unless Congress extends the tax cut, the lower tax rates on dividends and capital gains will revert to the rates in effect before the 2003 Act.

— From 2003 to 2010, the top tax rate is 35 percent.

Based on these changes the following investments and strategies will be more attractive:

— Qualified common or preferred stock

— Dividend reinvestment plans

— Gifting of stock to children

The following investments will be less attractive:

— Annuities

— Taxable bonds

— Municipal bonds

— Bond funds

— REITs

— Non-deductible IRAs

— Dividends from stock in a retirement plan

Keep in mind that taxes should not be the sole guide to investing.

2. DEFINITIONS

Government-backed Securities. Government-backed securities are one of the safest investment alternatives available. U.S. savings bonds, Treasury securities, and many state and municipal bonds are backed by the treasuries of government units and the full faith and credit of the government unit involved. Although a default on government securities is theoretically possible, in reality it is highly uncommon.

Although government-backed securities carry a fixed yield-to-maturity, they are still subject to market fluctuations during the life of the security, as market interest rates change. The investor needs to fully understand that the backing of the federal or state government will not protect against a drastic drop in market value should interest rates fluctuate over the life of the security.

Insured Investments. Insured investments are basically risk-free. Some of the best-known insured investments are bank investments insured by the Federal Deposit Insurance Corporation (FDIC). In 1989,

(Text continued on page 11)

the FDIC was given the additional duty of insuring deposits in savings associations (S&L's). As a result, the FDIC insures deposits in banks using the Bank Insurance Fund (BIF), and insures deposits in savings associations using the Savings Association Insurance Fund (SAIF). Both BIF and SAIF are backed by the full faith and credit of the United States. The FDIC insures deposits in commercial banks and ensures that accounts will be protected up to a $100,000 limit in the event of a bank insolvency. Federal law provides up to $250,000 in deposit insurance coverage for self-directed retirement accounts. Investments in other financial institutions are protected through regulations of the comptroller of the currency, the Federal Reserve, and various state regulations. These agencies examine the financial stability and asset-to-liability ratios of financial institutions.

Current Yield. Current yield is the percentage the annual interest or dividend payment bears to the investment market price. For example, a 6 percent bond with a $1,000 face value and a price of $800 would have a current yield of $60/$800 or 7.5 percent. Current yield is most useful in appraising bonds that may be held only in the short term. Current yields are reported in the *New York Times*, the *Wall Street Journal*, and other financial publications.

Yield-to-Maturity. Yield-to-maturity is the compounded rate of return over the life of an interest-bearing investment. It measures the return on the investment and is especially useful in comparing bonds that may be held long term.

Yield-to-Call. This is the compound rate of return on an interest-bearing investment, assuming the issue will be called for redemption by the issuer at the earliest date permitted in the indenture. The lower of yield-to-call or yield-to-maturity is the more realistic rate of return to be anticipated by an investor.

Coupon Rate. The coupon rate is the rate of interest paid on the bond's face value. It is normally printed on the face of the bond and never changes. The coupon amount is the basis on which two other yields—the current yield and yield-to-maturity—are measured.

Holding Period Return. The holding period return refers to the rate of return realized over the holding period of the security. It is calculated by dividing the total investment income during a given period by the purchase price or sum invested. The numerator, or income, is the amount received on an investment over and above the amount initially invested. It is the total value minus the basis. For example, if an investor purchases a stock for $72 per share, holds the stock for a year, and then sells it for $75.50 after a dividend payment of $3.70, the holding period return is calculated as \$75.50 – \$72.00 equals \$3.50 + \$3.70, or \$7.20 total gain, divided by the invested amount of \$72.00, for a holding period return of 10 percent.

Net Present Value (NPV). Present value is the discounted value of future cash flows, represented by the present value of the total benefits less the present value of the total investment. Net present value can be used to compare the total benefits from an investment with the capital required to make the investment in today's dollars. For example, by applying a present-value factor, one may determine that receiving \$1,000 two years from now is equivalent to receiving, perhaps, \$850 today.

Net Future Value (NFV). Net future value is the future value of the total benefits of an investment less the future value of the capital required to make the investment. Net future value can be used to compare the consequences of investing versus not investing. The future value of the investment contributions represents what the investor will have in the last year of the projection if the investor does not make the investment and invests the capital elsewhere at a certain reinvestment rate.

Internal Rate of Return (IRR). Internal rate of return is the discount rate that yields an NPV of zero. The IRR is not always a reliable measure of an investment, since it has two potential faults. First, IRR assumes that as the benefits and the returned principal from the investment are received, they are reinvested at the same rate as the investment that internally generated it. The investor must reinvest the benefits in alternative investments that yield a return as high as the investment being reviewed. This may be unrealistic when the IRR is relatively high or low. Second, when there are negative benefits, there may be more than one solution to the IRR. Negative benefits occur if taxable income generates a tax cost greater than the cash disbursements for the year.

Adjusted Rate of Return (ARR). Adjusted rate of return, an alternative to the more traditional IRR, is a more realistic measure of an investment's value because it allows adjustment of reinvestment and tax rates. The use of the ARR permits reinvestment of smaller cash flows at different rates.

3. BANK INVESTMENTS

Bank investments include items such as money market funds, savings accounts, and certificates of deposit. These items make up a large portion of short-term, relatively liquid investment sources. Although short-term investments usually have a lower yield than longer-term securities, they have many advantages:

— They provide liquidity and are easily accessible.

— Many are insured and virtually risk-free.

— They do not require investment sophistication and are easy to understand.

— They are generally good for small investors because they do not require large sums.

— Short-term interest-bearing investments, such as money market funds, make excellent investments during periods of generally rising interest rates because their yield moves in direct relation to market interest rates, and they are not subject to a decline in market value, which could plague long-term bonds and even equity securities at these times.

Short-term investments also have several disadvantages:

— Under FDIC limits, they are not insured for amounts above $100,000.

— Most certificates of deposit contain early withdrawal penalty costs that can drastically reduce the yield if not held to maturity.

— In periods of falling interest rates, many other investments, such as long-term debt and equity securities, generally provide a substantially higher yield.

3.1 Certificates of Deposit (CDs)

Certificates of deposit are issued by commercial banks and savings and loan associations. They pay a yield often based on the going Treasury bill (T-bill) rate. These certificates can be purchased in a variety of denominations and with maturity dates that range from thirty days (short-term) to longer than five years (long-term). The minimum purchase amounts usually become higher as the maturity period becomes shorter. Interest rates on certificates normally remain fixed over their maturity and investors face an interest penalty for early withdrawal. Interest rates generally increase as the term of the certificate increases.

3.2 Jumbo Certificates of Deposit

Jumbo certificates of deposit are issued in various denominations by commercial banks and savings and loan associations. Interest rates on these CDs are often high to attract large investors; their maturity dates can range from thirty days to several years. Jumbo CDs are generally issued for a minimum investment of $100,000. The interest rate is generally the highest available given this level of safety. Jumbo CDs issued up to $100,000 are therefore a minimal risk. These CDs can also be used as collateral for loans. Jumbo CDs have several disadvantages, including full taxation of the earnings, interest penalty for early withdrawal, and lack of capital appreciation. Large-denomination CDs are rated by *Moody's* and other investment services.

3.3 Banker's Acceptances

A banker's acceptance is created when a bank "accepts" or signs a letter of credit for a business. By so doing, the bank accepts responsibility for payment of the business debt. The letter of credit then becomes a banker's acceptance or the equivalent of a promissory note written by the bank.

Banker's acceptances are frequently sold to acceptance dealers. One reason a bank may sell the acceptance is to recoup the money it invested in the loan before the loan expires. Banker's acceptances may be resold to numerous other parties before the loan is repaid. The investor who last owns the acceptance when the debt becomes due has a right to collect from the borrower. Should the borrower default, the investor can also pursue payment from the accepting bank. Banker's acceptances have a very low risk with a moderate return.

3.4 Repurchase Agreements

Repurchase agreements are contracts in which an investor or security dealer sells a United States security to a bank or other corporation and agrees to repurchase the security later at a specified time and price, including interest. The security itself serves as collateral. Repurchase agreements are a common institutional investment and generally require a large investment amount. The investment period ranges from one day to several months, and the purchaser earns interest competitive with money market rates.

4. BONDS

A bond is a loan to the bond issuer, who must pay back the principal of the bond with interest. A bond represents a creditor position, rather than ownership, as with stocks. For example, to cover a $10 million debt, a bond issuer may sell 10,000 bonds with a $1,000 face value, a sale known as a *bond issue*. Bonds generally are issued for the long term, and are marketable during this term, with a value that moves inversely to changes in market interest rates. For example, a $10,000 bond issued at 8 percent would be marketable for considerably less than $10,000 if interest rates were to move to 10 percent (since an $8,000 bond at 10 percent yields the same annual interest payment), and could be marketed for considerably more than $10,000 if interest rates were to fall to 6 percent.

Corporate bonds are usually general debentures. That is, bond holders are second in line for payment behind secured creditors in case of default. In contrast, mortgage bonds are secured by specific real estate of the issuer.

Behind every bond issue is a legally enforceable contract called an *indenture* which describes the relationship between the bond issuer and the original purchaser. Bond issuers must inform all original purchasers in writing of what the money will be used for, what interest the purchasers will receive, when the bonds will mature, and of other pledges and restrictions of the indenture.

All U.S. government securities fall into the general categories of treasury and agency securities. U.S. government bonds are generally seen as a source of risk-free interest income because they represent the safest investment grades of debt available.

Federal securities are divided between marketable and nonmarketable issues. Marketable issues make up about two-thirds of the federal debt and include T-bills, Treasury notes, Treasury bonds, and certificates of indebtedness. Nonmarketable issues are mostly U.S. savings bonds. Interest income from U.S. Treasury securities is exempt from state and local income taxes.

All new issues of T-bills, Treasury notes, and Treasury bonds are in book-entry form. No certificates are issued for any of these securities. A receipt or account statement serves as the record of ownership.

Investors may use the Treasury Direct Securities System, whereby book-entry accounts are maintained on the records of the Department of the Treasury, Bureau of the Public Debt. Securities held in Treasury Direct can be purchased at original issue directly from a Federal Reserve Bank or Branch, or from Public Debt. Broker commissions are eliminated on Treasury Direct purchases.

Investors receive a statement of account after establishing an account in Treasury Direct, and whenever certain transactions occur within the account. Principal and interest payments are processed electronically by direct deposit into the investors' account at their locally authorized financial institution.

In early 1998, Treasury announced a number of changes to the Treasury Direct program:

— Investors may now pay for securities directly with a debit to their bank account. Previously, investors had to pay with a cashier's check or with a certified check.

— Investors may now reinvest maturing securities by calling toll-free (800) 722-2678 from a touch-tone phone 24 hours a day, 365 days a year. Reinvest Direct enables an investor to reinvest the security simply by logging into the "virtual lobby" at www.publicdebt.treas.gov. Previously, investors had to reinvest by mail. After August 31, 2004, however, investors may no longer reinvest HH/H bonds or exchange EE/E bonds for HH bonds.

— Investors may now sell securities directly by mailing a form to the Chicago Federal Reserve Bank, which will accept three price quotes from dealers and accept the highest bid. The Bank will charge a $34 fee for each security sold. Previously, holders had to sell the securities through a bank or dealer.

Forms and information about the Treasury Direct program may be obtained on the Internet at www.publicdebt.treas.gov, by calling (800) 722-2678, or from any Federal Reserve Bank.

4.1 T-bills

T-bills are short-term notes that mature in thirteen, twenty-six, or fifty-two weeks after date of issue. New bills are usually offered by the federal Treasury every week. T-bills are sold at a discount from the face value of the bill, a difference that represents the investment value of T-bills. For example, a $10,000 thirteen-week or ninety-day T-bill might be purchased for $9,875 at approximately a 5 percent effective annual interest rate. The $125 difference represents the income gained from the bill. T-bills can be purchased in a minimum amount of $1,000 and in multiples of $1,000 thereafter.

The Treasury began offering four-week bills issued on a weekly basis. The four-week bills are available on the commercial market through financial institutions, brokers, and securities dealers. They are not sold in Treasury Direct.

4.2 Treasury Notes

Treasury notes resemble certificates except for the time of maturity. Newly issued notes usually have a maturity period of two to ten years. They pay a fixed interest rate semiannually and their market prices, which fluctuate continuously, can rise and fall in inverse relationship to market interest rates. New issues of Treasury notes can be obtained from Federal Reserve Banks without a fee for the service under the Treasury Direct System. Treasury notes can be purchased in minimum denominations of $1,000.

Since only new Treasury issues can be purchased directly from the government, previously issued notes and bonds must be purchased through banks or brokers while incurring an additional commission cost. For issues after 1986, the Treasury no longer prepares engraved or registered securities. New issues are done by book entry only. Registered bonds are not readily marketable and should generally be avoided.

4.3 Treasury Bonds

Treasury bonds have the longest maturity period of all the Treasury issues, ranging from 10 to 30 years, are sold at face value, and pay semiannual interest. Treasury bonds are issued in denominations of $1,000. Because of their longer maturity, they generally carry a higher interest rate. If long-term bonds are traded before maturity, their values can be volatile in periods of rising or falling interest rates. Therefore, the investor needs to be aware of cyclical changes in interest rates and other economic trends.

Treasury bonds can be obtained through banks, brokerage firms, and government securities dealers, both for new issues and for secondary market issues. New issues can be purchased at Treasury auctions directly from the Bureau of Public Debt or from the Federal Reserve Banks and branches.

The Treasury Department stopped issuing fixed-principal Treasury bonds between August 2001 and February 2006. The 30-year bond was reintroduced to diversify Treasury's funding options and stabilize the average maturity of the public debt. The 30-year bond no longer maintains a position of significance in the financial markets. Its role in liquidity has been significantly impaired by the substantial reduction of issuance that has occurred over the last decade. The Treasury has also been calling certain long-term bonds before maturity to reduce the cost of debt financing on those bonds that are significantly above the current cost of securing financing.

4.4 Zero Coupon Treasury Securities

As discussed in section 4.10.10, zero coupon bonds are issued at a substantial discount from par with all interest payable at maturity. Nonetheless, interest is taxable annually as it accrues. U.S. Treasury zero coupon securities are state tax exempt and have the financial security of

U.S. government backing. Zero coupon Treasury securities are available from a number of sources.

4.4.1 Separate Trading of Registered Interest and Principal of Securities (STRIPs)

The U.S. Treasury introduced zero coupon securities, better known as STRIPs, in February 1986. All new T-Bonds and T-Notes with maturities greater than ten years are eligible. STRIPs are available in book-entry form only. STRIPs may be purchased and held only through financial institutions and government securities brokers and dealers.

4.4.2 Certificates of Accrual on Treasury Securities (CATs)

In 1982, Salomon Brothers began issuing Certificates of Accrual on Treasury Securities, or CATs. These fully registered certificates are available in $1,000 maturity values with all interest payable at maturity. Since the Treasury's introduction of STRIPs, Salomon ceased to issue new CATs.

4.4.3 Treasury Investment Growth Receipts (TIGRs)

Merrill Lynch made available Treasury Investment Growth Receipts, or TIGRs (pronounced *Tigers*). Characteristics are the same as other Treasury zeroes, but like CATs, TIGRs are available in registered certificate form. Since the Treasury began issuing STRIPs, no new TIGRs have been issued, however, existing issues are still available on the market.

4.5 U.S. Savings Bonds and Inflation-Protection Securities

Savings bonds represent the nonmarketable issue of U.S. securities. They cannot be traded on the securities markets and are not transferable or negotiable. They can be purchased and redeemed from the U.S. Treasury through commercial banks, or directly from the Bureau of Public Debt on the Internet at www.publicdebt.treas.gov or by calling (800) USBONDS or (800) 872-6637. They are most attractive to small investors and are sold in relatively small denominations. Savings bonds present little or no investment risk, but their return is also relatively low compared to other government issues.

There are three types of savings bonds on the market. Series EE and Series HH replaced the old Series E and H bonds issued between 1941 and 1952. Series I bonds are inflation-indexed debt securities which have been issued since 1998. Series E and H bonds no longer yield interest. Accrued interest on matured Series E Bonds is not taxable until cash is received. Taxation on the interest can be deferred if the Series E bond had been exchanged for a Series HH bond prior to August 31, 2004.

Bond holders should check maturity dates annually to determine if any bonds have matured. Series E bonds issued before 1965 reach maturity after forty years, and discontinue accruing interest upon maturity. Also, unless Series E bonds had been traded in for Series HH bonds within twelve months of maturity, accrued interest on the Series E bonds is taxable in the year of maturity.

Certain interest income from U.S. savings bonds used for higher education tuition and fees is exempt from taxation. Section 135 of the Internal Revenue Code defines the requirements for the interest income to be tax-exempt. Limitations exist on the use of the redemption proceeds, and a limitation on the tax-exempt status of the income is based on the adjusted gross income of the taxpayer redeeming the bonds. Certain other restrictions also exist as defined in Section 135 of the Internal Revenue Code.

4.5.1 Series EE Patriot Bonds

Series EE bonds have a minimum purchase price of $25 (face value $50) and a maximum of $15,000 (face value $30,000) that may be purchased by an individual in a calendar year. The investment return on Series EE bonds is from the appreciation in value of the bond. Series EE bonds are purchased for half the face value of the bond.

The time required for a bond's value to be equal to its face value is based on the minimum guaranteed rate in effect at the time the bond is purchased. The maturity period is twelve years if the minimum guaranteed rate is 6 percent. For example, a bond purchased for $500 can be redeemed after twelve years for $1,000.

The interest on EE bonds held five years or longer is calculated to equal 85 percent of the average market yield on five-year Treasury notes, compounded semiannually. Bonds purchased after April 2005 earn interest at a fixed rate for the 30-year life of the bonds.

Series EE bonds may be exchanged at redemption for Series HH bonds at a minimum of $500 face value. Interest on Series EE bonds may be tax-deferred until maturity, or the taxpayer may elect to report the interest income annually.

Series EE bonds purchased beginning December 11, 2001, are specially inscribed with the words *Patriot Bond.* The bonds have terms identical to traditional Series EE bonds. The change is in name only, to inspire Americans to contribute to the government's war effort and save for their futures as well.

4.5.2 Series HH Bonds

Series HH bonds have a maturity period of 10 years. The investment value of HH bonds is the semiannual interest payments, which yield an average of 5 percent to 10 percent depending on market factors. The minimum purchase price of Series HH bonds is $500; the maximum annual purchase limit is $20,000. Unlike Series EE bonds, Series HH bonds are purchased at the face value of the bond.

Series HH bonds are no longer available from the Treasury after August 2004. Prior to that date, Series E or EE bonds or savings notes worth $500 or more in redemption value could be exchanged for HH bonds. Series HH bonds may not be exchanged for Series EE bonds.

4.5.3 Series I Bonds

Beginning in 1998, a new type of bond is available for investors seeking to protect the purchasing power of their investment and earn a guaranteed real rate of return. Like Series EE bonds, I bonds interest is added to the bond monthly and paid when the bond is redeemed. Unlike EE bonds, however, I bonds are sold at face value and grow in value for up to thirty years.

The I bond earnings rate is actually a combination of a fixed rate of return and a variable inflation rate which is adjusted semiannually. Like other direct U.S. government securities, the interest is exempt from state and local income taxes with federal income taxes deferred until redemption or maturity.

I bonds are available in $50, $75, $100, $200, $500, $1,000, $5,000, and $10,000 denominations and up to $30,000 may be invested in any calendar year. They may be purchased at most financial institutions, through employer-sponsored payroll savings plans, or directly from the government Web site with direct withdrawal from the investor's bank account.

4.5.4 Inflation-indexed debt instruments

The Treasury issued "Treasury Inflation Protection Securities" starting January 29, 1997. These securities are adjusted for inflation and deflation, and provide for semiannual payments of interest and a payment of principal at maturity. In general, each payment is adjusted to take into account any inflation or deflation that occurs between the issue date of the security and the payment date.

The principal amount of these securities is adjusted for inflation and deflation based on monthly changes in the CPI for All Urban Consumers, published by the Bureau of Labor Statistics of the Department of Labor. The inflation-adjusted principal amount of the security for the first day of any month is determined by multiplying the principal amount at issuance by a fraction, the numerator of which is the value of the index for the adjustment date and the denominator of which is the value of the index for the issue date. The inflation-adjusted principal amount of the security for a day other than the first day of the month is determined based on a straight-line interpolation between the inflation-adjusted principal amount for the first day of the month and the inflation-adjusted principal amount for the first day of the next month. The value of the index used to determine the adjustment for the first day of a particular month is the value of the index reported for the third preceding month.

Each semiannual payment of interest is determined by multiplying a single fixed rate of interest by the inflation-adjusted principal amount of the security for the date of the interest payment. Therefore, although the interest rate is fixed, the amount of each interest payment varies with changes in the principal of the security as adjusted for inflation and deflation.

The securities also provide for an additional payment at maturity if the security's inflation-adjusted principal amount for the maturity date is less than the security's principal amount at issuance. The amount of the additional payment is equal to the excess of the security's principal amount at issuance over the security's inflation-adjusted principal amount for the maturity date.

4.5.5 Online Bond Accessibility

Internet accessibility to savings bond information allows an investor to not only find information on suitable bond investments, but also to monitor current redemption values and determine if older savings bonds are still earning interest. This information is available online at www.publicdebt.treas.gov/sav/savinvst.htm.

Savings bond wizard software may also be downloaded from this site allowing a user to manage a portfolio of savings bonds. This application allows a user to maintain an inventory of savings bonds and determine current redemption value, earned interest, and other information.

Treasury Direct is an online system that allows investors to purchase Treasury bills, notes, and bonds directly from the government using the phone or Internet. Access to these services is available by calling (800) 722-2678 or on the World Wide Web at www.publicdebt.treas.gov.

4.6 Agency Bonds

An agency bond is a security offered by a federal agency created by Congress. There are two types of federal agencies: (1) agencies that are a part of the federal government and (2) federally sponsored but privately owned agencies that have a public purpose. Most agency debt is issued by federally sponsored agencies.

Agency bonds have characteristics similar to other governmental bonds. Agency bonds are not as secure as other federal obligations because the federal government makes no direct guarantee that the principal and interest of these bonds will be paid. They, therefore, have higher yields than other federal bonds. In practice, though, the federal government has an implied guarantee protecting any of its own agencies from default, and in times of agency financial crisis in the past, the Treasury has provided help. The greatest risk to the investor may be a delay in interest payments or principal payments, but an investor's expectations may also be thwarted by interest rate risk or by early retirement of the debt.

4.6.1 Government sponsored agencies

Direct government agencies that issue bonds have an implied government backing and are considered to be of extremely sound quality. They are as follows:

— Federal Farm Credit Banks (FFCB)

— Federal Land Banks (FLB)

— Federal Home Loan Banks (FHLB)

— Federal National Mortgage Association (FNMA) (Debentures and Notes)

— The Financing Corporation (FICO)

— Student Loan Marketing Association (SLMA)

— Resolution Funding Corporation (REFCORP)

4.6.2 Federally sponsored enterprises

Federally sponsored enterprises were created by congressional action, but may or may not have complete government backing of their securities. Nonetheless these securities are considered to be of very high quality. They are as follows:

— Export–Import Bank of the United States (Eximbank)

— General Services Administration (GSA)

— Washington Metro Area Transit Authority

— Tennessee Valley Authority (TVA)

— United States Postal Service

— National Power Corporation (NPC)

— Maritime Administration (Merchant Marine)

4.7 State and Municipal or Tax-Exempt Bonds

State and local governments issue bonds referred to as *municipals* or *tax-exempts*. Municipals offer both security and favorable tax status, although recent tax-law changes have removed the favorable tax status for some

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forms of municipal bonds. Most municipal bonds are issued by local-government counties, cities, and townships, school districts, state and local commissions, agencies, universities, and colleges. The wide variety of issuers provides an opportunity for broad diversification among bondholders.

Municipal bonds are unsecured debenture contracts that promise to pay principal and interest solely from tax or operating revenues. Bonds are issued in straight and serial maturities. Serial bonds pay off part of the debt periodically, usually every six months. If a debt is not paid through serial payments, a sinking fund is used to set aside money to pay off the bond at maturity. The two basic types of municipals are revenue bonds and general obligation bonds.

The Tax Reform Act of 1986 removed the tax exemption for interest earned on certain types of state and local obligations. Interest remains tax exempt on obligations issued by a qualified governmental unit to finance activities of the government unit itself. For example, financing of general government operations for construction of schools and highways continues to qualify for the interest exemption.

Interest on government bonds used for nonexempt private activities generally is taxable if the bond was issued on or after September 1, 1986. Bonds that finance sports or convention or trade show facilities are also taxable after that date.

Certain bonds, while remaining tax exempt, produce interest income categorized as a tax preference item for purposes of the alternative minimum tax. Included in this category is interest earned on certain nonessential bonds issued after August 7, 1986.

The taxable equivalent yield of municipal bonds has been affected by the tax rate reduction (see section 1.4). Certain investors who previously bought municipal bonds when they were in the 39.6 percent bracket may be better served with other investments, especially if they no longer are in the highest marginal tax bracket under the 2003 Act.

However, investors' appetites for tax-exempt bonds will likely remain very strong in high-tax areas such as New York City, where local taxes are heading sharply higher and many investors prefer bonds issued by their home state or municipalities.

4.7.1 Revenue bonds

Revenue bonds are bonds issued by a political subdivision, government, or public authority that pays the debt out of revenues of the project being financed. Some revenue bonds may also have additional support from tax revenues. These bonds are sometimes called combination bonds.

There are three types of revenue bonds: utility, quasi-utility, and nonutility. Each type includes or represents a certain kind of service project or entity such as public transportation—a bridge, tunnel, or highway—or an airport or hospital.

Revenue bonds tend to be, at least theoretically, less secure than general obligation bonds because they are dependent upon the success of the project they are financing. For example, a bond debt incurred to build a toll bridge would be paid off through the toll charges for the use of the bridge. If those charges become insufficient to meet the bond obligation, the bondholder has little recourse. These bonds generally carry a higher interest rate, however, and it is not unusual for a state or other government subdivision to intervene in the case of revenue-bond default.

4.7.2 General obligation or full-faith-and-credit bonds

General obligation bonds are guaranteed by the political subdivision's power to tax. Although there is no property securing the bonds, holders receive an unconditional guarantee of payment. General obligation bonds account for most of the debt incurred by subfederal government units. Revenues for payment on the bonds are generally raised through property taxes.

To be fully secure, general obligation bonds must be issued by a government unit that has an unqualified authority to issue the bonds. Legal consultants are employed to study the constitution, statutes, charters, and bylaws of the issuing entity to ensure that it meets all the legal requirements. If the bonds are legal, the consultant will issue an opinion attesting to that fact. This opinion will not prevent a loss if it is incurred, but it does provide assurance that everything is in good order for issuance. A copy of the legal opinion is usually provided to each buyer.

4.7.3 Assessment bonds

Assessment bonds make up a very small portion of municipals. They are usually issued to raise money to improve existing government facilities such as sewers, sidewalks, and streets. Payments on the bonds are made from the proceeds of special assessments on the property owners who benefit from the improved property. The assessment is set up so that a portion is specifically designated for payment of bond obligations. The risk related to these bonds corresponds to the potential decline in the value of the property and the possibility that property owners simply refuse to pay, even under threat of attachment of the property.

4.7.4 Other characteristics of government bonds

Other features may be present in municipal bonds, including callable bonds, put bonds, and variable rate bonds. A callable bond can be redeemed by an issuer prior to maturity, usually during periods of falling interest rates. Typically, a premium is paid to the bondholder when it is called. A put bond allows the bondholder to sell the bond back to the issuer at a predetermined price. The variable rate bond pays fluctuating interest rates, according to market conditions. Put and variable rate bonds are offered to bondholders as a hedge against the risk of an unprofitable investment as a result of rising interest rates.

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One of the most attractive features of municipals is their tax-exempt status. Income from certain municipals is exempt from federal taxation. In many states, income from municipals within the state is also exempt from state taxation. They are therefore particularly attractive to high-income buyers. Although interest rates and yields on municipals are usually lower than on other bonds, their tax-exempt status may generate a better yield after taxes. For example, a taxpayer in a 35 percent federal tax bracket buying a 5.25 percent tax-exempt bond would receive an after-tax yield equivalent to that of a taxable bond of 8.1 percent.

4.7.5 Qualified Zone Academy Bonds (QZAB)

Qualified Zone Academy Bonds, or QZABs, are new financial instruments that provide a different form of subsidy from traditional tax-exempt bonds. The federal government pays interest on QZABs in the form of an annual tax credit to a bank (or other eligible financial institution) that holds the bond. A state or local government entity issues QZABs for the benefit of schools located in a Qualified Zone Academy. The QZAB issuer is responsible for repayment of the principal upon maturity. The credit (interest) rate and maximum maturity applicable for each month of issue are determined by statutory formulas as described in IRS Rev. Proc. 98-9.

The amount of the tax credit claimed must be included in the bondholder's taxable income for the year. Accordingly, the effective yield is competitive with other taxable, fully guaranteed securities.

4.8 Mortgage-Backed Securities

Home ownership is possible for most individuals only through the use of mortgages. Mortgage-backed securities are secured by a pool of mortgages and offer a relatively secure, income-oriented investment. For many mortgage-backed securities, a government agency provides a guarantee, or assurance against default is provided by a private firm. Payments on the mortgages are made to a bank or to a mortgage banker, which collects the monthly payments of interest and principal, removes a servicing fee, and passes the remainder through to the investors.

Mortgage-backed securities generally have a higher stated yield than direct government securities. However, it is normally very difficult to determine an effective yield to maturity. Since the mortgage pools return principal as well as interest monthly, the principal received must be reinvested to continue earning.

In an environment of falling interest rates, the level of principal repayments can increase dramatically due to homeowners refinancing at lower rates. Accordingly, the stated maturity term is often severely eroded and an investor is forced to reinvest larger amounts at lower prevailing rates. Because of the repayment acceleration, mortgage-backed securities often do not enjoy the gains produced by fixed income securities when rates fall.

4.8.1 GNMA securities

The Government National Mortgage Association (GNMA) issues mortgage-backed securities. These securities are commonly known as *Ginnie Maes.* Mortgages are purchased from private lenders by the GNMA at low yields to encourage certain types of home ownership. The GNMA then sells pools of these mortgages to investors at current market yields. The difference between the low yield of the mortgages and the yield to the investors is paid by GNMA as an incentive to stimulate housing activity. Unlike U.S. Treasury obligations, Ginnie Mae securities are issued by private firms and cannot be purchased directly from the government.

Since the GNMA securities are issued against a specified pool of mortgages guaranteed by certain government agencies, from an investment perspective they are effectively guaranteed by the U.S. government. Principal and interest payments are made monthly on GNMA securities, similar to the payment for other mortgages. The minimum denomination on new GNMA pools is $25,000 but the pools are available in any dollar amount greater than that. It is possible, however, to make investments of less than $25,000 by purchasing Ginnie Mae certificates that are either selling at a discount or have substantially reduced their principal. For more information visit the Web site www.ginniemae.gov.

4.8.2 FHLMC and FNMA securities

Similar to GNMA securities, the Federal Home Loan Mortgage Corporation (Freddie Mac) and Federal National Mortgage Association (Fannie Mae) sell pools of mortgages to investors. Unlike GNMA, however, these securities are generally available in denominations of $1,000. More information can be found at www.fanniemae.com or at www.freddiemac.com.

4.8.3 Collateralized mortgage obligations

Collateralized mortgage obligations (CMOs) actually represent serial bonds that produce income on a quarterly basis. CMOs are structured into two or more classes, each of which has its own coupon rate and maturity. Interest is paid to all interest-paying classes, but principal is paid to only one class at a time. While CMOs enjoy a high quality of collateral, they are subject to interest-rate risk, particularly for long-term CMOs. Some CMOs are collateralized by various federal agencies, whereas others are collateralized by conventional mortgages.

Interest and principal payments on CMOs come from the mortgage payments of the home owners. The CMOs then make fixed-rate interest payments to eligible security holders on a quarterly basis. CMOs are divided into short-, intermediate-, and long-term classes. As principal on the mortgages is paid by the home owners, it is applied to each investment class of the CMO in succession. As one investment class is totally paid off, the next investment class begins to receive principal payments.

CMOs are divided into an interest-paying bond class and a deferred-interest bond class. The interest-paying bond class offers investors current income. Interest payments are made to the bondholders from the cash resulting from the pool of underlying mortgages. Any remaining cash flow is then used to retire the shortest maturity bonds in the class. Deferred-interest bonds differ from the interest-paying bonds in that payments are not distributed until all previous classes have been retired. Interest accrues on the unpaid balance and the principal amount grows at each payment date. The deferred-interest bonds are ideal for retirement and profit-sharing accounts, since payments do not occur until some point in the future.

Real estate mortgage investment conduits (REMICs) represent collateralized mortgage obligations and work similarly.

4.8.4 Reverse mortgages

The Home Equity Conversion Mortgage program (HECM) is a HUD-approved program that provides reverse mortgages. Under a reverse mortgage, a borrower (normally a retired individual) taps into the equity of a home to pay expenses, make improvements to the home, or simply to have cash on hand. The loans are made in a nonrecourse manner, resulting in the sole recourse of the lender for repayment being foreclosure upon and sale of the property. As such, the borrower is not obligated for more than the home is worth and neither the borrower nor the borrower's estate is liable for any deficiency.

Reverse mortgages are targeted to older homeowners who have substantial equity in their homes. Both husband and wife borrowers, however, must be eligible to collect Social Security benefits, age sixty-two, or older.

Homeowners are allowed to borrow against the equity in a home in an amount based on the age of the borrower, the amount of equity along with the appraised value of the home, and the payment option selected by the borrower. Payment options include a lump sum payment from the lender to the borrower at closing, a line of credit available to the borrower, or some combination of the two. The ability to obtain a reverse mortgage is neither dependent on the borrower's income or credit history because the reverse mortgage is nonrecourse and the amount that can be obtained by the borrower is based upon the value of the home and the life expectancy of the borrower.

At present, secondary market sources have been unwilling to purchase reverse mortgages, with the result that most mortgage lenders are unable or unwilling to offer the product. The Federal National Mortgage Association (FNMA) has introduced a homekeeper loan program which allows mortgage lenders to offer reverse mortgages by providing a secondary market source to which these loans may be sold. Because of the small secondary market for these reverse mortgages, they do not represent viable investment vehicles at this time. As the secondary market increases, investment opportunities in these securities should expand as with other mortgage-backed securities.

Several Internet Web sites provide calculators to determine the maximum reverse mortgage homeowners may obtain considering their age, home value, and location. One such user-friendly Internet site is at www.reverseweb.com.

4.9 Bond Ratings

The potential bond purchaser needs to investigate the legality and financial position of a municipal bond issue. Bond-rating services are available for this purpose. *Moody's Municipal and Government Manual* is a factual, interpretive rating service for almost all state and municipal bonds. *Standard & Poor's Bond Guide* is another well-known bond-rating guide, as is *Fitch's Investors Service.* Bonds are rated from Aaa to D (for default—meaning the payor is late in making one or more of the scheduled interest payments), with several subratings within a triple-A rating for the best-quality bonds. Conversely, C-rated bonds are considered risky or poor quality bonds. Bonds rated B or below are not investment grade; that is, in most states they may not legally be purchased by persons or institutions acting in a fiduciary capacity.

4.9.1 Junk bonds

Lower quality bonds generally provide higher yields, at the price of higher risk. These high yield, or "junk bonds," are normally rated Ba and below. While these bonds provide the highest levels of income, they also provide the greatest potential for default. The prices of junk bonds often fluctuate a great deal, based on the fortunes of the bond issuer. Junk bond prices are also impacted in the short term by interest rate fluctuations. Accordingly, junk bonds carry a high degree of risk and should be used cautiously by investors.

4.10 Corporate Bonds

Corporate bonds represent legal debt of a corporation that finds it necessary to raise capital by borrowing. There are several types of corporate bonds. Besides ordinary corporate bonds, there are discount and zero-interest (coupon) bonds, silver-gold indexed bonds, put bonds, and variable-rate bonds. Some bonds also offer the bondholder a share in the growth of earnings.

4.10.1 Bond indentures

The promises made by a corporation to a bondholder upon the sale of a bond are set out in the bond indenture. The agreement itself is usually made between the corporation and a representative of the bondholder, such as a commercial bank or trust company. The use of such a representative or trustee is the only practical way the corporation can issue to individual bondholders. The indenture usually describes the authorization of the issue; the interest rate; the property pledged as security; and the rights, restrictions, and remedies of the parties upon default.

4.10.2 Value and denominations

A common value of a bond is $1,000, although bonds with a $5,000 or $10,000 value are not uncommon. This value is known as the par value, face value, or maturity value.

4.10.3 Short-term versus long-term bonds

Maturity dates of corporate bonds vary. Long-term bonds generally have maturity lengths of over ten years. Short-term bonds mature within five years and intermediate bonds, in five to ten years. The longer the maturity, the more a bond is subject to interest rate risk and purchasing power risk. Recently some Fortune 500 companies have successfully sold fifty-year bonds.

4.10.4 Call feature

Most modern corporate bonds are callable at the discretion of the issuer, an option known as the *call feature.* The call feature allows the corporation flexibility in retiring outstanding bond debts. Bonds are usually called at a price higher than par value to compensate the bondholder for the loss of earnings from early retirement of the bond. The difference between the par value and call price is referred to as the *call premium.* The time and the amount at which a bond can be called are usually spelled out in the indenture.

4.10.5 Serial bonds

Some corporate bonds are serial bonds—actually a series of bonds with different maturity dates. An issue matures every six months or at another regular interval. The yield varies with the maturity date. Generally, serial bonds are not callable because the corporation is already systematically retiring the debt.

4.10.6 Debenture bonds

Not all bonds are secured by a pledge of the corporation's personal property or real estate. A debenture bond carries a full-faith-and-credit obligation whereby the corporation pledges its assets, earnings, and character to fulfill its bond obligation. The corporation's assets could

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be used to satisfy unpaid bond interest or principal. In the case of default, bondholders become general creditors. All assets not specifically pledged, or any funds remaining after payments of secured debts from assets previously pledged, are available to pay the legal claims of the general creditors.

4.10.7 Interest on bonds

Interest on a bond is usually paid semiannually, by check or coupon, and either directly or to the bondholder's representative or trustee. The par, or face amount, of the bond multiplied by the stated interest rate determines the dollar amount of interest to be paid for a year. The amount is fixed for the life of the bond. If interest payments are not paid on time, the bond is in default and all interest and principal normally become due and payable pursuant to an acceleration clause in the bond agreement. This acceleration provision primarily establishes the bondholder's claim to assets and does not ensure repayment of the principal. The trustee is usually responsible for acting on behalf of and for protecting the bondholder's interests.

4.10.8 Income bonds

Income bonds pay interest only if there are sufficient earnings. In some cases interest payments must also be approved by the board of directors. Unpaid interest may be cumulative and payable later. Income bonds are often issued pursuant to a corporate reorganization or recapitalization.

Income bonds vary in detail. Some are convertible into common stock. A portion of the interest paid may be mandatory or contingent on earnings. Interest is usually paid only once a year.

A bond indenture may contain protective covenants that serve to preserve the bondholder's investment. An example would be a limitation on dividends payable on common stock to protect the financial status of the company.

Many income bonds have proved to be good investments, and many have mortgage security and sound indentures.

4.10.9 Bond quality ratings and services

As with government bonds, professional rating services are available to investors who want to investigate the advisability of purchasing a certain corporate bond. Ratings are based on the reputation of the bond issuer—its interest payment record, its profitability, and so forth. *Moody's Industrial Manual* and *Standard & Poor's Bond Guide* are two well-known, well-respected rating services available to investors. Rating services differ, but the highest ratings given are often AAA for the most secure, followed by AA, A, B, and so on, with many intermediate steps to the lowest ratings.

4.10.10 Zero coupon bonds

Zero coupon refers to a bond that pays no current interest. Instead, the bond is purchased at a deep discount and redeemed after a holding period for face value. The gain on zero coupon bonds is comparable to the gain from interest paid on other bonds. Interest is actually compounded each year on a zero coupon, but the bondholder does not receive it. Rather, it is "reinvested" into the bond so that the face value of the bond increases every year until it reaches total face value at the end of the term.

Even though interest is not actually paid annually, the increase in face value is treated as annual income taxable to the bondholder. (Some tax-exempt bonds are available in zero coupon form as discussed at section 4.4. The increase in value is not taxable.) The zero coupon bond is not unlike a savings account or certificate of deposit for which the interest gain is continually reinvested.

4.11 Payment-in-Kind (PIK) Bonds

Bonds having interest paid in the form of additional securities are known as "payment-in-kind" (PIK) bonds. These bonds allow investors to combine the advantages and disadvantages of equity investments, as described in Section 5.10 of this chapter, with the advantages and disadvantages of debt securities.

5. COMMON STOCK

Stocks represent an ownership or equity interest in a corporation. Although investment in stocks entails a greater risk of loss than does that in bonds, the potential for a greater gain is also present. A gain or loss on a stock investment is subject to market risk, to the earnings of the company, and to the dividends paid. Common and preferred stocks are the two basic types of stock traded. (Preferred stocks are discussed in section 7, below. See also the discussion of Stock Market Analysis in section 13.2, below.)

Common stock represents an interest in the residual earnings of the corporation after taxes, general liabilities, bondholders, and preferred stockholders have been paid. Common stock bears the greatest burden of risk of the enterprise but receives the greatest share of the returns if the corporation is successful.

5.1 Stock Certificate and Par Value

Ownership of common stock is evidenced by a stock certificate. The certificate states the number of shares owned and par value, if any. Par value is the face value at or above which shares must be issued. Low par values make it easier to sell the stock, and corporations that pay state excise and franchise taxes on par values pay lower taxes when par values are lower. In terms of the actual value of a stock at any given time, however, par value is meaningless. Investors should be interested in the value of stock as established by earnings and capital gains and not by the par value of stock. Some stocks are issued with no par value.

5.1.1 Initial public offerings

When a company goes public through an initial public offering (IPO), a brokerage firm, acting as underwriter, purchases stock from the company and resells it on a listed stock exchange. The initial prospectus, commonly called a red herring, provides prospective investors with complete details of the company, operating results, and the stock offering. The majority of stock issued in an IPO is reserved for institutional investors, although individuals can also participate in IPO offerings.

5.2 Preemptive Rights

Common stockholders enjoy a number of rights or privileges that correspond with their stock ownership. First, a preemptive right allows stockholders the first opportunity of purchasing from a new issue of shares so that they may retain their same overall ownership percentage of all outstanding shares. Shareholders then retain the same proportionate voting control and an undiluted share in the corporation's earnings and assets. It is quite common for the preemptive right to be waived via the articles of incorporation and, thus, not to be of benefit to shareholders. Some states make the preemptive right an automatic part of all corporate charters.

5.3 Voting Rights

Common stockholders have a right to vote on major issues (such as corporate mergers or new product lines) and election of directors. A small number of issues of common stock are classified into class A and class B shares. This is known as *classified common stock.* Historically, classified stock has represented an attempt by management to raise capital through the sale of public stock while retaining complete control of corporate decision-making. Class A stock was sold to the public and paid dividends but gave no voting right. Class B stock was voting stock and was held by management. Classified stock is not listed on the New York Stock Exchange. Most classified stock now issued is sold by new companies that want to retain management control while raising capital.

5.4 Cumulative Voting

Stocks with full voting rights permit a stockholder to vote as many votes as shares held. Each share is entitled to one vote; therefore, a shareholder with 100 shares could vote 100 shares for each director. About one-half of the states' laws of incorporation mandate cumulative voting. The rest allow it if provided for in the firm's articles of incorporation. With cumulative voting, each shareholder may cast all the cumulative votes for only one director or divide them among several. By concentrating votes on one director, shareholders otherwise in the minority can get representation on the board of directors.

5.5 Cash Dividends

The board of directors determines when and to what extent common shareholders are entitled to dividends. Cash dividends may be fixed in amount and represent a percentage of the earnings and cash flow per share. The *payout ratio* is that percentage of a firm's annual profits paid out as dividends annually to its shareholders. This ratio will vary over time and among companies and industries as dividends increase or decrease in relation to a company's prosperity.

The majority of all common stocks listed on the New York Stock Exchange pay dividends. Companies with greater excess cash flow naturally tend to declare higher dividends. Companies intent on retaining profits within the company for debt retirement, repurchase of stock, or expansion are called growth companies. As such, growth companies tend to have relatively low or nonexistent dividend payments. The investor appeal for growth companies lies in the prospect for future higher earnings rather than the current dividend income.

5.6 Stock Dividends

Although most dividends are paid in cash, some dividends are paid with stock. Stock dividends are paid in shares of the issuing company's stock. Stock dividends are usually stated as a percentage of shares outstanding. For example, a 2 percent stock dividend would give a holder of 100 shares two additional shares.

Stock dividends are usually issued by young companies, growth companies, or companies that are interested in conserving cash for further internal reinvestment of capital. Only a very small number of the companies listed on the New York Stock Exchange pay stock dividends. The percentage rate for stock dividends is usually below 10 percent, with a range from 2 to 5 percent being common.

5.7 Stock Splits

A stock dividend that pays more than 25 percent is usually referred to as a stock split. A stock dividend or split will increase the number of outstanding shares, but the effect on market price is unpredictable. Since the increased shares are in the hands of existing shareholders, however, the value remains unchanged. The primary reason for a stock split is to reduce the market value of the stock, making it more affordable for small investors.

5.8 Other Types of Dividends

In rare instances, dividends are paid through methods other than cash and stocks. A property dividend consists of one of the company's products, property, or securities of other companies that the issuing company owns. Extra dividends may be declared on a regular or irregular basis and represent dividends above those paid regularly. An extra dividend normally will not be paid unless the earnings substantially exceed those anticipated in the normal course of business.

5.9 Valuing Common Stock

An investor can determine the value and the risk involved in the purchase of a given stock by one of several methods. The four calculations discussed are preliminary indicators of whether a stock is worth further investigation. The figures derived from these calculations can be found in securities manuals and analytical reports.

All major brokerages and many business publications have online stock trading information to allow investors to follow the real-time value of a stock. Extensive company research is available online to track a stock's historical price performance and share volume. One can also find much analytical information on publicly traded companies, such as cash flows, balance sheet ratios, trends, and new developments. Due to the sheer number of such Web sites, users might be best served by starting at the "bookmarks" or "favorites" links on their Internet browsers.

5.9.1 Earnings per share

Earnings per share is derived by taking the net income after taxes, less preferred dividends, and dividing the result by the weighted average of outstanding common stock and common stock equivalents for the year. Common stock equivalents include stock options, warrants, convertible debt, and similar instruments.

5.9.2 Cash flow per share

Cash flow per share is calculated in a manner similar to earnings per share. This ratio is becoming increasingly important in analyzing stock performance because it adjusts earnings for special one-time charges against income or the amortization of intangible assets that do not require current cash flows. The ratio also distinguishes companies that are relatively debt free from those highly leveraged.

5.9.3 Book value

The net asset value per share or book value measures the amount of equity the corporation has with respect to each share of common stock. It is determined by taking the net balance-sheet cost of corporate assets less liabilities and dividing by the number of shares of common stock outstanding. Book value has little actual effect on market price—normally only indirectly when market price is low in relation to book value.

5.9.4 Price-earnings (PE) ratio

The price-earnings ratio is the market price of the stock expressed as a multiple of the earnings per share. For example, a stock with annual earnings of $5 per share that sells for $60 per share would have a price-earnings ratio of 12. The price-earnings ratio is also referred to as the stock's *earnings multiplier.* It is primarily an indicator of the degree of confidence investors have in the stock. The lower the price-earnings ratio, the less optimistic the evaluation of its future earning potential. Stocks with price-earnings ratios of 15 to 30 are believed to have significant growth prospects.

5.9.5 Yield

Yield is the percentage the annual dividend bears to the current price of the stock. For example, a stock that pays annual dividends of $4 and sells at $50 has a yield of 8 percent. The yield represents the cash flow the stock will generate if it is purchased at the current price and suggests the future return on investment, assuming no change in dividend payout.

Some investors invert the price-earnings ratio and compute the earnings-to-price ratio, earnings yield, or the percentage that the annual per-share earnings bear to the stock price. Thus, a price-earnings ratio of 12 or 60/5 is inverted to read 5/60. Earnings yield reflects what the firm earned per share expressed as a percentage of the stock's market price. The dividend yield and price-earnings ratio are listed in most financial publications.

5.10 Advantages and Disadvantages of Common Stock

Advantages. The major advantages of common stocks are dividend increases and potential for appreciation in value. Many common stocks, except closely held stocks, have a high degree of liquidity because they can usually be easily marketed. The minimum investment necessary to acquire common stocks is small, since even as little as one share can be purchased. Conservative dividend-paying stocks are relatively less volatile in price and produce a steady stream of income. Based on the 2003 Act (see Section 1.4 for a summary of the act), stock paying high dividends, such as preferred stock and utilities, have become more attractive than they were before the 2003 Act; so will stocks of companies that haven't been paying dividends but could afford to do so.

Disadvantages. Major disadvantages of common stocks relate to the fact that many common stocks lack price and earnings stability and returns are variable. There is no assurance that the owner will receive dividends. Prices can fluctuate wildly and future earnings are difficult to estimate. The common stockholder bears the risk of the success or failure of the corporation in proportion to the percentage of stock owned, although the stockholders may not be liable for the debts of the corporation.

A high level of expertise is necessary because stock market investing requires the critical timing of transactions and close monitoring of stocks. Many investors can better diversify their portfolio and take advantage of professional stock management by investing in mutual stock funds as discussed at section 8.

5.11 Brokerage Firms

There are many alternatives to executing securities transactions in today's market. Full-service and discount brokers exist, and now on-line services can be used to execute securities trades.

The advantage of full-service brokerage firms is that they communicate key financial information and key industry reports to their investors, inform investors of the status of their accounts at all times, offer general assistance in terms of portfolio diversification and selection of security transactions, and in general, offer thorough communication with the investors regarding market trends and specific investment trends.

Discount brokers tend to focus less on communication and information with the customers, and more on a simple execution of a securities trade at a lower cost. Similarly, on-line brokerage services allow execution of trades using the Internet and other on-line mechanisms. Even with discount brokers, valuations can normally be checked with touch-tone phones and via on-line services.

In general, investors looking for recommendations based on the findings of research analysts tend to use full service brokerage firms, while investors doing their own stock selection often use discount brokers and on-line services to execute their trades.

6. OPTIONS AND WARRANTS

Options are contracts that give the purchaser a right to buy or sell shares of a particular security at a specified price within a predetermined period. There are two basic types: puts and calls.

Security brokers normally bring option buyers and sellers together and act as agents to carry out the sale. Every option has three prices: (1) the market price of the optioned security, which continually fluctuates; (2) the purchase price or premium, which is the price the option buyer or seller pays to the option writer; and (3) the exercise price, the price at which the option buyer or seller may buy (call) or sell (put) the optioned security.

New puts and calls are originated every three months, with maturity terms as long as nine months. This practice allows investors who buy and sell options to choose from a variety of maturities. The quarterly expiration of such contracts is often referred to as the *triple-witching hour* and can be marked by wide swings in market activity and pricing.

6.1 Puts

A put gives the purchaser a legal right to sell or "put" shares to another. This negotiable or transferable contract allows the owner to sell a specified security within a fixed period of time at a fixed price. This predetermined price is known as the exercise price, the striking price, or the

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contract price. The buyer of a put hopes the price of the optioned security will fall.

6.2 Calls

A call is an option, also negotiable, to buy securities or "call in" shares for purchase of a specified security, within a fixed time period, at a specified price. The buyer of a call hopes the price of the optioned security will rise.

6.3 Other Options

Other kinds of options are created with a combination of puts and calls:

— A *straddle* results when a put and a call are placed on the same security at the same exercise price for the same time period.

— A *strip* results when two puts and one call are placed on the same security at the same exercise price for the same time period.

— A *spread* results when a put and a call option are placed on the same security for the same time period, but at *different* exercise prices.

— A *strap* results when two calls and one put are placed on the same security at the same contracted exercise price for the same time period.

6.4 Premiums

The premium or purchase price the buyer of the option pays to the option writer is based on the stock price, the option period, the riskiness of the stock, and the exercise price. Thus an option call on a higher-priced stock will likely be more expensive than one for a lower-priced stock because the option writer has a greater potential for loss if prices drop on a higher-priced stock than on a lower-priced stock. Premiums also tend to be higher if the time period in which the option buyer can exercise the option is longer, since the probability of a loss for the option writer increases with the time the option remains open. A risky security will also bring a higher premium, since a significant price change may be of high value to the option owner. The exercise price of the option is usually close to the market price of the stock on the day the option is written. Sometimes, however, the exercise price is "points away," or several dollars above or below the market price. If the exercise price is several dollars from the current market price, the probability of the option being exercised changes.

6.5 Trading Options

Options can be sold. If sold, the time period of the option will carry over from the seller to the buyer. For example, John Doe purchases a nine-month call, keeps it for three months, and sells it to Stan Smith. Stan Smith will be purchasing a six-month call.

Options are bought and sold on put and call markets. The Chicago Board Options Exchange (CBOE) was the first organized options exchange and secondary options market. The American Stock Exchange (AMEX) and other securities exchanges now also trade options.

Options, the prices of which are listed daily in many newspapers, can be purchased through stockbrokers.

6.6 Warrants

A warrant is an option to buy unissued shares of common stock. Like calls, they are a contract to buy shares at a fixed price for a fixed time period. A warrant, however, is different from a call in several ways. Warrants are written by the corporation that issues the optioned stock, not by an option writer. Warrants are sometimes given by the issuing corporation with a new issue of bonds or preferred stock, thus making the new issue more attractive to buyers. Some warrants can be perpetual and never expire, and—like options—they can be traded.

The exercise price of a warrant is the amount the owner must pay to purchase the fixed number of shares. The minimum value of a warrant is determined by subtracting the exercise price from the market price per share multiplied by the number of shares obtained with one warrant. For example, if a warrant gives the owner a right to purchase two shares of stock at an exercise price of $100 per share while the market price is $120 per share, the minimum value per warrant would be $40, calculated as follows:

Price per share − exercise price × 2 = Minimum value per warrant.

$120 − $100 = $20
$20 × 2 = $40.

The minimum value per warrant changes in larger proportion than the stock price as the stock price changes. Thus, if the price per share rose to $140 in the above example, the minimum value of the warrant would double to $80 ($140 – $100 = $40; then $40 × 2 = $80). It is also possible for the minimum value per share to be negative, that is, to have no value.

Like options, warrants are sold on exchanges; they are also frequently sold by speculators. The terms governing a warrant are generally set out in the warrant agreement.

7. PREFERRED STOCK

Preferred stock is distinguished from common stock primarily by the fact that preferred stockholders are normally entitled to dividend payments before common stockholders are paid. Preferred stock represents a hybrid between bonds and common stock. It usually offers a greater rate of return than bonds do, but with a slightly greater risk. Similarly, the rate of return is usually lower than that available with common stock, but preferred stock is also less risky than common stock.

7.1 Preemptive Rights

Preferred shareholders enjoy the same preemptive right to purchase new issues of stock that common stockholders enjoy. Shareholders are able to maintain their proportionate share of ownership in the corporation, limited only by state statute, the articles of incorporation, or a waiver of the right. If preferred stock is nonvoting, a shareholder would be more likely to waive the preemptive right than voting common stock shareholders would be.

7.2 Par Value

As with common stock, preferred stock usually has a par value. When it does, the dividend rights are usually stated in terms of a percentage of the par value. No-par preferred stock also would have a specified dividend rate stated in dollars. Par value is, therefore, useful only as a good measure of sale price at the time of original issue.

7.3 Voting Rights

Preferred stock is usually nonvoting stock. Preferred stockholders are essentially guaranteed a dividend payment if there are sufficient earnings, so voting rights are unnecessary. Most preferred stock has contingent voting rights—in time of corporate financial trouble, preferred stockholders would have the right to elect some of the directors. Preferred stockholders normally also have the right to vote on the issuance of additional preferred shares or bonds, company mergers and consolidations, and certain charter amendments.

Nonvoting stock may also become voting stock if dividends are not paid for a specific length of time. The trend is to give shareholders more voting rights.

7.4 Dividends

Dividends on preferred stock can be cumulative or noncumulative and participating or nonparticipating. Cumulative dividends accumulate if the company fails to pay the periodic dividends. For example, if a corporation fails to pay dividends for two years, in the third year (assuming dividends are paid) the stockholder is entitled not only to dividends for the third year but also to the accumulated unpaid dividends for the first and second years. Participating dividends get to share, beyond their stated dividend rate, in earnings with common shares. Participating dividends allow an equal share in the earnings with common shares, but very few preferred stocks are participating.

7.5 Convertible Feature

Some firms issue preferred stock that can be converted into common stock. Thus converted shares come with the right to share in any increase in common-stock value. Convertible preferred stock is a highly regarded investment because it combines the relative security of preferred dividends with the potential growth of common stock. The period during which the stock may be converted is usually limited. Frequently, the time limits do not allow conversion until several years after the stock has been issued; the stockholder may then convert for an indefinite time period or for a limited time. Once converted into common stock, the security cannot be converted back into preferred stock.

7.6 Call Feature

As in the case of bonds, many preferred stocks are callable at the discretion of the corporation. The purpose of calling preferred stock is to force retirement of the issue when the conversion value is well above the call price. The call provision allows the company to retire all or part of the issue at a price stated in the original agreement. To compensate the investor for the call, the company usually pays higher dividends as a call premium. The call provision, however, allows the corporation to end the relatively fixed charges associated with preferred stock dividends.

7.7 Sinking Funds

A good percentage of preferred stocks, usually those of railroads and utilities, have sinking funds. Sinking funds require corporations to purchase and retire a certain percentage of the issue each year. The amount to be retired may be fixed or may depend upon sales volume and earnings. Frequently, the shares to be retired are selected by lot, particularly if the corporation cannot buy shares on the open market at or below the call price. Sinking funds are beneficial for the investor because they progressively reduce the number of shares outstanding while increasing the security behind those that remain.

7.8 Valuing Preferred Stock

As with common stock, there are four basic measures of the value of preferred stocks.

7.8.1 Earnings per share before preferred dividends

The earnings per share show the number of earned dollars per share from which preferred dividends may be paid. The figure is derived by dividing the net after-tax income by the total shares outstanding (whether from the same or different issues). For example, a company with 100,000 preferred shares outstanding and $1,000,000 in net income would have earnings per share of $10, indicating that $10 was available to pay preferred dividends. Earnings per share is generally reported in the major analytical services.

7.8.2 Times dividend earned

A second measure of the value of preferred stock is referred to as *times dividend earned, overall basis.* This measure is most useful in comparing the quality of preferred stocks within the same industry. It is derived by dividing the company's profit before interest and taxes by the total interest and preferred dividend requirements.

7.8.3 Book value

The book value or net assets per preferred share is useful to determine the net assets that support each preferred share. It is calculated by taking net assets minus all debts and dividing by the number of preferred shares outstanding.

7.8.4 Yield

The yield of a stock is a measure of the annual dividend rate as a percentage of the stock price. It measures the current profitability of a given preferred stock. This measure is more significant with preferred stock than with common stock since common stockholders may be entitled to undistributed earnings that are retained in the corporation. The yield is calculated in the same manner as are common stock yields (the annual cash dividend divided by the current stock price).

7.9 Advantages and Disadvantages of Preferred Stock

7.9.1 Advantages

The major advantage of preferred stock is its preferred dividend status over common stock. Preferred stock also receives a preference in bankruptcy litigation. It is generally more risky than bonds but less risky than common stock. Convertible preferred stock is particularly advantageous because it combines the safety of preferred shares with the potential for greater gain through common-stock conversion.

Corporations that invest in common and preferred stocks of other corporations are entitled to exclude 70 percent of the amount of dividends earned (80 percent if the receiving corporation owns 20 percent or more of the paying corporation) for regular income tax purposes. To qualify for this tax treatment, the corporation must comply with requirements for holding periods and affiliations. The dividends received deduction does not apply to S Corporations (see chapter herein).

7.9.2 Disadvantages

The potential for unlimited gain available with common stock is not available with preferred stock. This difference is the price paid for the lesser risk. In addition, preferreds are sometimes callable at the option of the company, thus lowering the investment gain of the preferred shareholder. At least traditionally, preferred shareholders have had no voice in the management and control of the corporation. Only under certain circumstances are preferred shareholders allowed to vote.

8. MUTUAL AND OTHER FUNDS

Mutual funds managed by investment companies invest in a large portfolio of diverse stocks and bonds. This method provides the investor relative safety and security through diversification in addition to professional portfolio management. Diversification is a means of reducing investment risk. Investment companies are regulated by the Investment Company Act of 1940, which tries to protect the public from fraud and dishonesty. There are two basic types of investment companies in the United States: closed-end and open-end (usually called *mutual funds*).

Bond funds that collect interest and then pay it out as dividends would not qualify for the lower tax rates (see section 1.4 for a summary of the tax act) under the 2003 Act because the funds paid are really interest.

8.1 Closed-end Funds

Closed-end funds buy and hold portfolios of stocks and bonds. Unlike open-end funds, which continually sell and redeem shares, closed-end funds sell only a fixed number of shares at initial offering, which subsequently trade on exchanges like other stocks. While open-end funds always sell at net asset value, closed-end funds trade at prices above or below the net asset value.

The fixed number of shares of closed-end funds allows the investment manager to keep orderly investment strategies. Open-end funds, on the contrary, may be forced to buy or sell securities at inopportune times because of heavy investor purchases or redemptions.

8.1.1 Standard & Poor's Depository Receipts (SPDRs)

SPDRs (pronounced "spiders") are exchange-traded funds which track market indexes similar to index mutual funds. Although a SPDR is similar to a closed-end fund it is actually a unit investment trust, or UIT. SPDRs can be bought and sold on the AMEX under the symbol SPY and short positions may also be taken.

8.1.2 World Equity Benchmark Series (WEBS)

World Equity Benchmark Series (WEBS) are similar to SPDRs but invest in overseas securities. WEBS trade on the AMEX and track the Morgan Stanley Capital International country indexes.

8.2 Open-end Funds

An open-end fund continually offers shares for sale and will always redeem existing shares for cash at the request of the shareholder. Open-end mutual funds make up the vast majority of all investment companies.

Many open-end funds charge a sales commission or *load* of between 2 percent and 10 percent of the net asset value of the securities. For example, a purchaser of $1,000 in shares may actually purchase only about $915 in assets, with the difference representing the "load charge" on the purchase.

No-load funds, as the name implies, carry no sales commissions or other up-front costs to invest. However, an investor should determine whether such funds carry additional charges and back-end (or sales or exit) loads. No-load funds are sold directly to investors without commissions paid to sales representatives, sometimes through the mail and other direct means.

Many open-end funds belong to fund families, permitting investment switching between funds with different investment objectives at little or no cost (but deemed as a taxable transaction) as changes in the investment climate are perceived.

Open-end funds may become closed to new investors when they become so large that it becomes difficult to profitably invest all of the fund's assets according to the fund's objectives.

8.3 Investment Objectives

The Investment Company Act of 1940 regulates the operation of investment companies, requiring that mutual funds state their fundamental investment policies clearly and requiring shareholder approval for any change in policy. Investment policy is an important factor for investors. A fund could have a policy of investing in more diverse but speculative securities with added risk, but also added potential for gain. Another fund may invest only in conservative, well-known, strong securities. The investor can therefore invest money with funds that have policies to match the investor's goals. It is vital that the fund's prospectus be read before investing. Most funds have a minimum initial investment and allow additional minimum investments over time.

Mutual funds can be divided into several classes, depending upon their holdings, described in the following paragraphs.

Balanced. Funds that change the relative mix of their investments but tend toward a maximum of 60 percent in equities (stocks) and 40 percent in fixed-income securities, with the remainder in cash or cash equivalents.

Contrafunds. Funds that seek capital appreciation by investing in companies that are currently *out-of-favor* but show above-average long-term growth potential.

Equity Income. More conservative funds investing in conservative, dividend-paying stocks and income-producing bonds and convertible bonds. In rising markets, equity income funds produce capital gains and, in down cycles, provide steady income.

Global. Funds that invest in U.S. and foreign securities. Global funds are able to follow bull markets throughout the world, including the United States. They have the additional income or loss factor created by currency exchange rate fluctuations.

Gold and Precious Metals. Funds that invest in bullion and mining stocks. A good hedge during inflationary periods or risk of war, they can be highly volatile in the same manner as sector funds.

Growth. Aggressive funds that look for undervalued stocks with an emphasis on long-term appreciation.

Growth and Income. Growth funds with some emphasis on current income through dividends.

High-Grade Corporates. Bond funds that invest primarily in issues rated BBB or better by Moody's or Standard & Poor's.

High-Grade Tax-Exempts. Funds investing in state and municipal obligations with a rating of BBB or better.

High-Yield Corporates. Bond funds that seek the highest return, often from "junk bonds," and that are, therefore, the riskiest of bond funds.

High-Yield Tax-Exempts. Funds that invest in state and municipal obligations while seeking the highest yield possible.

Index. Funds that invest in a representative portfolio of securities included in a well-known market index. The objective of index funds is to mirror the performance of the market as a whole.

Intermediate-Term Tax-Exempts. Funds investing in state or municipal obligations with an average weighted maturity of less than twenty years.

International. Funds that invest primarily in foreign securities. They are heavily influenced by foreign currency exchange rates in addition to the strength or weakness of the individual securities themselves.

Maximum Capital Gains. Among the most aggressive stock funds, maximum capital gain funds aim to achieve above-average returns through investment in stocks that have potential for short-term appreciation, but that may be subject to greater loss during down cycles.

Money Market Funds. Funds that invest in Treasury bills, commercial paper, and other short-term money market investments, generally with an average maturity of thirty days. Money market funds are generally open-end, no-load funds that invest in a large and diverse number of money market instruments. They retain a small operating fee and pass the rest of the interest income to shareholders. Some funds also offer check-writing privileges and telephone transfer.

Mortgage-Backed Securities. Funds that invest primarily in GNMA and FNMA issues.

Option Income. Specialized funds that invest in stock options in the hopes of profiting in market swings.

Regional. Funds that invest in companies of a particular geographic region to take advantage of disparity in economic strength often existing in regions of the country.

Sectors. Funds that invest in a number of issues within one particular industry. Sector investing requires a keen eye for the markets because sectors lack the diversification of other funds and rise and fall swiftly.

Small-Company Growth. Aggressive stock funds that invest in small emerging growth issues.

U.S. Government Securities. Funds that invest primarily in issues of the U.S. government and its agencies.

8.4 Real Estate Investment Trusts (REITs)

A Real Estate Investment Trust (REIT) allows many investors to combine capital to acquire or provide financing for real estate. A REIT essentially operates similar to a mutual fund for real estate, in that investors obtain the benefit of a diversified portfolio of real estate under professional management. Shares of a REIT are freely traded, often on a major stock exchange.

REITs generally do not pay corporate income tax, nor do REITs pay income tax in most states. Accordingly, almost all of the income of a REIT can be distributed to shareholders without double taxation. However, unlike a partnership, a REIT cannot pass tax losses through to the investors.

Most distributions from REITs will not benefit from the lower rates under the 2003 Act (see section 1.4), because of the very nature of REITs—they must distribute most of their income in order not to pay tax at the entity level.

Complex rules exist within the Internal Revenue Code for corporations or trusts to qualify as a REIT. REITs are owned by individual investors, along with pension funds, insurance companies, bank trust departments and mutual funds. Income distributions occur from REITs, and they also enjoy the potential of long-term appreciation. Because

REITs are actively traded in the secondary market, investor liquidity is high. Like stocks and mutual funds, publicly traded REIT share prices change daily, based on the anticipated growth of the underlying real estate, the underlying asset value of the real estate, income distributions occurring out of the REITs, and so forth.

8.5 Exchange-Traded Funds (ETF)

ETFs are mutual funds that trade on stock exchanges, just as stocks do. The price of shares in ETFs fluctuate all day long since shares are traded in an exchange, while mutual funds are priced once a day at the end of stock trading. An ETF will always have brokerage commission that must be paid. ETFs have blossomed recently thanks to their low fees and investment advantage. EFTs are similar to mutual funds in that both contain a batch of common stocks that track an underlying index. ETFs cover a variety of stocks and indexes, such as homebuilder, gold, utilities, technology, and health care.

8.5.1 Fees

ETF fees are very reasonable because, like regular index mutual funds, they don't have to pay for research and fund managers.

8.5.2 Investment Advantages

The holder of an ETF can put stop orders to automatically sell the ETF if it falls below a certain level. In addition, the investor has the ability to sell the ETF short. Short selling individual stocks has one big drawback: the uptick rule. You can sell short only if the stock's last movement was up. ETFs are exempt from the rule as they can be sold short at any time.

8.6 Hedge Funds

Hedge funds are generally set up as private investments that are open to a limited number of wealthy investors, who are qualified as accredited investors. Hedge funds are typically organized by professional investment advisors that manage a hedge fund's investments. Hedge funds are different from traditional investments, because they rely on the specific expertise of the manager or management team to obtain a substantial return rather than the influence of the market itself. The hedge fund manager receives both a management fee and a performance fee, computed as a percentage of the funds performance. They get to keep performance fees even if they lose money for their investors.

The heads-I-win, tails-you-lose arrangement provides the fund manager with an attractive incentive to take risky bets with clients money.

Hedge funds require a substantial initial minimum investment (a minimum investment of $1 million or more is often required of hedge fund investors). Investments in hedge funds are illiquid and often require investors to keep their money in the fund for a minimum period of at least one year. Many of the hedge funds are highly sophisticated, secretive and located offshore. There are considerable risks involved when investing in hedge funds, including the loss of all of the investor's capital.

8.6.1 Regulatory Requirements

Hedge funds—unlike mutual funds—are not required to register with the SEC. They issue securities in private offerings not registered with the SEC under the Securities Act of 1933. Furthermore, hedge funds do not have to make periodic reports under the Securities Exchange Act of 1934. The current administration reached an agreement with independent regulatory agencies and announced that investors, hedge fund companies and their lenders were able to monitor or police their own activities by establishing and adhering to a set of non-binding principles and procedures.

8.6.2 Investment Strategies

Today there are approximately 9,000 active hedge funds with a variety of investment strategies that now manage more that 1.2 trillion dollars of assets. Some use short-selling leverage derivatives such as puts, calls, options and futures. while others are more conservative and employ little or no leverage. Others may invest in distressed assets or employ arbitrage techniques that endeavor to capitalize on merger opportunities. Hedge funds can move quickly in and out of the markets, take concentrated positions, and exploit unique sources of potential return. Hedge funds can invest in anything from commodities to real estate, and some funds even buy whole companies, while others buy and sell stocks like day traders, but with billions of dollars at stake.

8.6.3 New Vehicles for Small Investors

One of the hottest stock offerings available right now gives a small investor a back door into hedge funds. Fortress Investment Group, LLC which manages hedge funds and private-equity firms went public in February 2007. Fortress investors, of course, simply own a piece of the money-management company.

Some mutual funds are unveiling products that mimic the investment strategies of hedge funds. Yet such products have high fees, and a number of new offerings are taking on extra layers of expenses.

In addition, small investors are being offered shares of a registered fund of hedge funds, that invests in hedge funds; however, there is a double layer of fees. The underlying funds charge a fee, as well as the manager of the registered fund. Therefore the fees are very high. This translates to "layers" of fees before the investor receives dollar-one.

8.7 Securities Investor Protection Corporation (SIPC) Insurance

Securities owned by an investor, including mutual funds, held in an account by a broker, or a brokerage subsidiary of a bank, are protected against loss by the Securities Investor Protection Corporation (SIPC). SIPC is a non-government entity funded by assessments paid by SIPC members. SIPC protects customer accounts held by its members up to $500,000, including up to $100,000 in cash, if a SIPC broker member or bank brokerage subsidiary fails.

SIPC protection differs from FDIC insurance on bank deposits in that SIPC offers no protection insuring against loss in the value of an account, while FDIC insurance protects the deposit amount up to the $100,000 limit and $250,000 limit on self-directed retirement accounts. That is, under SIPC protection, the value of an investment can either increase or decrease, depending on the market demand for the investment, and SIPC offers no protection against such a change in market value.

(Text continued on page 43)

9. COMMODITIES

The commodities market involves the trading of tangible assets, such as crops, precious metals, livestock, grains, currencies, and real property. Major U.S. commodity exchanges include the Chicago Board of Trade (www.cbot.com); the Chicago Mercantile Exchange, Inc. (www.cme.com); the New York Mercantile Exchange (www.nymex.com); the Commodity Exchange, Inc.; and the New York Board of Trade (www.csce.com), parent company of the New York Cotton Exchange and the New York Coffee, Sugar and Cocoa Exchange.

9.1 Cash Markets

Commodities can be traded in both a cash market and a futures market. Cash markets trade commodities that are available for immediate sale. Grain elevators and stockyards where farmers sell their products for cash are examples of cash markets, just as stock exchanges are the cash markets for stocks and bonds.

9.2 Futures Markets

The futures market involves trading for commodities that are due for delivery in the future. Futures contracts that call for delivery in less than a month are referred to as *spot contracts.*

Commodities traded on the futures market must meet certain requirements. The commodity should be homogeneous and capable of being graded. The commodity must have sufficient supply for there to be a large enough market to trade, and there should be enough competition for each commodity so that one producer cannot control the market.

9.3 Speculators

Speculators hope to profit through price changes by continually buying and selling commodity contracts. They are not interested in the actual delivery of the commodity but use margins to try to increase their profits (see section 9.4, below)

9.4 Margins

Margins are small down payments that bind purchase contracts. Margins are used by commodity exchanges to guarantee that purchasers will perform as expected. They essentially allow the speculator to buy commodities on credit.

9.5 Margins on Commodity Exchanges

Low margins make commodity trading extremely risky. Daily price limits therefore are set to keep prices from rising or falling more than a certain amount per pound or other unit. Both margin requirements and daily price limits change frequently, so the investor must continually check to see if there has been a change. In addition, commodity futures are time-limited, unlike other types of investments where a depressed investment can be potentially "held" indefinitely until the investment improves. Futures contracts must be fulfilled at the expiration date or delivery date. The investor knows when the contract expires and when to sell to avoid having to accept delivery.

9.6 Hedgers

Hedgers use futures contracts to avoid having to sell at a lower price or pay a higher price for a commodity later. Hedgers will contract for a position on the commodities market before what they perceive as an anticipated price change or to protect ("lock in") a current price.

9.7 Long and Short Positions

The commodities market is often referred to as the zero-sum game. This means that for every long position there is a short position. A price movement causes one position to gain and forces a corresponding loss to the other position. The market, therefore, tends to level off between positions.

A spread transaction involves the purchase of a future to be delivered in one month coupled with a sale of a future, in the same commodity, to be delivered in a different month. The purpose is to profit from the price difference between the futures. This price difference is known as the basis.

9.8 Spread Transactions

One form of spread transaction is an intracommodity spread, which involves the purchase of one future and the sale of a different future for the same commodity. The object is to predict a future price difference.

While many speculative commodity transactions may be losses, leverage can be so great that only one profitable transaction can more than offset several losses. Thus, commodity trading requires a great deal of cash reserve, market knowledge, and self-possession. Even among professional commodities traders, the great majority of transactions are closed out showing losses.

9.9 Sources of Information in Commodities

As is evident in the use of spread transactions, the prices on the commodities market are determined in large part by supply and demand and by the expectations of speculators about supply and demand. Speculators need information about inventories held in storage, current harvests, exports and imports, and changes in government policy. Commodity information can be found in the publications of the U.S. Department of Agriculture, situation reports that discuss the issues affecting specific commodities, and material from research organizations that publish analyses about certain commodities. Several major city newspapers have commodities information, and brokerage houses frequently publish newsletters on the positions of various commodities.

9.10 Types of Commodities Traded

A large variety of commodities are traded on the futures market. These include farm products such as grains, meats, and other food goods such as sugar, coffee, rice, and potatoes. Metals that are frequently traded include gold, silver, platinum, and copper. Worldwide currencies are traded, as are U.S. securities. Certain money market instruments are also traded, as are cotton, hemp, wood products, and rubber.

10. LIFE INSURANCE

Many life insurance products offer investment advantages in addition to death benefits. (Insurance and investment aspects of life insurance alternative products are discussed in detail in the Insurance chapter of this manual.)

10.1 Whole Life

The whole life policy covers the insured for his or her entire life.

Basic elements. Whole life policies have three basic parts: premium, death benefit, and cash value. The cash value represents the investment aspect of whole life, which arises from the interest gain that is achieved from the annual increase in cash value of the policy.

Participating. Participating whole life policies also pay dividends and are usually issued by mutual companies. Dividends are paid annually and are calculated as a proportion of the value of the policy: a $10,000 policy with a 4 percent dividend would pay a $400 annual dividend.

Tax aspects. The cash value of a whole life policy is tax-deferred. It is not taxed until withdrawal and then it is taxed only to the extent the cash value exceeds the total premiums paid throughout the policy life. The cash value of a whole life policy is taxed only to the owner of the policy. It is not taxed if paid at the death of the insured. Dividends on whole life policies are also tax-free. The IRS considers the dividends a refund of prior premium payments.

10.2 Universal and Variable Life

Universal and variable life insurance provide flexibility not available with other types of life insurance products on the market.

Basic elements. As with whole life, universal and variable policies have three parts: premium, death benefit, and cash value. These policies are not unlike a savings account that pays death benefits upon the death of the insured. Basically, as the insured pays premiums, the cash value grows. The company deducts its expenses and the mortality cost of providing the death benefit, and the remainder of the cash value is reported in an annual statement showing all transactions in the account.

Cash value. The money that accumulates as the cash value is available to the insured. The insured may borrow or withdraw all or any of it. Interest is earned on whatever accumulates and remains in the "cash value account." Most universal policies guarantee a minimum investment rate (such as 5 or 6 percent). Although the rate could go higher, this guarantee becomes important if interest rates drop. Interest rates on universal policies tend to be competitive with the interest rates available on other investments. Variable policies allow the owner to invest the cash value in a number of investment opportunities.

10.3 Retirement Annuities

Annuities pay the insured a fixed periodic sum for the duration of the insured's life. The amount of gain or investment value of an annuity contract depends on how long the insured lives.

Cost. Annuities are sold at a price that depends on the age and sex of the insured. The price is set in limits of how much monthly income can be purchased for $1,000.

Benefits. Payments on an annuity may yield only a tiny fraction of the amount invested if the insured dies early. Therefore the insured may purchase an annuity that guarantees payment for a minimum number of years. Retirement annuities are not unlike an endowment policy. Joint and survivor life annuities pay married couples benefits as long as either lives, although the payment may be reduced when one spouse dies.

11. TAX-SHELTERED RETIREMENT PLANS

11.1 Individual Retirement Accounts (IRAs)

Individual Retirement Accounts (IRAs) have been one of the more popular investment vehicles available, with the added benefit of tax advantages. (Contributions may be tax deductible, and earnings are tax deferred.) Generally, the taxpayer must be under age 70½ in the year in which the IRA contribution is made. However, there is no age limitation on the ability to use a Roth IRA.

Contributions are limited to 100 percent of compensation, or the following amounts, whichever is less:

	Age 49 and Under	*Age 50 and Over*
2005	$4,000	$4,500
2006	4,000	5,000
2007	4,000	5,000
2008	5,000	6,000

After 2008, amounts are indexed for inflation. Contributions can be made for each spouse (including nonworking spouses) if the combined compensation of both spouses is at least equal to the contributed amount.

To qualify for favorable tax treatment, contributions to IRAs must be made by April 15 of the year immediately following the year for which the tax advantage is desired. Taxpayers are also allowed to move funds from one account to another without losing their favored tax status, subject to certain limitations.

The Tax Reform Act of 1986 placed additional limitations on eligibility for IRA deductions. Taxpayers who are not covered by an employee pension or profit-sharing plan can fully deduct IRA contributions to the maximum allowed amount described above. Starting in 1998, an individual may fully deduct an IRA contribution even if the individual's spouse is an active participant in an employer-sponsored retirement plan. The deduction, however, phases out for taxpayers with AGI between $150,000 and $160,000. Single persons who are covered by an employee pension or profit-sharing plan retain the full deduction up to $50,000 of adjusted gross income. For married persons filing jointly, the deduction is allowable at the following rates:

	Threshold	*Phase-out*
2005	$70,000	$ 80,000
2006	75,000	85,000
2007	80,000	100,000

Payments to IRAs can be made through financial institutions, insurance companies, mutual funds, or through an account managed by the taxpayer. When withdrawals are made from IRAs the taxpayer has an ordinary income gain. Unless the taxpayer is at least age 59½ or can meet certain other requirements, there is also a 10 percent penalty for early withdrawal that is due in addition to the tax on the ordinary income gain.

Starting in 1998, Roth IRAs are available to taxpayers. Contributions to a Roth IRA are nondeductible, but qualified distributions are eventually totally tax-free. In 2007, Roth IRA contributions are phased out for single taxpayers with AGI between $99,000 and $114,000 and for joint filers with AGI between $156,000 and $166,000.

A number of special rules are associated with Roth IRAs. In general, qualified distributions are totally nontaxable and are not subject to the 10 percent early withdrawal penalty. Qualified distributions must satisfy a five-year holding period and must be:

— Made on or after the date on which the taxpayer reaches age 59½

— Made to a beneficiary on or after the taxpayer's death

— Made to the taxpayer because of a condition of disability, or

— Made to the taxpayer for qualified first-time homebuyer expenditures.

Any unqualified distributions from a Roth IRA are treated as being made first from contributions, and are tax-free to that extent. Roth IRAs are further discussed in the chapter on Employee Retirement and Deferred Compensation Plans, herein.

Under current law, an individual is not allowed to convert at traditional IRA to Roth IRA unless, in the year of the conversion, the individual's modified adjusted gross income is no more than $100,000 a year and individual's tax filing status is other than married filing separately. Starting in tax year 2010, the Tax Increase Prevention and Reconciliation Act of 2005 allows the conversion regardless of the income. In tax year 2010 only, an individual gets two years to ratably pick up the income (years 2011 and 2012).

11.2 Employer-Funded Plans

Qualified retirement plans include employer-funded pension plans that offer deductible payments to employers and tax-deferred earnings to employees. To be tax sheltered, however, plans must meet certain requirements imposed by the Treasury. The two basic Treasury requirements are that the benefit allocations must follow a certain formula and that benefits must apply equitably to all members of the plan. (See the chapter on Employee Retirement and Deferred Compensation Plans, herein.)

11.2.1 Profit-sharing and Keogh plans

Under profit-sharing plans, the employer contributes from annual profits to an investment trust. The benefits are then distributed to employees under prescribed conditions. Keogh plans are designed for self-employed individuals. As with IRAs, payments to Keogh plans are tax deductible and investment earnings are tax exempt. After retirement, however, distributions from the plan are taxable. Keogh plans must be approved by the Treasury to qualify for favorable tax treatment. They cannot be later changed without permission of the Treasury.

In 2006, Keogh plans allow up to 25 percent of the taxpayer's compensation to be contributed up to a maximum contribution of $44,000. If a lower percentage is used, only the first $220,000 of compensation may be used in determining the maximum contribution.

Strict discrimination rules apply to Keogh and profit-sharing plans. For example, if a self-employed owner is to be covered, all full-time employees must also be covered on a nondiscriminatory basis, subject to certain vesting requirements. In general, employees who have attained age 21 and are employed for more than 1,000 hours during the year are entitled to coverage. Participation must be allowed no later than one year after attaining eligibility (or after two years if the plan calls for immediate vesting).

11.2.2 Simplified employee pension

Another form of self-employed retirement plan, the Simplified Employee Pension (SEP) combines many of the characteristics of a Keogh plan with the simplicity of an IRA. In 2006, contributions to a SEP plan can be up to 25 percent of an employee's compensation (up to $220,000), subject to a $44,000 per participant contribution limit.

Employee coverage rules allow participation for employees who have met the following three tests: (1) employees must have attained age 21, (2) they must have been employed at least three of five prior years and (3) they must have earned at least $450 per year.

11.2.3 Defined benefit pension plans

Pension plans provide benefits to employees through systematic contributions for specific benefits to the employees. Pension plans offer a more definite final benefit to employees than either profit-sharing or stock bonus plans do.

Pension plans often include life insurance coverage or may be contributory or noncontributory. Contributory plans receive contributions from both the employer and the employee. An insured plan requires the employer to make payment to an insurance company for the purpose of either group or individual annuities. Trusteed plans pay benefits to a trust, with a bank or trust company acting as a trustee.

Pension plans are regulated by both the Treasury and the 1974 Employee Retirement Income Security Act (ERISA). The IRS sets the standards that plans must meet and approves proposed plans. The pension act imposes rules of conduct, funding requirements and fiduciary responsibility on trustees and investment managers. The Pension Benefit Guaranty Corporation (PBGC) ensures the vested benefits of employees in specific types of plans.

11.2.4 Employee stock ownership plans

Employee Stock Ownership Plans (ESOPs) are often used as employee pension and profit-sharing plans, although they may be used primarily as a corporate financing device. ESOPs are popular because they allow a company to retain pretax earnings by selling stock to its employee stock ownership trust. A company may deduct up to 25 percent of covered payroll for its contributions to certain qualified benefit plans. ESOP-backed pension plans, however, tend to be more risky than other plans because they are not diversified and are subject to any financial setbacks the company might experience. The distribution of shares to an ESOP may also dilute the earnings per share and net worth of stock already outstanding.

11.3 Elective Deferral Plans

11.3.1 SIMPLE plans

Beginning in 1997, an eligible employer may establish a SIMPLE retirement plan to obtain many of the benefits of qualified plans without facing many of the eligibility requirements. SIMPLE plans are discussed further in the chapter on Employee Retirement and Deferred Compensation Plans, herein.

An employee may defer up to 100 percent of his or her compensation to a limit of $10,000 in 2006. Employees who have attained age 50 may defer up to $12,500 in 2006. Contribution limits increase annually in subsequent years as described in the Appendix.

Eligible employees include those who have earnings of at least $5,000 in any two preceding years and at least $5,000 in the current year.

The employer is required to match contributions dollar for dollar, limited to 3 percent of compensation or, alternatively, provide a 2 percent across-the-board contribution for all employees. The employer is allowed some flexibility to reduce the 3 percent matching contribution to 1 percent in any two of five years.

11.3.2 401(k) plans

In 2006, employees may defer into a 401(k) plan up to 100 percent of compensation, limited to $15,000. Employees who have attained age 50 may elect to defer up to $20,000 in 2005. Contribution limits increase annually thereafter as described in the Appendix.

Eligible employees include those who have attained age 21 and have been employed greater than 1,000 hours during the year. There may be up to a one-year waiting period before enrollment in the plan.

Employers with rank and file employees are not required to provide a matching contribution but they are subject to top-heavy testing. To avoid top-heavy testing on elective of deferrals, the employer may choose from two options: (1) match 100 percent up to 3 percent of compensation, plus 50 percent match from 3 percent up to 5 percent of compensation or (2) a 3 percent across-the-board match for all employees.

Employers who have no rank and file employees other than the sole owner may contribute up to 25 percent of total compensation subject to a $44,000 per participant limit in 2006.

11.3.3 Roth 401(k) plans

Beginning in 2006, employees may defer after-tax funds into a Roth account. Contribution limits for 2006 are $15,000 (or $20,000 if age 50 or over).

11.4 FDIC Insurance

Employer-sponsored retirement plans are generally eligible for Federal Deposit Insurance Corporation (FDIC) insurance of up to $100,000 per participant. IRA and Keogh funds held by banks are separately insured from any nonretirement funds. However, the combined total of these retirement funds is aggregated and insured up to $100,000. For self-directed retirement accounts the amount is up to $250,000.

12. TAX-DEFERRED INCOME PLANS

12.1 Annuities

Annuities allow investors to establish a retirement plan while providing a tax-sheltered investment. Annuities pay a fixed sum annually for a given time period. They can be purchased in a lump sum or through a series of premium payments. Tax-deferred annuities may present a valuable long-term investment option. They allow the investor to earn interest on the principal, tax-deferred, until the investor withdraws certain amounts or begins to receive payments under the annuity.

Under the 2003 Act (see section 1.4), Congress has reduced taxes on capital gains and dividend income, so taxable investments don't look so bad. And tax-deferred vehicles, such as annuities, have lost some of their luster because gains on money held in an annuity continue to be taxed as ordinary income when withdrawn.

Should the investor die before converting the contract to an annuity, the funds in the account are paid directly to the beneficiary, without probate. Annuity contracts may be used as collateral for a loan, or the investor can borrow directly on the contract. Withdrawals of principal and interest from one company with immediate investment in a similar contract with another company is a tax-free transfer.

Annuity contracts can be purchased through insurance companies, brokerage firms, and mutual funds. Some contracts charge a sales commission; others charge none. Contracts that charge no sales commission, however, frequently charge a fee when the contract is surrendered for cash, while those with a sales commission allow surrender at no charge.

In buying a fixed annuity, which typically guarantees a minimum return for a set period of time, one should make sure that the surrender charges don't last longer than the rate guarantee period.

12.2 Tax Shelter Limited Partnerships

Tax shelter limited partnerships allow an investor to participate with other investors in an economic venture while taking full advantage of the tax incentives available. The investor should be sure that the tax shelter has some economic merit and does not produce all its advantages from tax incentives. Limited partnerships invest in many areas, including real estate, leasing activities, oil and gas, research and development, and agriculture.

The limited partner is primarily an investment partner and generally has no part in the management or everyday operation of the partnership, which is the role of the general partner. (Partnerships are discussed in detail in another chapter in this manual.)

Tax shelter limited partnerships are long-term investments that may not produce a cash flow for several years and may not return capital to the investor for five to ten years. Therefore, the investor must have adequate liquidity and cash flow, since there is not a broad market for the resale of limited partnership interests.

As discussed in the following paragraph, the Tax Reform Act of 1986 has severely limited the tax advantages of passive losses arising from limited partnerships. Since the tax advantages are eliminated or minimized, the economic aspects of such an investment must be given even greater significance.

12.2.1 Tax considerations

As the name implies, tax shelter limited partnerships must be matched closely to an investor's personal tax situation. Most limited partnerships

(Text continued on page 51)

produce passive losses in their early years that can only be used to offset passive income from other sources. Also, the use of "tax preference" items to generate deductions may subject the investor to an alternative minimum tax situation.

13. INVESTMENT ADMINISTRATION AND STRATEGIES

To make successful investments, the investor must be aware of what is going on in the world. Societal, economic, political, industrial, and international trends and events have an important impact on the value and strength of investments.

13.1 Economic Analysis

Attention to the national economy may help the investor make decisions not only for the present but also for several years into the future. If strong economic growth and stability is expected, an investor may be smarter to invest in stocks and other corporate securities. If the economy is expected to turn down, an investment in fixed-income instruments such as bonds may be safer than common stock. If one segment of the economy is expected to grow faster than others, the investor may want to focus on that segment.

13.1.1 Gross National Product (GNP)

The Gross National Product (GNP) is the broadest measure of activity and is useful in determining the present state and to some extent the near future of the national economy. The GNP theoretically represents the dollar value of all goods and services produced in the economy over a given time period.

It is important to look at the GNP in real rather than nominal terms. A large increase in the GNP is not necessarily indicative of a large increase in real growth. The growth must be measured in terms of both dollars from the current year and constant dollars (inflation-adjusted). This comparison is necessary to measure the effects of inflation on the GNP. An increase in GNP may reflect a real decrease in the absolute purchasing power of the dollar rather than overall growth.

The GNP should be used with other economic indicators and measures to determine more specifically where a strength or weakness exists.

13.1.2 Federal Reserve Board Index of Industrial Production

The Federal Reserve Board (FRB) Index of Industrial Production is one of the most widely used indexes of industrial activity. It measures the current value of industrial production relative to a base year. The FRB index analyzes many segments of the economy and uses a base year to show growth in later years relative to that year.

Market groupings and industry groupings are set out separately. The index is then further broken down by products and materials, manufacturing, construction, nonagricultural employment, retail sales, and personal income. The FRB index indicates strengths and weaknesses in specific industries.

13.1.3 Government and private studies

Economic trends can also be studied from numerous federal government and private publications (some of these are cited in the references). Business periodicals such as *Forbes, Business Week, Money,* and *Fortune* are also good sources of investment information.

13.2 Stock Market Analysis

The stock market probably has one of the most well-developed systems of evaluation of any investment vehicle. The strength of the stock market and the movement of individual stocks is easily determined through the numerous available indexes, quotations, and indicators.

13.2.1 Major market indexes

The major market indexes provide a fairly accurate measure of market activity. They are computed by adding the prices of the securities in the averages and dividing by a number that has been set periodically to reflect stock splits and dividends.

The Dow Jones averages are probably the best known and oldest stock market indexes. They include the Dow Jones Industrial Average (DJIA), the Dow Jones Transportation Average (DJTA), the Dow Jones Utility Average (DJUA), and the Dow Jones Composite Average (DJCA). All are published in the *Wall Street Journal,* the *New York Times,* and other newspapers as well as in financial publications.

The Dow Jones Industrial Average covers thirty stocks in a variety of industries; the companies listed are considered representative of their industries in general. The DJIA is intended to reflect the market as a whole but does not include all types of securities.

The Dow Jones Transportation Average is a market indicator for twenty stocks in the transportation industries such as airlines, railroads, and trucking companies. The Dow Jones Utility Average lists fifteen gas and electric utilities. The Dow Jones Composite Average consists of the sixty-five securities listed in the other three Dow Jones indexes, representing a combination of industrial, transportation, and utility companies.

As with the DJIA, the latter three Dow Jones indexes are also computed by dividing the total prices of the securities by a certain divisor. While the DJIA, the DJTA, and the DJUA reflect the activity only in those industries, the DJCA provides an overall view of the market.

Standard & Poor's also maintains several indexes monitoring stock market values. These include the S&P 500 Index, Industrials, Utilities, 400 MidCap, 600 SmallCap, and 1500 Index.

The NASDAQ stock market also has several widely followed indexes. These include the NASDAQ Composite, NASDAQ 100, Industrials, Insurance, Banks, Computer, and Telecommunications. Other popular stock indexes include the AMEX Composite, Russell 1000, Russell 2000, Russell 3000, Value-Line, and Wilshire 5000.

13.2.2 New York Stock Exchange

The New York Stock Exchange (NYSE), often referred to as "the big board," measures the price trends of over 3,000 common stocks and represents about 80 percent of the market value of all publicly owned companies in the United States. Non-U.S. issuers play an increasingly important role on the NYSE. The exchange may be found online at www.nyse.com.

The NYSE provides important information in an abbreviated easy-to-read format. It lists the high and low price per share for the prior 52-week period, the name of the company, the type of stock, the dividend and percent dividend yield, the price-earnings ratio, the number of sales for the day in lots of 100, the high, low, and closing prices for the day, as well as the net change from the previous trading session. These elements are listed in the order just described in the several columns of the NYSE pages of major U.S. newspapers.

13.2.3 American Stock Exchange

The American Stock Exchange (AMEX) is wholly-owned by the National Association of Securities Dealers (NASD) and provides a floor-based auction that complements the NASD's Automated Quotations System (NASDAQ) market. Both are units of NASD subsidiary NASDAQ-AMEX Market Group. AMEX lists about 800 smaller, newer issues and specializes in trading derivatives, foreign issues, ADRs (American depositary receipts), and ADSs (American depositary shares). The exchange may be found online at www.amex.com.

13.2.4 NASDAQ

The NASDAQ stock market is the world's first electronic stock market. Today it lists about 5,000 stocks and ranks second among the world's securities markets in terms of dollar volume. Unlike traditional floor-based stock markets, the NASDAQ allows multiple market participants to trade through a computer network that links buyers and sellers from around the world with extended trading hours. The NASDAQ lists a heavy concentration of technology issues. The stock market may be found online at www.nasdaq-amex.com.

13.2.5 Local and regional exchanges

There are a number of regional and local exchanges located in various parts of the country. The Chicago Stock Exchange, the Pacific Stock Exchange, the Philadelphia Stock Exchange, the Arizona Stock Exchange, and the Miami Stock Exchange are probably the best-known smaller exchanges. Regional and local exchanges are organized much like the NYSE and trade mostly in small regional and local companies.

13.2.6 Over-the-counter (OTC) market

The OTC Bulletin Board (OTCBB) is a regulated quotation service in over-the-counter equity securities. An OTC equity security is generally any equity that is not listed on NASDAQ or a national securities exchange. The OTCBB was established in 1990 in response to legislation mandating an electronic system to provide transparency in the OTC equities market. The OTCBB may be found online at www.otcbb.com.

Although most equity securities may be traded through online brokerage services, Internet auction services, such as eBay.com, are prohibited from listing securities. This includes stocks, bonds, or any other investment interest in any entity or property.

13.2.7 Foreign exchanges and securities

Certain foreign exchanges trade foreign stocks internationally. Major foreign exchange indexes are as follows:

— Tokyo — Nikkei Average

— London — Financial Times 30-share

— Frankfurt — FAZ

— Zurich — Credit Suisse

— Paris — CAC General

— Milan — Stock Index
— Sydney — All ordinaries
— Hong Kong — Hang Seng
— Singapore — Straits Times
— Johannesburg — Johannesburg Gold
— Toronto — 300 Composite
— Spain — Madrid Stock Exchange
— Mexico — Mexican Bolsa
— Worldwide — Dow Jones World Index

Trading in foreign securities tends to be more risky for the American investor than trading in American securities. Less public information is available on foreign securities and lax accounting principles may not be consistently applied. Fluctuation in exchange rates for foreign currencies also creates risk. Some foreign governments may be unstable, making the already narrow market for certain foreign securities even more unfavorable. International mutual stock funds, however, can spread this risk among many investments and countries while providing professional management of the portfolio. Foreign investing also allows individuals to participate in economies having higher growth rates than the United States. This phenomenon is particularly apparent in developing countries that are adopting capitalism.

When purchasing a foreign stock, it is common to receive an American Depository Receipt (ADR). These certificates give evidence of ownership, while the actual stock of a foreign company remains in that country.

13.3 Investments Held in Street Name

Investors have the option of holding securities in *street name* as opposed to personally holding the security. Holding a security in street name means the investor has physically given a broker the security. Such a transfer provides the following advantages:

— Possibility of a same day sale
— Protection from loss of the security
— Statements provided by the brokerage firm detailing the current market value of the security
— Automatic sweep of earnings (interest, dividends) to an interest bearing account set up with the brokerage firm
— Use as collateral for a margin loan

A disadvantage to holding the security in street name results if the relationship between the investor and the brokerage firm sours. The transfer of the security back to the investor or to another firm may take several days to a couple weeks.

13.4 Investment Advisory Services

An investment adviser is a person or entity that is compensated for providing advice to others or issuing reports or analysis regarding securities, as defined in section 202(a)(11) of the Investment Advisers Act. Investment advisers are not brokers in the sense that they do not act as intermediaries between buyers and sellers. A broker usually charges a commission. Advisers are also distinguished from solicitors, who locate and refer clients to an investment adviser for a fee.

Third parties usually pay commissions to the investment advisers rather than the clients. Commission contracts are between the adviser and the third party, and the adviser is not responsible for performance, reliability, products, or services. The charge for an investment program that bundles or "wraps" a number of services, such as brokerage, advisory, research, consulting, and management, and covers them with a single fee based on the value of the assets under management is called a wrap fee.

Accountants are well-suited for investment advisory services, given their knowledge of client tax, estate, retirement, and investment. Information, education, and resources in the investment advisory services field are available from the AICPA Center for Investment Advisory Services at www.aicpa.org.

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APPENDIX: Retirement Plan Annual Contribution Limits

Traditional IRA Contribution
Deduction Phaseout Range
Joint Returns

Year:	*Phaseout Range*
2002	$54,000–$64,000
2003	$60,000–$70,000
2004	$65,000–$75,000
2005	$70,000–$80,000
2006	$75,000–$85,000
2007 and thereafter	$80,000–$100,000

Traditional IRA Contribution
Deduction Phaseout Range
Single and Head of Household

Year:	*Phaseout Range*
2002	$34,000–$44,000
2003	$40,000–$50,000
2004	$45,000–$55,000
2005 and thereafter	$50,000–$60,000

Traditional IRA Contribution
Deduction Phaseout Range
Married Filing Separate Returns

Year:	*Phaseout Range*
All years after 1997	$0–$10,000

Roth IRA Contribution Phaseout Range

2007 Filing Status	*Phaseout Range*
Joint return	$156,000–$166,000
Single or head of household	$99,000–$114,000
Married filing separate return	$0–$10,000

Beginning in 2007, the income limits for IRA contributions are indexed for inflation. Any increases will be rounded to the nearest multiple of $1,000.

Roth and Traditional IRA Contribution Limitations

Year:	*Maximum Contribution*
2002 through 2004	$3,000
2005 through 2006	$4,000
Individuals who reach 50	$5,000

Source: After 2006, the limit will be adjusted annually for inflation in $1000 increments.

IRA Contribution and Deduction Limitations

Year	*Contribution (Deduction) Limit for Traditional/Roth IRAs*	*Age 50 or Over Limit*
2002	$3,000	$3,500
2003	$3,000	$3,500
2004	$3,000	$3,500
2005	$4,000	$4,500
2006	$4,000	$5,000
2007	$4,000	$5,500
2008	$5,000	$6,000

Annual Elective Deferral Contribution Limits

Year	*Limit for 401(k)s*	*Limit for SIMPLE Plans*
2002	$11,000	$ 7,000
2003	$12,000	$ 8,000
2004	$13,000	$ 9,000
2005	$14,000	$10,000
2006	$15,000	$10,000 + COLA increases

Age 50+ Additional Catch-up of Elective Deferral Contributions

Year	*401(k) Plans*	*SIMPLE Plans*
2002	$1,000	$ 500
2003	$2,000	$1,000
2004	$3,000	$1,500
2005	$4,000	$2,000
2006	$5,000	$2,500

Source: Beginning in 2007, the $5,000 and $2,500 amounts are adjusted for inflation.

Bankruptcy/Insolvency

BANKRUPTCY/INSOLVENCY

1. INTRODUCTION

Bankruptcy is a federal debtor's relief provision and a creditor's remedy. Current federal bankruptcy law derives from the Bankruptcy Reform Act of 1978, which became effective October 1, 1979. The Reform Act repealed the Bankruptcy Act of 1898 and is found in Title 11 of the United States Code. It is the fourth major bankruptcy act to be enacted by Congress since 1800. All code section references in this chapter refer to the Bankruptcy Code as set forth in the 1978 reform act. Four major amendments have substantially modified the Bankruptcy Code since it became law in 1979. The latest modification—Bankruptcy Abuse Prevention and Consumer Protection Act of 2005[1] (2005 Act)—was passed in 2005 and became effective generally for all petitions filed after October 16, 2005. There are, however, a few sections that do not have the same effective date; for these sections the effective date will be identified as the provisions are discussed.

Driven to a large extent by the credit card companies, there was a desire to make it harder for consumers to walk away from their debts. The motive underlying the 2005 Act is in its title, "Bankruptcy Abuse Prevention." Some of the underlying objectives driving the changes in the law were to:

- Use a means test as a method to reduce perceived abuses of the current system by requiring some individuals to either have their petition dismissed or agree to transfer to Chapter 11 or 13 and make at least some debt payments with future income.
- Eliminate perceived abuses by consumers, in addition to limiting the extent to which individuals can walk away from their debts, by adjusting amounts available for homestead exemptions, for example, and increasing amounts that may be recovered from fraud.
- Reduce the time a business is in bankruptcy, as evidenced by, among other things, a limit on the time a debtor has to decide whether to assume or reject a lease and a limit on the amount of time a debtor has the exclusive right to develop a plan.
- Provide a source of tax revenue, especially for state and local governments, by changing the tax law to provide fewer tax benefits to individuals and businesses in bankruptcy. With a significant amount of influence from state attorneys general, the drafters of the law were convinced that state and local governments were at a disadvantage when it came to the collection of their taxes.

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[1]Pub. L. No. 109-08, 119 Stat. 23.

- Provide additional opportunities for creditors of businesses under certain conditions to recover all or a large percent of their prepetition claims by, for example, increasing the reclamation period and providing that goods shipped within 20 days of bankruptcy are administrative expenses.
- Reinstate Chapter 12 on a permanent basis and make other changes perceived as necessary to the Bankruptcy Code.
- Provide protection to certain creditors, including, for example, those owed amounts for domestic support obligations and secured creditors in Chapter 13.

This chapter is provided to explain the new bankruptcy law and to introduce CPAs to bankruptcy practice, whether it be for advising clients, businesses, or for their own understanding. By becoming better informed on this subject, CPAs can help protect and educate their clients on the ins and outs of bankruptcy law and to advise them on their general financial well-being. Advising clients on bankruptcy matters offers many opportunities to generate additional business income, and, while this material touches on the technical aspects of bankruptcy, it also discusses the diverse practice roles available to the CPA and identifies a few avoidable pitfalls. [See Appendix 1: Bankruptcy/Insolvency—Comparison of the Old and New Law on the *Accountant's Business Manual Toolkit CD-ROM.*]

2. BANKRUPTCY OVERVIEW

Congress felt that the current bankruptcy system needed to be improved; therefore, it created the National Bankruptcy Review Commission (NBRC) to review the bankruptcy system. In 1997 the NBRC issued its report. Based on this report and input from other constituents, various bankruptcy bills were introduced over a period of eight years before major modifications to the Bankruptcy Code became law on April 20, 2005.

2.1 Means Test

The 2005 Act primarily related to consumer bankruptcy provisions designed to eliminate some of the perceived abuses of current practice. Among the targeted abuses were situations wherein a debtor with considerable income and debt was able to file a Chapter 7 petition using nonexempt assets to satisfy part of the debts, with the balance being discharged even though future income may have been sufficient to satisfy part or all of the debt existing at the time of filing.

This chapter includes a discussion of the key business and tax provisions applicable to CPA practice.

2.2 Bankruptcy Code

The bankruptcy law appears in Title 11 of the U.S. Code. The code has nine Chapters:

— Chapter 1 General provisions

— Chapter 3 Case administration

— Chapter 5 Creditors, the debtor, and the estate

— Chapter 7 Liquidation

— Chapter 9 Adjustment of debts of a municipality

— Chapter 11 Reorganization

— Chapter 12 Adjustment of debts of a family farmer with regular income

— Chapter 13 Adjustment of debts of an individual with regular income

— Chapter 15 Ancillary and other cross-border cases

Chapters 1, 3, and 5 apply to all proceedings under the code except Chapter 9, to which only specified sections of Chapters 1, 3, and 5 apply. The term *Title 11 case* refers to any case under the Bankruptcy Code's Chapters 7, 9, 11, 12, 13, and 15 provisions. Chapter 15 was added by the 2005 Act and deals only with filings outside the United States. Chapter 9 is used only by municipalities, and both Chapters 9 and 15 are beyond the scope of this chapter.

The most commonly used chapters in the Bankruptcy Code in order of frequency of use are Chapters 7, 13, 11, and 12.

Chapter 7 provides for the liquidation of a debtor's assets. This alternative is available to both businesses and individuals and is equivalent to closing the doors and calling it quits. Simply stated, the trustee, who is appointed in all Chapter 7 cases, attempts to pay off as many creditors as possible with whatever assets are available.

Chapter 11 is also available to both businesses and individuals. A Chapter 11 filing is referred to as a *reorganization*. However, a reorganization can mean one of two things: a *rehabilitation* or an *orderly liquidation*. It provides time for businesses or individuals to "get their acts together" without having to worry about the immediate repayment of current creditors. Also, unlike Chapter 7, this option typically permits those electing it to remain in control of their assets and continue to manage their own situation during the course of the bankruptcy proceedings.

Chapter 13 is a pared-down version of Chapter 11, often called an *individual wage earner or small business reorganization.* The process is easier and more cost efficient than its counterpart, Chapter 11. The legal costs are reduced because the process is not as complex and therefore requires less formal paperwork. The election of Chapter 13 is restricted; the limitations are covered in detail later in this chapter.

Chapter 12 was enacted because family farmers could rarely opt for the simpler Chapter 13 alternative. The financial limitations surrounding Chapter 13 were not sufficient to handle the typical debt associated with running a farming operation. Unfortunately, farmers needing to reorganize could rarely justify the Chapter 11 alternative because it was often too complicated, time-consuming, and expensive to be a workable solution. Chapter 12 was designed to allow family farmers facing bankruptcy a chance to reorganize their debts and keep their land. The 2005 Act modified Chapter 12 to expand its coverage to family fishermen.

With this brief introduction, this chapter takes a closer look at the following bankruptcy alternatives:

- Chapter 7 (liquidation)
- Chapter 11 (reorganization)
- Chapter 12 (adjustment of debts of a family farmer with regular annual income)
- Chapter 13 (adjustment of debts of an individual with regular income)

In addition to the statutory provisions of the Bankruptcy Code, many rules regarding bankruptcy cases are also found in the Federal Rules of Bankruptcy Procedure, which govern the procedural aspects of bankruptcy litigation.

Section 525 of the Bankruptcy Code provides protection to bankrupt debtors from discrimination by governmental units and private employers. Governmental units may not deny, revoke, suspend, or refuse to renew a license or permit, and may not deny, terminate, or discriminate with respect to the employment of a person who is, or has been, a debtor under the Bankruptcy Code. Private employers are prohibited from terminating or discriminating with respect to the employment of any debtor who has been bankrupt. These prohibitions apply equally to individuals who are or were associated with the debtor. The purpose of the antidiscrimination provision is to protect the "fresh start" that the code intended to give to the debtor.

As Section 525 covers only governmental units and private employers, Section 524, concerning the effects of discharge, should be read in conjunction with Section 525. Thus, for example, a university that withholds transcripts from an alumnus for nonpayment of tuition, even after the alumnus received a discharge, could be prohibited from doing so under Section 524, but would not be covered under Section 525.

2.3 U.S. Trustee

The U.S. Trustee office was created for the purpose of taking over some of the administrative aspects of the bankruptcy process from the bankruptcy judges. The U.S. Trustee's office is a branch of the Justice Department located in Washington, D.C.; 21 regional offices are located throughout the United States.

Among the functions performed by the U.S. Trustee are:

1. To monitor applications for compensation and reimbursement for trustees, accountants, attorneys, and other professionals filed under Section 330 of Title 11 and, whenever the U.S. Trustee deems it to be appropriate, file comments with the court with respect to any such applications.
2. To monitor plans and disclosure statements filed in cases under Chapter 11 and file comments regarding such documents.
3. To monitor plans filed under Chapters 12 and 13 and make appropriate comments.
4. To take appropriate action to ensure that all reports, schedules, and fees required by Title 11 and Title 28 are properly and timely filed.
5. To monitor creditors' committees under Chapter 11.
6. To notify the U.S. attorney of matters that relate to the occurrence of any action that may constitute a crime under the laws of the United States and, on the request of the U.S. attorney, assist the U.S. attorney in carrying out prosecutions based on such action.
7. To monitor the progress of cases under Title 11 and take action to prevent undue delay.
8. To monitor requests for employment of professionals (including accountants and attorneys) and, when appropriate, file comments with respect to approval of such requests.
9. To appoint an interim trustee in each Chapter 7 case filed.
10. To appoint, in Chapter 11 cases, creditors' committees and other committees of creditors or equity holders, if authorized by the bankruptcy court.
11. To appoint a trustee or examiner in Chapter 11 cases when such appointment is authorized by the bankruptcy court.

12. To move for the appointment of a trustee if there are reasonable grounds to suspect that current members of the governing body of the debtor, the debtor's chief executive or chief financial officer, or members of the governing body who selected the debtor's chief executive or chief financial officer, participated in actual fraud, dishonesty, or criminal conduct in the management of the debtor or the debtor's public financial reporting.
13. To perform other duties prescribed by the U.S. Attorney General.

Each office of the U.S. Trustee generally maintains a panel of individuals who have qualified to serve as Chapter 7 trustees. From this list Chapter 7 interim trustees are appointed. Some offices maintain a separate, unofficial list of those qualified to serve as Chapter 11 trustees; other offices just keep a file of Chapter 7 trustees and may supply the Chapter 11 requirements from the same list. To serve as a Chapter 11 trustee, the U.S. Trustee generally selects individuals who have the appropriate type of experience, including industry-specific experience. If an individual is on the list who has appropriate experience, that individual will be appointed; otherwise, the trustee will look outside the panel for a trustee. The U.S. Trustee's office monitors the trustees in an attempt to determine not only that the caseload is being managed, but also that it is manageable.

3. ALTERNATIVES TO BANKRUPTCY

A business may use several alternatives to bankruptcy to deal with financial crisis. The method chosen will depend on the unique factors of each case, such as the likelihood of recovery for the business, the liability-to-asset ratio, and the desirability of risking the bankruptcy stigma. Many of the alternatives may be less costly, simpler, and less time-consuming than formal bankruptcy proceedings.

3.1 Voluntary Liquidation

Many forms of liquidation are available. It may be argued that the availability of liquidation methods is limited only by the creativity of the parties involved. Some of the more commonly used methods are outlined here.

3.1.1 Assignments for the benefit of creditors

A commonly used liquidation method is assignment for the benefit of creditors. Under this method, all the debtor's property is transferred to a trustee or assignee for the benefit of the debtor-assignor's creditors. Although requirements vary by state statute, most assignments must be written and a majority of the creditors must agree to the assignment terms and conditions. Dissenting creditors who believe their interests are not protected may file an involuntary bankruptcy petition pursuant to Section 303. An assignment is most useful to debtors whose assets exceed liabilities in secured claims.

Assignment governed by statute. Assignments are generally governed by state law. There is little uniformity between statutes, which vary in length, detail, and complexity. For example, the Idaho statute offers no substantial guidance on provisions for executing and administering assignments. The only requirement is that the assignee be a state resident. Presumably, parties are free to fashion an agreement to their own desires and needs. One problem with such scant guidance is that the rights and duties of parties-in-interest are not clearly defined and may depend on conflicting common law.

In contrast to the Idaho statute, the New York statute provides comprehensive detail for handling assignments. The New York statute contains many of the features of the Bankruptcy Code such as avoidance of transfers and preferences, court supervision, strict documentation requirements, and duties parallel to those in the code for assignees and assignors.

Statutes in other states vary between the simplicity of the Idaho statute and the complexity of the New York statute. Although most states provide assignment statutes, those that parallel the code too closely have been struck down on constitutional grounds as an interference with congressional intent to occupy the field. The presence of a discharge in the state statute appears to be a consistent test that the Supreme Court has used to strike offending statutory provisions.

Common law assignments. In states where there is no assignment statute, a debtor may be able to proceed under a common law assignment. The common law assignment was the forerunner of the present statutes. Debtors were deemed to have an inherent common law right to make assignments. Under common law, the debtor had wide discretion to fix the terms and conditions of the assignment. Presumably, debtors are free to do so in the remaining common law states unless the common law assignment has been held to be void.

3.2 Bulk Transfer

In a bulk transfer, the debtor agrees to sell its inventory and other assets to a third party, with the consideration being distributed to the debtor for the benefit of the creditors or directly to the creditors. The governing law is the Uniform Commercial Code, Article 6.

3.2.1 Requirements

Creditors must be given 10 days' notice of the sale. A failure to comply with the notice requirements may result in an ineffective transfer, at least against unnotified creditors. The debtor/seller is also required to furnish a list of all creditors. The responsibility for completeness and accuracy rests with the seller. Errors and omissions will render the transfer ineffective only if the buyer had actual knowledge of them.

3.2.2 Advantages and disadvantages

Bulk sale is an inexpensive and relatively fast way for a debtor with mostly unsecured creditors to liquidate the business without judicial supervision. Creditors, however, are disadvantaged against a good-faith purchaser, who will prevail over competing claims by unlisted creditors. Another disadvantage arises when the seller sells the assets at an unreasonable price. As in assignments, however, the omitted creditor may be able to file an involuntary bankruptcy petition under Section 303 of the code.

3.3 Receiverships

Troubled companies may be liquidated by a general receiver state or district court in appropriate cases. A receivership may be the only court-supervised liquidation procedure available to debtors not eligible to file under the Bankruptcy Code.

Receiverships involve the appointment of a receiver to collect and preserve the debtor's assets for the benefit of creditors. In most states, a creditor with an unsatisfied court judgment on a claim may commence a receivership action for liquidation if the corporation is insolvent. An action can also be commenced if an insolvent corporation admits that a claim is due and owing. A federal court may appoint a receiver in appropriate circumstances.

Under Section 303 of the Bankruptcy Code, the appointment of a receiver is grounds for sustaining an involuntary petition filed by creditors within 120 days of the receiver's appointment. The bankruptcy court may choose not to exercise jurisdiction if it believes that the interests of the creditors would be better served by a receiver.

3.4 Mediation

Mediation—that is, formal, statutory mediation—is a relatively new method for dealing with insolvency problems. It appears at the same time that alternative forms of dispute resolution such as negotiation and arbitration are becoming more popular. Mediation has been used to help bankrupt farmers work out agreements with creditors.

3.5 Composition and Extension Agreements

A composition is a contract between a debtor and creditor in which the creditor agrees to take a specified partial payment in full satisfaction of the debt. An extension is a contract between the debtor and creditor whereby the creditor agrees to extend the time period for payment of the debtor's claims. An agreement can combine aspects of both compositions and extensions and may involve an increase or reduction in the interest rate.

3.5.1 Requirements

Compositions and extensions must be written. The provision of each agreement may be adapted to the needs of the case. Typical provisions cover the binding of creditors and debtor, the payment of small claims, the release of judgment liens, the timing and manner of payment, and defaults, accelerations, and covenants regarding the operation of the debtor's business during the term of the agreement.

The agreement must be accepted by substantially all affected creditors. Dissenting creditors may be bound under Sections 1126 and 1129. Dissenting creditors have the option of filing an involuntary petition under Chapters 7 and 11. The court may, however, dismiss such a petition if the interests of the creditors or debtor would be better served by the dismissal.

3.6 Asset, Liability, and Company Maneuvers

3.6.1 Asset maneuvers

Asset maneuvers involve the use of a debtor's assets as collateral for additional loans or for the partial sale of assets or complete liquidation to pay off debts. Assets may include both paper assets, such as accounts receivable, and intangibles, such as good will, as well as buildings, equipment, and real estate. Three common asset maneuvers are the use of assets to collateralize new loans, the sale of both unprofitable and profitable operations, and the complete liquidation of company assets. These maneuvers are frequently used in the order given as the financial problems of the debtor worsen. In fact, asset collateralization and the partial sale of assets may be used by solvent companies to benefit shareholders or for tax or other strategic purposes.

3.6.2 Liability maneuvers

Liability maneuvers involve a variety of strategies that use company liabilities to handle financial crises. The three main types of liabilities include current liabilities (loans and funds that must be repaid within a year), debts (money borrowed for a period exceeding a year), and equity (money obtained from stock and bond holders). Composition and extension agreements are two common methods of restructuring or reordering liabilities or debts (see section 3.5 of this chapter). Other methods include selling additional stock or obtaining a loan guarantee from investors in exchange for an interest in existing equity. Liability maneuvers tend to be more drastic than asset maneuvers, but may be one of the only ways for the debtor to solve a financial crisis.

3.6.3 Company maneuvers

Company maneuvers involve nonfinancial strategies to help save a failing business. They tend to be tailored to the specific problems of an individual company. Theoretically, company maneuver strategies are limited only by the ingenuity of management or outside consultants. Some of the more common maneuvers include establishing a new product line or focusing on a new market, changing company management, demanding concessions from company employees or suppliers, temporarily reducing or shutting down operations, and merging.

4. TYPICAL ACCOUNTANTS' ROLES IN BANKRUPTCY

4.1 Limited Roles in Chapters 7, 13, and 12 Cases

Except when the accountant acts as a trustee, Chapters 7, 13, and 12 cases rarely require a CPA. By design, Chapters 12 and 13 are simple to implement. Usually, the only parties involved in these situations are the debtor, trustee, lawyers, one or two secured creditors, and a judge. Creditors have little to say when these alternatives are filed, as long as the debtor makes the required monthly payments. As a matter of course, debtors have often made several payments before their bankruptcy plan is finally approved by the courts. Therefore, as long as the lawyer can show that the creditors are being repaid at a higher rate than if Chapter 7 were elected, the details of bankruptcy are worked out in very short order between the debtors and the debtors' lawyers. Since the assets in question are usually minimal, disputes are fairly rare. Therefore, the requirement for the expertise of a CPA is limited.

In Chapter 7 cases, the objective by definition is to liquidate all the debtor's assets and pay as many obligations as possible. As assets are liquidated, tax issues frequently arise requiring trustees to retain the services of a CPA. Unless there are tax issues, questions about the value of some asset of the estate, or where the estate consists of a significant amount of assets, there are few other opportunities for CPA involvement in Chapter 7.

4.2 Chapter 11 Commonly Requires the Assistance of an Accountant

Chapter 11 cases are often complex. Considerable money is spent to allow individuals or businesses time to restructure and repay their outstanding obligations. Logically, since more money is at stake, at least some creditors will take an active interest in resolving this alternative. And when the parties disagree as to financial matters, opportunities for CPAs emerge.

Accurate and timely information is critical to the resolution of these matters. Therefore, CPAs are often hired to prove, disprove, inform, compile, present, testify, analyze, value, and/or restructure data. The CPA can provide assistance to the debtor, to a creditor, to the creditors as a group, to the trustee, or to the judge.

The following discusses various ways CPAs can play a role in bankruptcy.

4.2.1 Trustee

A trustee is someone appointed by the U.S. Trustee to manage the assets of a debtor during bankruptcy. A trustee's job is to protect the creditors by obtaining as much money as possible from the debtor's estate. In most Chapter 11 cases a trustee is not appointed; the "watchdog" function is often performed by the creditors' committee.

The job of trustee changes with each type of bankruptcy as well as with the specific situation of the debtor. In a Chapter 7 filing, the main focus is usually to manage the liquidation of the assets. In a Chapter 11 filing, the emphasis changes because there is hope that the economic position of the debtor's estate can be improved over time. Therefore, a trustee in these cases may oversee a variety of circumstances, from liquidation of some assets to actually operating the debtor's business or estate. In filings under Chapters 13 and 12, the trustee's job is minimal as long as the debtor is making the prescribed scheduled payments; the trustee acts as a clearinghouse for the debtor's various incomes and expenses. If the scheduled payments are not being made, the trustee needs to either collect the past-due payments or approach the court to either dismiss the case or convert it to Chapter 7.

4.2.1.1 Court appointment

The Bankruptcy Code authorizes the court to determine whether a trustee should be appointed. The court may authorize the appointment of a trustee for fraud, mismanagement, and incompetence, or where the court determines that it is in the best interest of the estate for such an appointment. Once an order to appoint a trustee is entered, the U.S. Trustee's office is charged with selecting the individual who will act as trustee. Local custom often allows input to the U.S. Trustee's office from judges, creditors, and debtors. Therefore, there are times when a CPA can be appointed as a trustee because of requests arising out of local familiarity with a CPA's special knowledge or experience. Although this situation is often very desirable for the CPA, it is rare because the trustee appointment process can be very political, and the amount of influence judges, creditors, or debtors have in the selection of a trustee varies from district to district.

It should also be recognized that at a meeting of creditors under Section 341 of the Bankruptcy Code, a trustee may be elected if such request is made by at least 20 percent in amount of creditors who hold an allowable, undisputed, fixed, liquidated, unsecured claim; who do not have an interest materially adverse to the interest of all creditors; and who are not insiders. To elect a trustee, at least 20 percent of the qualifying claims must vote and the candidate must receive a majority in amount of those voting. If a trustee is not elected, which is true in most cases, the interim trustee will continue to serve as the trustee. If the bankruptcy court authorizes the appointment of a trustee in Chapter 11, the creditors also have the option to elect a trustee of their liking to replace the interim trustee appointed by the U.S. Trustee.

Ongoing business bankruptcy cases can be lucrative for trustees. The U.S. Trustee's office first tries to provide this opportunity to its current trustees rather than to someone outside the system. But if the local practice has been to allow the judge, creditors, or debtors a great deal of influence in the trustee selection process, individuals outside the U.S. Trustee's system may have a much greater chance of being appointed. The key element considered in the appointment should be the qualifications of the trustee. When the U.S. Trustee appoints a trustee not on the panel, it is often because there is not a member of the panel with the specific experience needed to represent the estate.

4.2.1.2 Becoming a trustee

Before an applicant can become a trustee, he or she must pass a governmental background check. In other words, people having past problems such as a criminal record will not qualify for this position. Trustees must post bonds in the amount of the on-hand liquid assets they are going to manage.

Trustees are compensated in a variety of ways. Chapter 12 and 13 trustees are paid a percentage of the planned payments scheduled for the debtor in bankruptcy. Typically, the trustee's share is somewhere between 5 percent and 10 percent of the planned payments. For Chapter 7 cases, the trustee is paid $60 for each filing for nonasset cases. For asset cases, the trustee receives a percentage of the proceeds from sales of assets. In Chapter 7 asset cases and in Chapter 11, trustees must file a fee application with the bankruptcy court, just like all other administrative claimants. The fees charged by trustees are based on the monies distributed to the creditors. For petitions filed after October 22, 1994, the Bankruptcy Reform Act of 1994 increased the trustee fees. The new rates are 25 percent on $0 to $5,000, 10 percent on $5,001 to $50,000, 5 percent on $50,001 to $1,000,000, and reasonable compensation (not to exceed 3 percent) on an amount in excess of $1,000,001 of all funds disbursed or turned over by the trustee to parties in interest, excluding the debtor, but including holders of secured claims.

Even though more red tape is involved in compensation for Chapter 11 cases, they are often the most financially rewarding. Depending on the circumstances, payment in Chapter 11 cases can be automatic. For example, if the trustee is operating the debtor's business, he or she may be paid a monthly salary from the business and then only have to file a fee application for the trustee's time billed in excess of salary. Obviously, this kind of situation would significantly improve the trustee's cash flow in a bankruptcy engagement. Thus, in many areas, trustees must have served in simpler cases (for example, Chapters 7, 12, or 13) before being considered for the more lucrative Chapter 11 cases.

4.2.2 Examiner

CPAs may also become involved in bankruptcy by serving as examiner. This need arises when the debtor, creditor(s), trustee, or judge requires information not readily available due to lack of or improper recordkeeping of the debtor or entities in which the debtor has an interest, or where there are questionable transactions or activities that the court concludes need to be examined. According to Section 1106 of the Bankruptcy Code, unless the court orders otherwise, the functions of the examiner are to investigate the acts, conducts, assets, liabilities, and financial condition of the debtor, the operations of the debtor's business and the desirability of the continuance of such business, and any other matter relevant to the formulation of a plan. Following the investigation, the examiner is required to file a report.

The court will authorize the appointment of an examiner if it is determined to be in the best interest of the creditors, equity holders or other interests of the estate, or if the debtor's fixed, liquidated, unsecured debt—other than debt for goods, services or taxes or owing to an insider—exceeds $5 million. Examiners have been appointed in both large and small cases; for example, two examiners were appointed in Enron.

4.2.3 Reconstruction

Often, CPAs are hired to reconstruct, analyze, or summarize financial information. This may be required to determine the debtor's tax liability, validate a creditor's claim, identify special financial transactions, pinpoint the time frames of those transactions, or derive a net book value. Just about every time a Chapter 11 bankruptcy occurs, there is a dispute of some kind between the debtor and the creditors about what happened to the assets, why it happened, when the trouble started, whether the debtor intentionally attempted to deceive the creditors, or whether improperly prepared financial information was distributed. Questions like these are often answered by involving an independent party, such as a CPA.

4.2.4 Restate financial statements

Many businesses, for various reasons, do not present their financial information according to generally accepted accounting principles (GAAP). Sometimes, bankruptcy courts or creditors will demand that a debtor's financial statements be converted to GAAP to obtain a true picture of a company's financial position. Logically, this is an opportunity for CPAs.

4.2.5 Improve controls

When a business continues to operate during bankruptcy, it makes sense that additional controls are often necessary. These controls may be intended to help the debtor better manage the business, to convince the creditors that the current assets are being adequately monitored, to provide the trustee with more timely information, or to prevent theft from disgruntled employees. Once again, many opportunities arise from Chapter 11 cases because there are ongoing transactions. These transactions create opportunities to make or lose money. The bankruptcy court is interested in any change in the debtor's financial condition, either good or bad. Therefore, improving or monitoring the financial controls of a business in bankruptcy is a definite opportunity for CPAs.

4.2.6 Determine value

CPAs are not only retained to analyze the value of a debtor's estate or business, they are also often asked to derive an estimated value for a debtor's investment. For example, a debtor may own a minority interest in a small business. As far as the creditors are concerned, they want cash, not stock in another business. Therefore, to satisfy and protect the interests of both debtor and creditors, asset valuations become necessary.

Another need for valuation of a debtor's estate or business occurs because there is always an underlying question about whether the creditors will be best served through liquidation or reorganization. For example, it may be in the creditors' best interest to allow the debtor or trustee additional time to sell off a subsidiary whose going-concern value is far greater than its liquidation value. On the other hand, if an asset or business is likely to lose value with the passage of time, the creditors may want to exert pressure on the bankruptcy court to force liquidation of the debtor's assets. Thus, both going concern values and values based on the assumption that the business will be liquidated must be prepared.

In addition to determining the value for the purposes of the plan, valuation analysis is needed for several other reasons, including adequate protection (Section 361). In situations where a creditor's security interest is in property that is endangered, depreciating, or being dissipated by the debtor's actions, the court must determine if the creditor is adequately protected. Valuations are needed to determine the value of the security interest and the extent to which a decline in the value of the collateral may cause a need for protection. Valuations are needed to determine the amount of a claim that is secured and unsecured and are also needed to determine whether the debtor is solvent or insolvent for purposes of preferences, fraudulent transfers, or other forms of recovery action.

4.2.7 Expert witness

An expert is someone with specialized knowledge hired to render an opinion on specific circumstances. Since bankruptcy involves debtors and creditors who are in adversarial positions, experts are brought in to validate arguments made by both sides. Because the debtor is generally attempting to hold onto every asset possible, and the creditors want to sell off everything of value, both sides seek experts to make convincing arguments to the judge. Experts are hired to testify on almost everything, with financial matters topping the list. Therefore, since CPAs are considered experts in this area, there are many opportunities to assist either side in proving or disproving its position.

4.3 Help Clients Prepare for or Avoid Bankruptcy

The threat of bankruptcy is hardly limited to clients with financial problems. On the contrary, many financially well-heeled clients work in litigious environments. Doctors, lawyers, and people serving as board members could face financial ruin as a result of lawsuits. To protect such clients from disaster, it's important for CPAs to understand the bankruptcy law and its process.

For example, in Texas a married couple—using the state exemption law afforded under the Bankruptcy Code—may exempt the following assets (this is not an all-inclusive list):

— One acre of land plus improved property (for city dwellers) or 200 acres plus improved property (for rural residents)

— $60,000 of certain categories of personal property, including

Home furnishings, including family heirlooms

Provision for consumption

Farming or ranching implements

Tools, equipment, books, and apparatus, including a boat, used in a trade or profession

Clothing, including jewelry

Two firearms

Athletic and sporting equipment

One vehicle for each family member who holds a driver's license

The present value of any life insurance policy

Current wages for personal services

Various retirement plans

At first glance, the $60,000 Texas personal property exemption is surprising. While it does not seem excessive, consider that this amount is based on fair market value less any outstanding liens. Thus, if one drives two cars with a combined fair market value of $20,000, but still owes $18,000, for bankruptcy purposes the court considers the cars to equate to only a $2,000 personal exemption. Obviously, a critical phrase in this exercise is "fair market value." Quite often, the fair market value of someone's used clothing, furniture, or equipment, is minimal.

Continuing to use the Texas law as an example, "one acre of land plus improved property" is any combination of land and improvements as long as it is the debtor's homestead or is used for business purposes.

Therefore, a debtor could have one-half acre with a house and one-half acre with an office and exempt it all. If the homestead was worth \$500,000 and the office \$2,000,000 with total liens of only \$400,000, the \$2,100,000 in equity would be exempt under the bankruptcy laws in Texas.

Consider the allowed exemption of various retirement plans. Certain retirement plans are advantageous places to accumulate wealth that are not generally exposed to lawsuits. However, reading the fine print is critical. For example, while the law says that an individual's retirement plan is exempt, amounts contributed over and above the IRS maximum yearly allowable contribution, and the interest accumulated on that excess contribution, are not exempt under bankruptcy.

In addition to exemptions under bankruptcy, there are other pre-bankruptcy alternatives that can protect assets in excess of the state or federal exemptions. Assets such as priceless paintings and jewelry can be placed in a trust for children, with the parents named as administrators. This not only allows the valuable objects to pass from generation to generation, but also removes them from the parents' personal estate. Note that these types of conveyances must be made at a time when bankruptcy is not being contemplated; otherwise, such conveyances can be reversed. [See Appendix 2: Bankruptcy/Insolvency—Federal Bankruptcy Exemptions on the *Accountant's Business Manual Toolkit CD-ROM.*]

The point is that a CPA who does some homework regarding the Bankruptcy Code, state fraudulent conveyance acts, and state and federal exemption statutes is likely to identify many techniques to help protect some or all of a client's assets.

Obviously, this level of understanding of bankruptcy has value not only for secure clients, but also for those in financial difficulties as well. While there are some time lines to manage, CPAs can help distressed clients minimize the financial impact of bankruptcy, too.

The time lines referred to have various associated comfort zones. Conveyances to relatives or other "insiders" are subject to reversal under the Bankruptcy Code if made within two years of the filing of the bankruptcy petition (see section 15.2.2). Some state fraudulent conveyance laws, which are applicable in bankruptcy, cover a period much longer than one year. Therefore, CPAs need to be careful in discussing or recommending conveyances of assets. Despite this caveat, CPAs should consider transfers of assets as an appropriate and legal tool for protecting their clients' estates. (It should be noted that fraud, alimony, and priority income taxes are not subject to discharge by individuals under bankruptcy.)

Taxes are in some cases the reason individuals and corporations file for bankruptcy protection. Since the interest-and-penalty meter continues to tick until payment in full is rendered, bankruptcy offers some leverage when tax amounts are substantial. Not only does it stop the meter from ticking, but the bankruptcy court can dictate to the IRS a repayment schedule (which has a maximum term of up to five years from the date of the order for relief).

5. THE INS AND OUTS OF WORKING IN BANKRUPTCY

As one would expect, there are many opportunities within the bankruptcy system, but there are many pitfalls as well. Knowing how the system works, or more important, knowing how to work the system, is essential to survive. For example, it is far easier to be hired to perform bankruptcy work than to get paid for it. Many CPAs have done valid work but will never see payment for their efforts. The following should shed some light on a few common stumbling blocks.

5.1 Who Retains and Pays the CPA

The agency hiring the CPA is of primary importance. The CPA can be hired by a creditor, creditors' committee, shareholder, trustee, or debtor-in-possession.

The creditors' committee is appointed by the U.S. Trustee's office. Typically, the unsecured creditors' committee is selected from the list of the 20 largest unsecured creditors filed by the debtor. If three of the creditors are willing to volunteer, the trustee may appoint a committee. The Bankruptcy Code provides that the committee should consist of the seven largest that are willing to serve; however, committees are often appointed by the U.S. Trustee with fewer than seven in smaller cases and with a much larger number in larger cases. The creditors' committee is formed to protect the interests of all the unsecured creditors and is charged with monitoring the actions of the debtor-in-possession.

The debtor is referred to as debtor-in-possession because the debtor still controls its assets. Should the creditors' committee lose faith in the debtor or determine that mismanagement is occurring, the committee (or any single creditor) can request the court to authorize the U.S. Trustee to appoint a trustee to manage the debtor's estate. The creditor, creditors' committee, trustee, or debtor-in-possession can hire an attorney, CPA, and other professionals to protect their interests.

If a creditor or shareholder hires a CPA directly, the creditor or shareholder's obligation to pay is no different from that of any other client. If the CPA is even slightly uncomfortable with the situation, a retainer should be charged. The CPA can work from the retainer and never jeopardize any fees. Even though the CPA is being hired to perform work within the bankruptcy system, the court is not involved or in control of either the services rendered or the fees paid for those services.

If the creditors' committee, trustee, or debtor-in-possession hires the CPA, the CPA is considered an administrative claimant and payment for services rendered comes from the bankruptcy estate's available funds through the fee application process. Even though administrative claimants are given payment priority over unsecured creditors, working for the bankruptcy court can be risky because if there are no funds in the debtor's estate, no one will get paid. Therefore, it is imperative that the CPA look at the magnitude of the debtor's estate to determine whether there will be adequate funds to pay for all the professional services (for example, lawyers, CPAs, and experts) being requested.

5.2 What to Watch Out For

There are a couple of basic points that should be noted. First, the bankruptcy court does not add credibility to a client's ability or desire to pay for services rendered. At no time is it advisable to take on an undesirable client. Before accepting an engagement such as this, always interview the potential client to determine whether he or she is suitable for representation. A second general issue is the payment time frame. Collection in bankruptcy cases is often very slow. CPAs wait months, and even years, before payment of court-approved fees are made. Therefore, it is important that CPAs working in bankruptcy do not overextend themselves or their firms. For example, when the services requested of a small firm require several months of billable hours, the job may be lucrative but it might also place too great a financial strain on the practice. The Bankruptcy Code provides that interim fees may be paid every 120 days, and in many of the large cases, 75 percent to 80 percent of the fees may be paid on a monthly basis.

Several other areas can be costly for a CPA. Some of the most common include work performed:

— Without prior court approval.

— That is of little or no benefit to the estate.

— Without the time adequately narrated or itemized.

5.2.1 Obtain prior court approval

Before any work is performed on a bankruptcy case, one must file an employment application. This outlines the work to be accomplished and the rates to be charged. The good news about this process is that CPAs don't need to be shy about their standard rates; rarely are a CPA's rates considered excessive because they are compared to the fees being charged by the lawyers. However, if the court thinks a CPA is padding his or her rates to take advantage of the bankruptcy system, the judge is likely to reduce the hourly rates being sought or just reject the employment application altogether.

Anyone doing work without an approved employment application is taking a risk. While there are ways to resolve this situation, the court frowns on professionals who have not properly complied with the bankruptcy system's policies and procedures. Sometimes, because of this lack of compliance, the judge will either arbitrarily reduce the CPA's fee application (the bill) or just not approve it at all.

5.2.2 Verify the benefit to the estate

When attorneys or judges claim that the work performed was of little or no benefit to the estate, be prepared for the worst. Even a properly filed and approved work application does not guarantee that the work performed will be deemed of benefit to the estate at the time the work was performed.

For example, if a CPA who was hired to assemble GAAP financial statements for a two-year period worked 100 hours but did not complete the assignment, some might argue that the work was of no benefit to the estate. While this example seems fairly straightforward, many situations are not. For instance, if a CPA firm that took on the task of analyzing three years of past financial data and identifying all questionable transactions found none, some might argue that the work served no benefit to the estate because there was a hidden agenda. The creditors expected to find additional revenue sources by conducting the investigation. The point is to understand the expectations and agendas of the parties involved regarding the work requested, and to verify how that effort will be of benefit to the estate.

Besides lack of benefit to the estate, there are other reasons why parties might object to the fees associated with work performed by CPAs. Many of these reasons may not be logical, but all objections will be heard. Objections can come from anyone: a creditor, the creditors' committee, trustee, judge, and/or debtor. Anytime there is an objection, payment for services will typically be held up for a minimum of several weeks until the court can schedule a hearing on the objection. If the concerns are deemed valid, the fees charged may be reduced or not approved at all.

5.2.3 Narrate and itemize work performed

Districts and local practices may vary on fees payable by the court. However, a good rule of thumb is to report all time worked on a detailed bill using increments of one-tenth of an hour. Hence, 48 minutes spent on a specific task would be recorded as .8 hour. In addition, narrative describing all work performed should be included. The notation "financial statement preparation" is not adequate. The specifics of the work performed—for example, "reconciled bank statements for June, July, and August"—should be itemized on the bill presented to the court. If the time is not recorded to the satisfaction of the court, or if it is not adequately detailed, there is a likelihood that the judge will penalize the CPA or write down an arbitrary total fee amount.

Another area within the billing function is itemizing time in straight blocks, such as eight hours. This is often frowned upon because there is an assumption that breaks occur during a normal work day, such as for lunch, using the bathroom, and making telephone calls to the office. When eight hours of straight time were billed, the court might presume that the CPA was either charging for personal time or working inefficiently. In either case, time or fees are often docked. Therefore, if the same general function is performed over long periods, the work should be broken down into phases on the bill.

It is also important to understand local practices for such issues as travel time and expenses. Bankruptcy courts may not allow travel time to be billed at standard rates but set it at 50 percent of the standard rate. For instance, if travel each way to the work location was an hour of air time, 30 minutes of productive work while in flight might be justified, depending on the work performed. It should also be realized that the confidential nature of some assignments precludes the CPA from working while traveling. A narrative presenting this justification for travel costs and time may need to be included in the fee application in some cases and in others the court may accept it as standard practice. While travel expenses are generally reimbursed, the reimbursement does vary from location to location. For example, one court may pay all expenses, while another might not pay for meals. Note that all expenses will be tested against the same standard, which is whether they are reasonable. The court can and will declare expenses to be excessive and reimburse only what it feels is fair. An hour or two spent investigating these local practices can be critical to engagement administration.

5.3 Obtain Your Own Counsel

Clearly, there are many ways to be swallowed up by the bankruptcy system. Therefore, it is important for CPAs to obtain their own counsel when working in bankruptcy.

The first reason for this is that CPAs are not normally permitted to address the court. Therefore, if arguments need to be made about why certain work was of benefit to the estate or why specific expenses should be reimbursed, having one's own counsel is essential.

Another reason to retain counsel is that there are very specific procedures and time frames that must be followed for work to be approved and paid for within the bankruptcy system. By retaining counsel, one can become better informed.

The third reason is that informal discussions between counsel can sometimes be more advantageous than raising the issues in formal court hearings. When CPAs have their own counsel, it can be easier to timely resolve these issues.

5.4 File a Fee Application

If the CPA is an administrative claimant, CPA services are paid through the fee-application process. This application is typically difficult to prepare. Not only can it be lengthy, but every "i" must be correctly dotted and every "t" properly crossed. A fee application may not be filed more than once every 120 days unless the court orders otherwise.

Once a fee application has been presented, the judge may approve it as requested or may modify it. If the judge believes the work performed was not worthy of the fees charged, or that it did not provide an equivalent value to the estate, the judge can reduce the fees.

Many believe they can eliminate this arbitrary valuation by collecting a retainer up-front. This works if a creditor is paying the CPA directly. However, if the retainer is paid from the debtor's estate, there is no reason to be overconfident. Anytime someone is paid from the debtor's estate before a bankruptcy plan's being confirmed by the court, the judge can disgorge those monies, that is, demand that they be remitted back to the debtor's estate. In other words, many retainers in bankruptcy are more like loans. It is, however, common practice for attorneys and in some cases financial advisers to obtain a retainer before the filing of the petition. However, before anyone can draw down on retainer funds, court approval is required.

5.5 Receiving Payment

Once the CPA's fee application is complete, a copy is sent to each of the debtor's creditors, unless local rules dictate otherwise. The creditors typically have 20 days to file an objection to the fee application. If there are any objections, the judge will set a hearing. Once the judge has heard the objections, a ruling will be made and the fee application will either be approved, adjusted and approved, or rejected, or a decision will be postponed pending additional information. If the fee application is approved, a court order must be signed authorizing payment before payment can be made. The CPA is often allowed to file an interim fee application every 120 days, as provided for in the Bankruptcy Code. Some courts will allow monthly payments to be made for a percent of the services rendered with the balance being held back. The holdback may be only until the interim fee hearing or it may be until the end of the case. There is no provision in the Bankruptcy Code for holdbacks; however, it is standard practice. The holdback percentage generally varies between 10 percent and 30 percent, with 20 percent being a common holdback percentage.

Once the assignment has been completed, there will be a hearing for a final fee application and in some smaller cases there may only be one fee hearing, which is the final hearing. Once the fee application has been approved, a signed order may take only a day or so; other times, especially if it is the final fee application, it may take weeks or even months (for example, if an appeal is filed, it may be several months, or even years, before a final order is signed).

After the judge signs the order, another issue takes the forefront: whether the debtor's bankruptcy plan has been confirmed. If the debtor's bankruptcy plan has not been confirmed, payment of the fee application may still not occur. Unless the judge signing the order specified when the bill is to be paid (which is unlikely), payment is left up to the debtor or trustee. Therefore, one technique to consider is including in the fee application a payment provision specifying the payment time frame based on the court approval date. Judges often overrule this paragraph, but sometimes they do not.

If the bankruptcy plan has been confirmed, the debtor or trustee loses discretion regarding payment and must by law operate according to the plan. The plan will state which administrative claimants to pay and when. Should a plan be confirmed and an administrative claimant not be identified, problems occur. Therefore, all administrative claimants need to verify that they are included in the plan.

5.6 Finding Opportunities

CPAs are well qualified to identify ways in which they can work in bankruptcy, because they know what skills they bring to the table. The attorneys know what demands the bankruptcy system makes on them, but not necessarily how a CPA will fit in. The problem of marketing services in this group is compounded by the fact that the number of bankruptcy cases has and will continue to put a great deal of stress on the court system.

While the opportunities for CPAs are great, lawyers and judges rarely have time to seek out new expertise. Therefore, to break into this marketplace, CPAs need to be aggressive about soliciting an audience with local bankruptcy practitioners to inform them of the skills, experiences, and qualifications they can provide.

The greatest challenge in this selling exercise is to educate the bankruptcy practitioners about how accountants can provide assistance. Often, these people are more than willing to hire expertise when they know it exists and have determined how to use it. Therefore, the best way to find opportunities is to put together a marketing plan that consistently and repetitively reminds the local bankruptcy professionals of the various ways CPAs can make their jobs easier.

6. ORGANIZATION OF THE BANKRUPTCY SYSTEM

6.1 Court Hierarchy

Under the Supreme Court are eleven courts of appeal spread throughout the country. Each court of appeals has many district courts beneath it. The bankruptcy courts, which are an arm of the district courts, are next in the hierarchy.

The bankruptcy courts are very powerful and can have a very broad reach. These courts generally hear a variety of matters that encompass both state and federal law. Should a bankruptcy court's decision be appealed, the appeal would move up through the court hierarchy. Several of the courts of appeal have established within their circuits bankruptcy appeal panels, where, with the parties' consent, a panel of three bankruptcy judges will hear the appeal from the bankruptcy court.

6.2 Courts and Jurisdiction

The United States Bankruptcy Court was established by the 1978 Bankruptcy Reform Act. It began on October 1, 1979, with bankruptcy judges appointed under the 1898 act serving until presidential appointments of bankruptcy judges made a new court effective on April 1, 1984. A pilot trustee program was also established in 18 judicial districts, expanded in 1984 to all districts except those in Alabama and North Carolina.

The reform act granted the courts broad and complete jurisdiction over all matters and proceedings related to bankruptcy. All cases and civil proceedings that arose directly under the code or that arose in cases related to the code were within the court's jurisdiction. Bankruptcy judges were adjuncts to the district court and were appointed by the President to 14-year terms.

In 1982, the United States Supreme Court held that the broad grant of jurisdiction to the bankruptcy courts violated Article III of the Constitution. Congress responded with the 1984 amendments to the Bankruptcy Code.

6.3 1984 Bankruptcy Code Amendments

Under the Bankruptcy Amendments and Federal Judgeship Acts of 1984, bankruptcy judges became a unit of the district court known as the bankruptcy court.

Bankruptcy judges are now appointed to 14-year terms by the U.S. Court of Appeals. The district courts have original and exclusive jurisdiction over all Title 11 cases and original but not exclusive jurisdiction over all civil proceedings arising under Title 11 or related to Title 11.

District courts refer all bankruptcy cases and proceedings to bankruptcy judges. The district court, however, has the right to revoke its reference for cause and must revoke, upon a motion, when the proceeding involves bankruptcy and nonbankruptcy law.

Bankruptcy judges have the power to determine only "core" proceedings; however, they may hear noncore proceedings and may determine noncore proceedings if both parties consent. Their decisions are subject to review by the district court.

6.4 Trial by Jury

Under certain circumstances, a jury trial may be obtained in bankruptcy court; however, the odds are against it.

7. TERMINOLOGY AND DEFINITIONS

The terminology and definitions in Section 101 of the 1978 act are much more specific than they were under preceding bankruptcy law. Many previous terms have been discarded. It is therefore very important to check terminology to be certain of current definitions. Here are some frequently used terms:

> The term *adjudication* of a debtor as bankrupt has been replaced by order for relief, which occurs immediately upon filing a voluntary petition.
>
> The term *bankrupt* has been replaced by *debtor.*
>
> A *case* is begun by filing a petition. A *proceeding* is any controversy or other matter requiring judicial action within a case. The terms *case* and *proceeding* are not interchangeable.

The term *claim* means a right either to payment or to an equitable remedy for breach of performance if such breach gives rise to a right to payment.

The term *commodity broker* means a futures commission merchant, foreign futures commission merchant, clearing organization, leveraged transaction merchant, or commodity options dealer.

The term *consumer debt* means debt incurred by an individual primarily for a personal, family, or household purpose.

The term *creditor* means an entity that has a claim against a debtor that arose at the time of, or before, the order for relief concerning the debtor; it is also an entity that has a claim against the estate of a kind specified in Section 348(d), 502(f), 502(g), 502(h), or 502(i) of the Bankruptcy Code.

The term *debt* means a liability on a claim.

The term *debtor* means a person concerning whom a bankruptcy case has been commenced.

The term *family farmer* means (1) an individual or couple engaged in a farming operation when aggregate debt does not exceed $3.237 million and when at least 50 percent of the debt arises out of a farming operation (excluding debt for the principal residence, unless such debt arises out of a farming operation), or when more than 50 percent of the individual's or couple's gross income for the taxable year or in each of the second and third taxable years preceding the year of filing is from farming or (2) a corporation or partnership in which more than 50 percent of the outstanding stock (not publicly traded) or equity is held by one family that conducts a farming operation, in which more than 80 percent of the assets are related to farming, and in which aggregate debt does not exceed $3.237 million, at least 50 percent of which arises out of farming.

The term *family farmer with a regular income* means a family farmer whose annual income is sufficiently stable and regular to enable the farmer to make payments under a Chapter 12 plan.

The term *family fisherman* means an individual or individual and spouse engaged in a commercial fishing operation whose aggregate debts do not exceed $1,500,000 and not less than 80 percent of whose aggregate noncontingent, liquidated debts (excluding a debt for the principal residence of such individual or such individual and spouse, unless such debt arises out of a commercial fishing operation), on the date the case is filed, arises out of a commercial fishing operation owned or operated by such individual or such individual and spouse; and who receives from such commercial fishing operation more than 50 percent of such individual's or such individual's and spouse's gross income for the taxable year preceding the taxable year in which the case concerning such individual or such individual and spouse was filed. A family fisherman also applies to a corporation or partnership in which more than 50 percent of the outstanding stock or equity is held by one family that conducts the commercial fishing operation; or one family and the relatives of the members of such family, and such family or such relatives conduct the commercial fishing operation; and more than 80 percent of the value of its assets consists of assets related to the commercial fishing operation and its aggregate debts do not exceed $1,500,000 and not less than 80 percent of its aggregate noncontingent, liquidated debts (excluding a debt for one dwelling which is owned by such corporation or partnership and which a shareholder or partner maintains as a principal residence, unless such debt arises out of a commercial fishing operation), on the date the case is filed, arise out of a commercial fishing operation owned or operated by such corporation or such partnership. If a corporation issues stock, the stock may not be publicly traded.

The term *family fisherman with regular annual income* means a family fisherman whose annual income is sufficiently stable and regular to enable such family fisherman to make payments under a plan under Chapter 12 of this title.

The term *farmer* (except when the term appears in the term *family farmer*) means a person who received more than 80 percent of gross income from a farming operation during the taxable year immediately preceding the year that a Chapter 12 case is filed.

The term *farming operation* refers to farming; tillage of the soil; dairy farming; ranching; production or raising of crops, poultry, or livestock; and production of poultry or livestock products in an unmanufactured state.

The term *financial institutions* means commercial or savings banks, industrial savings banks, savings and loan associations, or trust companies.

The term *governmental unit* is a department, agency, or instrumentality of the United States or of a state, commonwealth, district, territory, municipality, foreign state, or other foreign or domestic government.

An *individual with regular income* is an individual, other than a stockbroker or a commodity broker, whose income is sufficiently stable and regular to enable him or her to make payments on a plan under Chapter 13 of the Bankruptcy Code.

Insolvency is an inability to meet debts, or an excess of debts over assets.

Judicial lien refers to a lien obtained by judgment, levy, sequestration, or other legal or equitable process or proceeding.

A *lien* is the charge against or interest in property to secure either payment of a debt or performance of an obligation.

Perfection is the protection of a security interest against the claims of third parties other than the debtor. Frequently it is accomplished by complying with state recording acts, but it can also be created in other ways under the Uniform Commercial Code. For example, under the Uniform Commercial Code, a purchase money security interest in consumer goods perfects automatically.

A *person* includes individuals, partnerships, and corporations.

A *petition* commences a case by or against a debtor.

A *proceeding* is any controversy or other matter requiring judicial action within a case.

Purchase money security interest is created when a seller takes a security interest in goods sold on credit, or when a creditor lends money used to buy the collateral that secures the loan.

Secured and unsecured creditors are holders of secured and unsecured claims (*provable claims* are, simply, claims).

A *security agreement* is an agreement that creates or provides for a security interest.

A *security interest* is a lien created by an agreement.

The term *single asset real estate* means real property constituting a single property or project, other than residential real property with fewer than four residential units, that generates substantially all of the gross income of a debtor (excludes family farmer and property on which substantial business is being conducted) from operating the real property and activities incidental thereto with noncontingent, liquidated secured debts that do not exceed $ 4,000,000.

The term *small business case* means a case filed under Chapter 11 in which the debtor is a small business.

The term *small business debtor* means a person engaged in commercial or business activities (excludes business activities related to the business of owning or operating property) that has aggregate, noncontingent, liquidated secured and unsecured debts as of the date of the petition not exceeding $2,000,000 for a case in which the U.S. Trustee has not appointed a committee of unsecured creditors or where the court has determined that the committee is not active and representative to provide effective oversight of the debtor.

A *statutory lien* is either a lien arising solely by force of a statute on specified circumstances or conditions or a lien of distress for rent, whether or not statutory.

A *stockbroker* is a person engaged in the business of effecting transactions in securities for the account of others or with members of the general public, from or for such person's own account.

A *transfer* refers to the creation of a lien, retention of title as security interest, foreclosure of the debtor's equity or redemption, or every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property.

8. CHAPTER 7: LIQUIDATION

8.1 Introduction

The vast majority of bankruptcy cases are Chapter 7 cases. The terms *straight bankruptcy* and *bankruptcy* usually refer to a liquidation under Chapter 7.

The purpose of liquidation under Chapter 7 is to satisfy as many creditor claims as possible while providing a fresh start for the debtor by preserving exempt property. The debtor forfeits all nonexempt property in exchange for a complete discharge of debts. For a discussion of conditions under which the Chapter 7 case may be dismissed or converted, see section 16 of this chapter.

Because the debtor has the ability in bankruptcy to exempt certain assets, most Chapter 7 cases are no-asset cases; that is, no assets are available for distribution to unsecured creditors. To the extent nonexempt assets are available, the code provides various payment priorities and the order of distribution between classes of claimants.

In a Chapter 7 asset case, a trustee collects and sells all nonexempt property and, with the sale proceeds, makes payment to claimants in the order provided by the code.

A Chapter 7 liquidation case has five basic stages:

1. Commencement
2. Collection of all debtor assets
3. Liquidation of assets through sale
4. Distribution of sale proceeds
5. Discharge of debtor's debts

8.2 Commencement

8.2.1 How to file

A Chapter 7 liquidation is begun by the filing of a petition. Usually the debtor files the petition, making it a voluntary case (see section 16.7 of this chapter). In addition to the petition, the debtor must file a schedule of debts and assets and a statement of financial affairs containing income and expense information. The petition may be filed with the bankruptcy court where the debtor's residence, principal place of business, or principal assets have been located for most of the 180 days before filing.

8.2.2 Who may file

To be eligible to file a petition, the debtor must be a person, defined to include partnerships and corporations as well as individuals. A husband and wife may file a single joint petition. A sole proprietor would file as an individual, and the proprietorship assets would then be included in the individual's bankruptcy estate. The Chapter 7 debtor may not be a railroad, insurance company, or banking institution. Railroads are eligible for relief under Chapter 11; financial institutions and insurance companies may liquidate under various other regulatory laws. A

Chapter 7 debtor need not be insolvent to file a petition. The debtor must pay a filing fee (a petition may be dismissed for nonpayment of the fee).

8.2.3 Effects of filing

The filing of a Chapter 7 petition operates as an order for relief and requires no formal adjudication. Filing institutes an automatic stay of all debt enforcement and collection by creditors. The stay is very broad and applies not only to judicial proceedings but also to phone calls and letters from creditors. Exceptions to the stay include criminal actions against the debtor, maintenance and child-support decrees, and several other narrow circumstances (Section 362).

8.3 Collection of All Debtor Assets

8.3.1 Appointment of a trustee

A trustee is appointed to oversee every Chapter 7 case. To a large extent, the trustee is vested with the debtor's rights in property. The trustee's role is to collect and sell the assets of the debtor's estate and make payments to claimants against the estate. Under the Bankruptcy Code, trustees generally are required to file a bond in a case. Pursuant to Section 326, they are paid a certain percentage of the value of the debtor's estate as compensation for their services. Usually, an interim trustee is appointed by the court immediately after the petition is filed. The interim trustee administers the case until a permanent trustee is selected, generally at the creditor's meeting provided under Section 341.

8.3.2 Creditors' Section 341 meeting

As a practical matter, the interim trustee becomes the permanent trustee at the Section 341 meeting, except in the unusual event that the creditors elect a different trustee. The debtor is also examined under oath at the Section 341 meeting to allow the trustee and creditors to locate and evaluate the debtor's assets and to determine whether the debtor has made any conveyances or transfers of property that are avoidable. The scope of the examination is limited to actions and property that might affect the administration of the debtor's estate.

8.3.3 The debtor's estate

Filing a petition automatically creates an estate in the debtor's assets. The estate consists of all the debtor's nonexempt property at the commencement of the case. In general, the debtor's estate consists of "all legal and equitable interest of the debtor at the start of the case." The estate therefore includes all real and personal property, intangible assets, property of the debtor possessed by a third party, equitable and legal interests, and causes of action (Section 541).

Property acquired by the debtor after filing the petition that becomes part of the estate includes:

- Property the debtor acquires or becomes entitled to within 180 days after filing the petition by
  - Bequest, devise, or inheritance.
  - Property settlement or divorce decree.
- Life insurance proceeds as policy beneficiary.
- Earnings from the estate property, such as rents.
- Property received from the conversion of estate property, such as an insurance payment for destroyed property.

Any other property acquired after filing is excluded from the debtor's estate. The trustee has the power and duty to investigate all property transfers, liens, and improper conveyances to determine if they could be avoided and included in the estate. The trustee must also distinguish between valid and invalid liens under the code. Valid lien holders are paid, under the code, to the full extent of the lien's value.

8.4 Liquidation of Assets Through Sale

With some exceptions where property is subject to a lien, the trustee is empowered to sell all the assets of the debtor's estate under procedures provided in the Bankruptcy Code and rules of procedure. The trustee files with the court an accounting of the completed liquidation of the bankruptcy estate. From this accounting the court orders the distribution of the funds collected according to the schedule of priorities and distribution provided by the code.

8.5 Distribution of Sale Proceeds

Chapter 7 provides its own rules for the distribution of property in liquidation cases (of pertinence is Section 726). Sections 507 and 726 should always be considered together when determining priorities in a liquidation case.

Section 726(a) of the Bankruptcy Code provides for distribution or payment to claimants from property recovered in a Chapter 7 case in the following order:

1. Priority claims in the order provided by Section 507 (see section 16.5 of this chapter)
2. Unsecured claims filed in a timely manner or, if certain conditions are met, tardily filed
3. Unsecured claims that are tardily filed and that do not fall within second-priority treatment
4. Secured and unsecured claims for fines, penalties, forfeitures, or punitive damages arising before the earlier of the orders for relief or appointment of trustee, to the extent that they are not compensation for actual pecuniary loss
5. Interest at the legal rate from the date of the petition on the preceding four classes of claims
6. Any balance to debtor

Claims are generally paid pro rata to all claimants within a class in the descending order provided by statute.

8.6 Discharge of Debtor's Debts

An individual Chapter 7 debtor is ordinarily entitled to a discharge or release of liability for dischargeable debts under Section 727 of the Bankruptcy Code. The discharge is granted by a written document issued by the bankruptcy court within several months after the debtor's petition was filed. Unless there is some problem with discharge, it is normally granted without regard to whether the trustee has completed the liquidation of the debtor's Chapter 7 estate. A corporation or partnership cannot receive a discharge under Chapter 7 and is liquidated only to provide for the equitable distribution of assets to all creditors. Corporations or partnerships may dissolve after liquidation, but such dissolution would be carried out under state law because there are no such dissolution provisions under the Bankruptcy Code.

A discharge will not be granted if the debtor fails to complete an instructional course concerning personal financial management.

8.6.1 Nondischargeable debts

Section 523(a) of the Bankruptcy Code provides that the following types of debts are not discharged by an individual in a Chapter 7 case:

— Certain taxes or customs duties that are priority taxes, with respect to a return not filed, to a fraudulent filed return, or to a return that was filed late within two years before the filing of the petition.

— Debts incurred through false pretenses, false representations, or actual fraud; consumer debts owed to a single creditor for no more than $500 for luxury goods or services incurred within 90 days before the order for relief and certain cash advances for no more than $750 that are an extension of consumer credit under an open-ended credit plan obtained within 70 days before the order for relief.

— Debts not listed or scheduled in time to be allowed
— Debts arising from fraud or embezzlement while the debtor was acting as a fiduciary
— Debts owed for domestic support obligations
— Debts based on willful or malicious injury
— Debts for certain government fines, penalties, or forfeitures that are not compensation for actual pecuniary losses
— Student loans (in certain circumstances)
— Debts based on a liability incurred as a result of the debtor's operating a motor vehicle while legally intoxicated
— Debts from a prior bankruptcy where the debtor waived or was denied discharge

8.6.2 Effects of discharge

The discharge in bankruptcy not only releases the debtor's liability for dischargeable debts but also voids the debtor's personal liability for judgments of discharged debts and operates as an injunction against creditor collection action against the debtor personally (Section 524). A Chapter 7 debtor can receive no more than one discharge every eight years; the fact that a debtor has been granted a Chapter 7 discharge will therefore not preclude the debtor from filing again within eight years of a prior filing, but no discharge can be granted in the second case (Section 727(a)(8)).

9. CHAPTER 13: ADJUSTMENT OF DEBTS OF AN INDIVIDUAL WITH REGULAR INCOME

9.1 Introduction

Under the earlier bankruptcy act, a Chapter 13 case was referred to as a wage-earner bankruptcy. The code has broadened the former provisions to include people with regular income. The goal of Chapter 13 is debtor rehabilitation. The Chapter 13 debtor must submit a plan that generally provides for payment, over an extended time period, of the debtor's priority and secured claims, and all or a portion of unsecured claims. To the extent that a completed Chapter 13 plan does not pay the debtor's unsecured debt, the debtor receives a Chapter 13 discharge.

9.2 Limitations

9.2.1 Eligibility for relief

To be eligible for Chapter 13 relief, the debtor must be an individual with regular income (Section 101(27)). This requirement has been interpreted to mean an individual (including sole proprietors) who has income that is sufficiently stable and regular to provide payments under a Chapter 13 plan. In practice, therefore, the requirement allows for a plan tailored to the debtor's income flow whether the debtor receives income weekly, monthly, quarterly, or seasonally. Of course, the debtor's income must be sufficient to make the payments provided under the plan, or the plan cannot be confirmed.

9.2.2 Monetary limitations

A second limitation under Chapter 13 is monetary. To be eligible under Chapter 13, a debtor must have unsecured debts of less than $307,675 and secured debts of less than $922,975. Aggregate debts of a husband and wife must be within these limits (Section 109(e)).

9.2.3 Prior bankruptcies of the debtor

A third limitation concerns prior bankruptcy filings. A debtor will not be eligible for bankruptcy relief if, at any time within the preceding 180 days, the case was dismissed for the debtor's willful failure to follow court orders or to appear in court to follow through on the case, or if the debtor filed a request for relief from the automatic stay and thus obtained a voluntary dismissal of the case.

A Chapter 13 proceeding will generally proceed by these steps:

1. Commencement
2. Appointment of a trustee
3. Statement and plan
4. Confirmation
5. Discharge

9.3 Commencement

A Chapter 13 case is commenced by the debtor's filing with the bankruptcy court the original and a copy of a petition. The petition is filed with the bankruptcy court located where the debtor has resided or had a principal place of business or assets for the 180 days before filing. A filing fee must be paid, but the debtor may apply to pay the fee in installments. A creditor may not file an involuntary petition (see section 16.7 of this chapter) against a debtor under Chapter 13. The filing of a petition operates as an order for relief and institutes a stay against all debt-collection efforts.

9.4 Appointment of a Trustee

The principal administrator of the Chapter 13 case is the trustee. Section 1302 provides for the appointment of a Chapter 13 trustee unless the court has already appointed a standing trustee. A standing trustee is ordinarily appointed when the number of Chapter 13 cases in the district warrants the appointment. Standing trustees are chosen from a panel of private trustees under the U.S. Trustee program. Creditors may not elect the Chapter 13 trustee.

Chapter 13 trustee duties include attending meetings and hearings, investigating the debtor's finances and creditor claims, determining the feasibility or modification of the Chapter 13 plan, filing reports, and being accountable for all of the debtor's property. The trustee also advises the debtor on the plan, assists the debtor with performance under the plan, and ensures that the debtor makes timely payments under the plan. Chapter 13 trustees are required to file a performance bond before beginning their duties.

9.5 Statement and Plan

The debtor is required to file, in addition to the petition, a Chapter 13 statement and plan. The Chapter 13 statement contains the debtor's budget list of assets and liabilities and property claimed as exempt. In nonbusiness cases, this statement is filed in lieu of schedules and a statement of financial affairs in Chapter 7 cases. In business cases, the debtor must file a Chapter 13 statement and a statement of financial affairs. If the statements and plan are not filed with the petition itself, they must be filed within 15 days after filing the petition. Further extensions of time may be granted only by the court and for cause.

The Chapter 13 plan, which is the heart of a Chapter 13 case, provides a schedule for payment of creditor claims against the debtor. The form of a Chapter 13 plan will vary for every case, since a plan must be tailored to each debtor's own situation.

9.5.1 Required provisions

Section 1322 of the Bankruptcy Code requires that the plan must contain these four provisions:

1. The debtor's payment of future income to the trustee
2. The payment of priority claims as provided in Section 507 (see section 16.5 of this chapter)
3. Equal treatment of all claims within a class of claims
4. The above provisions notwithstanding, a debtor's payment of less than full payment of domestic support obligations under Section 507(a)(1), provided all the debtor's projected disposable income will be applied to a five-year plan period.

9.5.2 Permissive provisions

Some of the more important permissive plan provisions allowed under Section 1322 include higher-percentage payment of consumer debts for which another person may be liable with the debtor, modification of rights of secured creditors (other than mortgages on the debtor's principal residence), and cure of defaults in secured claims during the pendency of the plan.

9.5.3 Payment period

A Chapter 13 plan may not provide for a payment period in excess of three years unless the court approves a longer period for cause. In no event may the court approve a plan that is longer than five years. If the debtor's income is greater than the state medium income, payments in the plan must be over five years. Unless the court orders otherwise, the debtor must start making payments within 30 days after the proposed plan is filed. These payments are retained by the trustee until the plan is confirmed and are then applied by the trustee toward the plan. Annually, within 45 days of the confirmation date, the debtor must file a statement of income and expenditures during the tax year most recently concluded and statements that show the monthly income of the debtor indicating how income, expenditures, and monthly income are calculated.

9.6 Confirmation

9.6.1 Creditors' Section 341 meeting

As in Chapter 7, creditors are entitled to a Section 341 meeting whereby the financial affairs of the debtor are examined and a determination made as to whether the plan complies with code requirements. A Section

341 meeting, however, may not always be necessary, particularly if the trustee has already met with the debtor on filing.

9.6.2 The confirmation hearing

A confirmation hearing before the Bankruptcy Court is held not earlier than 20 days before and not later than 45 days after the creditors' meeting unless the court determines that it would be in the best interest of the creditors and the estate to hold it earlier and provided there is no objection to the earlier date. The court will determine whether the plan should be confirmed. Section 1325(a) provides that the court shall confirm the plan if the following conditions are met:

— The plan complies with applicable Bankruptcy Code provisions.

— All required fees and charges have been paid.

— The plan is proposed in good faith.

— Unsecured creditors will receive at least as much in payments under the plan as they would have received in a Chapter 7 liquidation case.

— Each secured creditor has accepted the plan, which must provide that (1) the holder of such lien retain the lien securing such claim until the earlier of the payment of the underlying debt or a discharge under Section 1328 and (2) if the case is dismissed or converted without completion of the plan, the lien shall be retained to the extent allowed by nonbankruptcy law. Additionally, the value of the property to be distributed must not be less than the allowed amount of the claim, and if (1) the property to be distributed under the plan is in the form of periodic payments, such payments must be equal monthly installments and (2) if the holder of the claim is secured by personal property, the amount of such payments shall not be less than an amount sufficient to provide the holder adequate protection. Alternatively, the plan may provide for the debtor to surrender the security collateral to the secured creditor. Secured creditors have limited veto power over the plan; if either of these two conditions is met, a secured creditor cannot veto the plan. Acceptance by unsecured creditors is not necessary. These provisions that allow lien stripping would not apply where the creditor holds an interest in a motor vehicle purchased within 910 days before filing.

— The plan is feasible, that is, the debtor will be able to make all payments and otherwise comply with the plan.

— The debtor has paid all required domestic support payments.

— The debtor has filed tax returns, if required, from four years before the Chapter 13 filing as required by Section 1308 of the Bankruptcy Code.

9.6.3 Objections to confirmation

Section 1325(b) of the Bankruptcy Code, provides that the trustee or an unsecured creditor may object to confirmation. In that event, the court may not confirm the plan unless the plan proposes to pay the objecting creditor in full or unless the plan provides that all of the debtor's projected disposable income to be received during the applicable commitment period will be applied to payments under the plan. The code defines *disposable income* as income received by the individual debtor that exceeds the reasonable expenses needed to support the debtor and the debtor's dependents, and income received by the business debtor that exceeds expenses needed to continue to operate the business.

9.7 Discharge

A Chapter 13 debtor may receive one of two types of discharge under Section 1328.

9.7.1 Full or expanded discharge

A full discharge is granted under Section 1328(a) to the debtor who fully performs and completes a confirmed Chapter 13 plan. When the plan is completed, all creditors have been fully paid pursuant to the plan. The exceptions to a discharge as modified by the 2005 Act are much broader than the discharge allowed under prior law. For example, many of the provisions in Section 523(a) denying a discharge now apply to Chapter 13 cases including the provision that taxes for which returns were not filed, filed late, or filed fraudulently are now not subject to a discharge.

A discharge will not be granted in Chapter 13 if the debtor fails to complete an instructional course concerning personal financial management.

9.7.2 Hardship or partial discharge

Under Section 1328(b), a hardship or partial Chapter 13 discharge may be granted to the debtor by the court even if the debtor does not complete payments under the plan. The hardship discharge is granted if three conditions are met:

1. The debtor's failure to complete the plan is due to circumstances not within the debtor's control.
2. The distribution made to each creditor under the plan is at least equal in value to the amount that would have been paid to the creditors under a Chapter 7 proceeding.
3. Modification of the plan is not practical.

The hardship discharge is not quite as broad as the full discharge and is comparable to a Chapter 7 discharge. In fact, a Chapter 13 debtor unable to complete the plan who is also not eligible for a hardship discharge can usually convert the Chapter 13 case to a Chapter 7 case and receive a discharge under Section 727.

9.7.3 Nondischargeable debts

Long-term debts, spousal debts, debts arising from willful and malicious injury, and fraud and misrepresentation are not dischargeable. Postpetition claims are also not dischargeable unless prior approval of the trustee was obtained.

9.7.4 Effect of discharge

The discharge serves as a total prohibition on any further debt-collection efforts. It also voids any judgment obtained on prepetition debts and any allowed postpetition claims.

A debtor granted a Chapter 13 discharge is not eligible for a Chapter 7 discharge within eight years after the Chapter 13 discharge, unless payments under the Chapter 13 plan totaled at least 100 percent of unsecured claims, or unless they totaled 70 percent of such claims and the plan was made in good faith, representing the debtor's best effort.

9.7.5 Revocation of discharge

A court may revoke the discharge on request of a party in interest and after notice and hearing only if the discharge was obtained through fraud and knowledge of the fraud came to the requesting party after the discharge was granted. The request for revocation must be made within one year after the discharge is granted.

10. CHAPTER 11: REORGANIZATION

10.1 Introduction

The typical Chapter 11 case involves a business, since the goal of Chapter 11 is business rehabilitation. A Chapter 11 case is based on the idea that a financially troubled business is in a much better position to pay off debts if it continues to operate while reorganizing its financial affairs than if it liquidates its assets and ceases operation. Chapter 11 allows the business to continue and devises a plan for payment or partial payment of its debts. A Chapter 11 case generally involves these five steps:

1. Commencement
2. Operating the business
3. Formulating a plan
4. Creditor acceptance of the plan
5. Confirmation

10.2 Commencement

A Chapter 11 case, which may be involuntary (see section 16.7 of this chapter), is commenced by filing a petition with the bankruptcy court in the district where the debtor has been domiciled, resides, or has had his or her principal place of business or assets for most of the 180 days before filing (28 USC Section 1408). As in Chapters 7 and 13, debtors must pay a filing fee. Individuals filing under Chapter 11 may pay the fee in installments. Individuals, partnerships, and corporations may file under Chapter 11, but governmental units, financial institutions, railroads, stockbrokers, and commodity brokers are prohibited from being Chapter 11 debtors (Section 109(d)). Stockbrokers and commodity brokers are provided with separate liquidation methods under Subchapters III and IV of Chapter 7. These subchapters are designed primarily to protect the clients of these debtors.

The filing of a petition under Chapter 11 operates as an order for relief and institutes an automatic stay of all debt-collection efforts. As in Chapters 7 and 13, the stay is very broad and covers not only judicial proceedings but also phone calls and letters from creditors (Section 362).

10.3 Operating the Business

10.3.1 Debtor in possession

In most Chapter 11 cases, the debtor will remain in control of its business operations as a "debtor in possession."

The debtor in possession has all the rights, duties, and powers of a bankruptcy trustee except for the right to compensation. The debtor in possession is required to perform all functions specified for the trustee except the investigation of his or her own acts, conduct, and financial affairs. These duties include filing with the court periodic reports of business operations and tax reports, and being accountable for all property. A debtor in possession retains the power to use, sell, or lease property; to obtain unsecured credit; to contract; to exercise the trustee's turnover and avoiding powers; to recover preferences and other property transfers; to file and object to creditor claims; and generally to exercise all powers of a trustee. The debtor may be required to lower the salaries of its corporate officers (Section 1107).

10.3.2 Appointment of a trustee

At the request of a party in interest, the court may authorize the U.S. Trustee to appoint a trustee if there is or has been fraud, dishonesty, incompetence, and gross mismanagement on the part of the debtor or if it is in the best interest of creditors or security holders. An example would be if the debtor continued to operate the business in a way that still damaged it financially. The Bankruptcy Code was modified in 1994 to provide that once the court has authorized the appointment of the trustee, the creditors have the right to elect a trustee as an alternative to having the trustee appointed by the U.S. Trustee. If a trustee is not appointed, the court may appoint an examiner to investigate any fraud, dishonesty, incompetence, or misrepresentation on the debtor's part.

10.4 Formulating a Plan

The term *reorganization* basically connotes an adjustment or reordering of the rights of parties having an interest in the business. The Bankruptcy Code allows the debtor great flexibility in designing a plan tailored to the needs and interests of each business. The debtor may also develop a Chapter 11 liquidation plan. Many businesses that are unable to reorganize elect to liquidate under Chapter 11, rather than allow the assets to be distributed according to the distribution plan described above in a Chapter 7 proceeding. Even though the creditors may not trust the debtor to effectively liquidate the business under Chapter 11, they may work out an agreement with the debtor to allow the financial adviser or other professionals to be in charge of the liquidation to avoid having to appoint a Chapter 11 trustee. In other situations one or more of the creditors or even the creditors' committee may decide not to allow the debtor to continue in charge of the business and file a motion with the court requesting the appointment of a trustee.

A decision to liquidate the business may occur under several different circumstances and may involve several different approaches, even in Chapter 11. For example, some companies that have no viable business liquidate the remaining assets and then distribute the cash to the creditors through a Chapter 11 liquidation plan. Other companies may convert the petition to Chapter 7 and distribute the assets in accordance with the discussion above. Finally, some companies may have the Chapter 11 case dismissed and liquidate under the assignment laws of the appropriate state. Recently there has been an increase in the number of 363 sales where the assets of the business are sold under the supervision of the bankruptcy court and the proceeds distributed to the creditors through a Chapter 11 liquidation plan. Banks and other financial institutions are less willing today to lend funds for the time period necessary for businesses to reorganize, but often are willing to provide funds for a shorter period while the debtor implements a 363 sale. Additionally, creditors appear to be less patient today than they were in the 1980s and early '90s, asking debtors to sell the business or in some cases filing a motion asking the court to provide for a 363 sale.

Asset sales are not restricted to the middle market or smaller cases. For example, companies like Polaroid (received $56.5 million cash for assets of its Identification Systems Business Division), Fruit of the Loom (business operations purchased by Berkshire Hathaway, Inc.), and LTV Corporation (sold its integrated steel assets to W.L. Ross & Co.) completed significant asset sales as a part of their Chapter 11 filing.

The 2005 Act provides that in the case of a prepackaged plan where the voting before filing has already been solicited, the court may dispense with a meeting of creditors.

10.4.1 Required provisions

Section 1123(a) lists the contents of the plan required under Chapter 11 for confirmation. In summary, a plan must:

- Designate the classes of claims and interests.
- Specify which classes are not impaired by the plan.
- Specify the treatment of impaired classes.
- Provide the same treatment for each claim or interest within a particular class (unless a claimant agrees to less favorable treatment).
- Provide adequate means for implementation of the plan.
- Provide, in certain instances, for corporate charter amendments.
- Contain provisions for the selection of officers, directors, and trustees and their successors consistent with interests of creditors, equity-security holders, and public policy.

10.4.2 Impaired classes under the plan

The concept of impaired classes of claims or interests is vitally important in the Chapter 11 confirmation process.

Whether a class of claims or interests is impaired under a plan must be determined by tests prescribed by Section 1124. Basically, the claim- or interest-holder whose legal rights remain unaltered or who will be fully paid under the plan is not impaired. The claim- or interest-holder that accelerated its right to demand payment under the terms of its contract with the debtor is not impaired, provided the plan cures the default, reinstates the maturity of the claim or interest, compensates the holder for any damages, and does not otherwise alter the legal rights of the holder.

10.4.3 Who may file a plan

Unless a trustee has been appointed in the case, the debtor has an exclusive right to file a reorganization plan during the first 120 days of the case. If the debtor files a plan within the 120 days, another 60 days are added, allowing the debtor 180 days to have its plan accepted. If a trustee has been appointed, if the debtor fails to file a plan within 120 days, or if a plan the debtor has filed is not accepted after 180 days, any party in interest may file a proposed plan. These periods of exclusivity may be increased or reduced for cause by the court (Section 1121). However, the period of exclusivity may not be extended beyond 18 months after the date of the order for relief and 20 months to have the plan accepted.

10.5 Creditor Acceptance of the Plan

A party cannot solicit acceptance or rejection of the plan from creditors and shareholders unless it receives a written court-approved disclosure statement. Section 1125(b) of the Bankruptcy Code requires that the debtor provide this disclosure statement before or concurrently with the solicitation. The court must approve the disclosure statement, after notice and hearing, as containing adequate information. Section 1125(a) of the Bankruptcy Code dealing with the disclosure requirements is expanded by the 2005 Act to require the proponent of the plan to include full discussion of the potential material federal and state tax consequences of the plan to the debtor, any successor to the debtor, and a hypothetical investor typical of the holders of claims or interests in the case.

10.5.1 Acceptance by impaired classes

A plan is accepted by the vote of each class of creditors or shareholders. The debtor or proponent need not obtain acceptance from all creditors and shareholders within a class. An impaired class of claims accepts the plan when a majority of the impaired class and two-thirds of the dollar amount represented by the claims of the impaired class vote to accept the plan (Section 1126). Additionally, the acceptance or rejection of the plan is based only on those that vote and not on all creditors and stockholders eligible to vote in each class.

10.5.2 Acceptance by unimpaired classes

Each class of claims or interests not impaired by the plan is deemed to have accepted the plan. Thus, it is not necessary to solicit acceptance from these classes, creditors, or interests.

10.6 Confirmation

The reorganization plan may be confirmed by the bankruptcy court only after notice and hearing. Any party in interest may object to confirmation. The Securities and Exchange Commission also has a right to object and to appear and be heard in Chapter 11 cases that involve SEC matters.

10.6.1 Requirements for confirmation

Under Section 1129(a), the plan must meet all the following requirements for confirmation:

1. The plan must comply with the applicable Bankruptcy Code provisions.
2. The plan proponent must comply with the applicable Bankruptcy Code provisions.
3. The plan must be proposed in good faith and not be forbidden by law in any way (Section 1129(a)(4)).
4. Payments for the administration of the case must be approved and disclosed (Section 1129(a)(3)).
5. Directors, officers, and the voting trustee who will be appointed to serve after the reorganization must be disclosed, and their appointment must be consistent with the interests of creditors, equity security holders, and public policy. The identity and compensation of any insider to be employed must be disclosed (Section 1129(a)(5)).
6. Any rate changes in the plan must be approved by the government regulatory commission having jurisdiction over such rates (Section 1129(a)(6)).
7. The plan must satisfy the best-interest-of-creditors' test (described below) (Section 1129(a)(7)).
8. The plan must be accepted by each class of impaired claims and interests (except for cramdown provisions) (Section 1129(a)(8)).

9. The plan must provide for the payment of priority claims, including administrative expenses, involuntary gap claims, employee wages, and priority taxes (Section 1129(a)(9)). The payments under Section 1129(a)(9) must be regular installments in cash of a total value as of the effective date equal to the allowed amount of the claim, must not exceed a five-year period from the order for relief, and must be in a manner not less favorable than the most favored nonpriority unsecured claim other than administrative convenience claims. The requirements of Section 1129(a)(9) also apply to secured taxes that are entitled to priority absent their secured status.
10. The plan must be accepted by at least one impaired class (Section 1129(a)(10)).
11. The plan must be feasible (Section 1129(a)(11))—that is, the proponent of the plan must be able to fund the interest and required debt payments.
12. The plan must not discriminate unfairly and must be fair and equitable with respect to each class (Section 1129(b)).
13. The filing fees and quarterly fees must be paid or the plan must provide that such fees will be paid as of the effective date of the plan.
14. The plan must provide, as of the effective date, for the continuation of all retiree benefits as defined under Section 1114 and at the level established under Section 1114.
15. If the debtor is required by judicial or administrative order or by statute to pay domestic support obligations during the Chapter 11 proceedings, such payments must have been made.
16. In the case of an individual, if the holder of an unsecured claim objects to the confirmation of the plan, the plan must provide that the value of the payments is not less than the amount of the claim or the value is not less than the projected disposal income of the debtor as defined in Section 1325(b)(2) to be received during a plan period that must be at least five years.

10.6.2 Cramdown

When unanimous approval is not obtained, the court may confirm the plan if one class of claims or interests accepts the plan and if the best-interest and absolute-priority tests are met. To meet the best-interest test, each holder of a claim or interest must receive at least what would have been received under a Chapter 7 liquidation. Secured creditors must receive at least the value of the property that secures the claim. The absolute-priority test requires that no class of claims or interests junior to a nonaccepting impaired class may receive anything until the nonaccepting class has been fully compensated. Once these requirements are met, the court may confirm the plan over the dissent of one or more classes. Confirmation under these circumstances is known as *cramdown* and must be requested by the proponent of the plan.

One exception to the cramdown requirement involves the issuance of stock for new value. Although the Supreme Court's decision in *Bank of America v. 203 North LaSalle Street Partnership* failed to decide if there is a place for new value, it held that one of the following two conditions must exist for a plan to be confirmed:

1. The debtor must give up its exclusive right to propose a plan and give the creditors an opportunity to also propose a plan.
2. Any "new value" plan that is filed during the debtor's exclusivity period under Section 1121(b) of the Bankruptcy Code is not confirmable unless it provides for the equity in the reorganized debtor to be subject to the competing bidding process. This process is designed to serve as a test to determine if the plan proponents of the debtor are paying the highest value for the equity.

10.6.3 Effect of confirmation

Confirmation discharges the debtor from all prepetition debts except as provided in the plan, the confirmation order, and under Section 1141(d) of the Bankruptcy Code, nondischargeable debts. Confirmation is binding on the debtor, stockholders, and all creditors. Confirmation vests all the property of the estate in the debtor unless the plan or order provides otherwise. Section 1141(d) is amended by the 2005 Act to provide that the confirmation of a plan does not discharge a debtor, which is a corporation, from any debt incurred under false pretenses or by making false statements in writing or from a tax or customs duty with respect to which the debtor made a fraudulent return or willfully attempted, in any manner, to evade or defeat such tax or custom duty.

11. CHAPTER 12: ADJUSTMENT OF DEBTS OF A FAMILY FARMER OR FISHERMAN WITH REGULAR ANNUAL INCOME

11.1 Introduction

Chapter 12 was enacted by the Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986. It is modeled after the

Chapter 13 plan of reorganization but makes it easier for a family farmer to confirm a plan of reorganization.

Typically, family farmers in need of financial reorganization have too much debt to qualify as debtors under Chapter 13 and many find Chapter 11 complicated, time-consuming, expensive, and in many cases unworkable. Chapter 12 is designed to give family farmers facing bankruptcy a chance to reorganize their debts and keep their land. Under Chapter 12, secured creditors are prevented from lifting the stay (that is, foreclosing) due to lack of adequate protection, provided the debtor pays "reasonable rent customary in the community." Thus, a farmer whose land values have decreased will be able to shift much of the loss to secured lenders.

11.2 Eligibility

In addition to individuals, partnerships and corporations in which 50 percent or more of the equity is held by one family may qualify for Chapter 12. See section 7.0 of this chapter for the definition of *family farmer.* To qualify for Chapter 12, all the following criteria must be met:

1. Aggregate debts do not exceed $3.237 million.
2. At least 50 percent of the debt (excluding debt for the principal residence) arises out of a farming operation.
3. More than 50 percent of the gross income in the taxable year before filing, or in each of the second and third taxable years preceding the year of filing, was from farming.
4. Annual income is sufficiently stable and regular to permit payments under the plan.

11.3 Operation of the Farm; Appointment of a Trustee

Like Chapter 11, Chapter 12 allows the family farmer to maintain possession and operation of the farm. And like Chapter 13, a standing trustee is automatically appointed to oversee the operation, file reports and attend hearings, account for the debtor's property, examine creditor claims, investigate the debtor's conduct, and report any dishonesty, fraud, or misconduct. This dual system of control is unique to Chapters 12 and 13. As in Chapter 11, a debtor farmer in possession may be removed for cause.

11.4 Filing the Plan

Under Section 1222, the debtor must file a reorganization plan within 90 days of the order for relief. The plan must provide that the debtor turn over to the trustee all future income and earnings to the extent necessary to carry out the plan. Unless agreed otherwise, it must also provide that all Section 507 priorities (see section 16.5 of this chapter) are paid in deferred cash payments and it must treat each class of claims and interests equally. Although the payment period ordinarily may not extend over more than three years, the court may increase this to up to five years.

The Chapter 12 plan may provide for repayment of secured debts over a period that exceeds the length of the plan. In addition, payments in the plan only need to have a present value that is equal to the value of the secured creditor's collateral. Thus, for example, if a farmer bought property worth $1 million with a secured loan of $850,000, and the value of the land securing the loan decreased by 50 percent, the secured lender would have a secured claim of $500,000 and an unsecured claim of $350,000. Under Chapter 12, the farmer would be able to keep the farm by making payments only on the secured claim and could treat the balance as unsecured.

11.5 Creditor Protections

Chapter 12 creditors are afforded less "adequate protection" (see section 10.6.2 of this chapter) than are Chapter 11 creditors. Section 1205 requires that the debtor compensate a secured creditor seeking relief from the automatic stay (1) only for any decreases in the value of the collateral, either by making cash payments or by providing additional or replacement liens (for example, a lien on a crop), or (2) by paying the creditor for the continued use of the collateral with a "reasonable rent customary in the community," based on the debtor's annual income and earning ability. Thus, if a farmer's income is low and the farmland has decreased substantially in value, Chapter 12 could substantially reduce the farmer's interim obligation if the reasonable rent is less than the principal and interest in the mortgage.

It is also easier for Chapter 12 debtors to sell farmland and equipment outside the ordinary course of business, as long as the sale proceeds are subject to existing valid liens.

11.6 Approval of the Plan

The court is to hold a hearing on confirmation of the plan within 45 days of filing. The court may approve a plan over the objections of unsecured creditors if it offers the unsecured creditors at least what they would have received under Chapter 7, or if all disposable income of the farmer in the plan period is applied to plan payments. Disposable income means income that is not reasonably needed for support of the debtor's family or for expenditures necessary for the continued operation of the farming business.

11.7 Discharge

After all payments required under the plan are paid, Chapter 12 debtors can get a full discharge of their unsecured debts. The debtor can also get a hardship discharge if the debtor fails to make full payments under the plan and shows that (1) he or she is not responsible for the failure to make full payment, and (2) modification of the plan is not practical. This option is available only if unsecured creditors have received more than they would have received had the debtor liquidated under Chapter 7.

12. EXEMPTIONS

12.1 Introduction

Exemptions provide the main vehicle through which a debtor is given a fresh start after a bankruptcy. The exemption system protects certain property of the debtor both from inclusion in the debtor's estate for liquidation and from judicial liens and other security interests.

Although exemptions may apply to cases filed under Chapters 11 and 13, they are most significant in Chapter 7. Debtors in Chapters 11 and 13 usually propose their own debt adjustment and reorganization plans that control the disposition of their property. Further, exempt property under a Chapter 11 plan may not be disposed of without the debtor's permission.

12.2 Claiming Exemptions

A debtor must file a statement, specifying property claimed as exempt, on or before the creditors' meeting but in any case no later than 30 days after filing the petition. The statement is included on scheduled forms.

12.3 Federal vs. State Exemptions: Sometimes a Debtor's Choice

The individual debtor may choose either the federal exemptions provided in the Bankruptcy Code or the exemptions afforded in the debtor's state and under federal nonbankruptcy law. The choices are mutually exclusive.

If the debtor's state has "opted out" or prohibits debtors within that state from choosing the federal bankruptcy package, the debtor must claim the exemption provided by the state. To date, most states have opted out.[2] Section 522(b) requires a husband and wife to choose the same exemption system. If they fail to do so, they will be given the federal exemptions, unless their state has opted out.

If the debtor chooses the federal exemptions, the debtor will waive all nonbankruptcy federal exemptions and state exemptions. In addition, the debtor will lose any state protections of joint tenancies and tenancies in the entirety, such as a law against creditors' reaching such interests. If the debtor chooses the noncode (state) exemptions, the debtor may use both state and local law and any federal nonbankruptcy statute. The state or local law that applies is that of the place where the debtor has been domiciled for most of the 180 days immediately preceding the bankruptcy filing.

Section 522(b)(3) of the Bankruptcy Code as amended by the 2005 Act provides that an individual may exempt from his or her estate retirement funds that are tax exempt under Sections 401, 403, 408, 408A, 414, 457, and 501(a) of the Internal Revenue Code of 1986. For example, this general rule applies to most retirement funds, including 401(k)-type plans and individual retirement accounts. The aggregate value of individual retirement accounts exempted under this section shall not exceed $1,000,000. The cap does not apply to rollovers into these accounts. The Bankruptcy Court may also increase the cap if the interests of justice so require.

The U.S. Supreme Court held in *Patterson v. Shumate*[3] that retirement funds under the terms of ERISA are not part of an individual's bankruptcy estate. It was generally held that such benefits did not apply to individual retirement accounts unless they resulted from a rollover of retirement funds under ERISA. That position was changed in 2005

[2] States that have opted out are Alabama, Arizona, Arkansas, California (with some exceptions), Colorado, Delaware, Florida, Georgia, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Mississippi, Montana, Nebraska, Nevada, New Hampshire, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, South Carolina, South Dakota, Tennessee, Utah, Virginia, West Virginia, and Wyoming.

[3] 112 S. Ct. 2242 (1992).

when the Supreme Court held in *Rousey v. Jacoway*[4], before the enactment of the 2005 Act, that IRAs may be exempt from the estate. This decision is codified in the 2005 Act.

12.4 Federal Bankruptcy Exemptions

The federal bankruptcy exemption system is found in code Section 522. All property claimed as exempt must be property of the debtor's estate. Since the debtor's estate is defined very broadly—that is, as "all legal and equitable interests of the debtor"—it is unlikely that any claimed property would be outside the bankruptcy estate. A debtor who has chosen the code exemptions has the following exemptions available under Section 522(d).

12.4.1 The homestead exemption

Probably the best known is the homestead exemption. Specifically, the exemption protects a maximum of $18,450 in the homestead. *Homestead* is defined as real or personal property that the debtor or a dependent uses as a residence. However, many states have homestead exemptions in excess of the federal limits, and at least three states have no cap on the homestead exemption. The 2005 Act modified the homestead exemption rules, providing that debtors may elect the state exemption in which they lived 730 days before the filing of the petition. If debtors lived in more than one state during the 730 days, the debtor must use the state in which he or she lived the majority of time during the 180 days before the 730-day period. The 2005 Act places a cap of $125,000 on interest in a homestead that was acquired within 1,215 days before the filing of the petition. The calculation of the amount of interest that was acquired does not include any interest transferred from a debtor's prior residence acquired before the beginning of the 1,215-day period, provided the previous and current residence are located in the same state. The $125,000 exemption cap does not apply to a family farmer.

Additionally, to the extent that the homestead was obtained by a fraudulent conversion of nonexempt assets, during the 10-year period before the filing of the petition, the exemption is reduced by the amount of the fraud. For debtors that violated the securities laws or were engaged in other criminal activities, the cap is $125,000 regardless of the time period or the otherwise allowed homestead exemption.

12.4.2 The grubstake exemption

If the debtor has no homestead or simply prefers to do so, the debtor may apply the homestead exemption to the only unrestricted exemption

[4] 125 S. Ct. 1561 (2005).

available in the code. This exemption allows the debtor to exempt any interest in the property to a maximum of $925, plus up to half or $8,725 of any unused portion of the homestead exemption. This unrestricted $8,725 exemption is known as the grubstake exemption. This exemption allows the debtor greater flexibility in protecting his or her most cherished property because it covers any property without restriction.

12.4.3 Exemptions specific to specific property

All other exemptions under the code are restricted to particular property. Although a few are available without limitation, most are limited as to value, value and use, or need.

Properties exempt without limitation include:

— Professionally prescribed health aids for the debtor or a dependent.

— The right to receive Social Security, unemployment compensation, local public assistance, veterans and certain employment benefits.

— The right to receive the proceeds from property traceable to crime-victim awards.

— Any unmatured life insurance policy.

Exemptions limited by value include:

— Up to $2,950 interest in a motor vehicle.

— Up to $9,850 value in a life insurance policy.

— The right to receive up to $18,450 in a personal injury award or the property traceable therefrom.

Exemptions limited by value and use include:

— Personal, family, and household property up to $975 in any single item or an aggregate of $9,850.

— Tools of trade up to $1,850 of the debtor or a dependent.

Exemptions limited by need or to the extent that they are "reasonably necessary for the support of the debtor and dependents" include:

— The right to receive alimony or separate maintenance.

— The right to receive payment under certain stock bonus, pension, profit-sharing, and annuity plans.

— The right to receive pensions and other employment-related permanent benefits.

— The right to receive payment of or property traceable to wrongful death awards of a dependent.

— The right to receive payment of or property traceable to payment of life insurance proceeds.

— The right to receive payment of or property traceable to payment compensating for loss of future earnings.

12.4.4 The "right to receive" and "tracing property"

The "right to receive" language accompanying many exemptions is significant because the right to receive does not necessarily include the debtor's right to exempt payment itself.

The right to preserve "property traceable" or "tracing" is restricted under the code—only the exemptions under Section 522(d)(11) can be traced. Section 522(d)(11) protects the exemption as it changes form from a right to receive, to payment in the form of a check, to a bank deposit and cash proceeds.

12.5 Avoiding Liens on Exempt Property

Section 522(f) of the Bankruptcy Code provides the debtor and the trustee with two powers to avoid certain liens on exempt property. A debtor's exemption is thus protected notwithstanding a creditor's lien on the exempt property.

The first power allows the debtor to avoid a judicial lien that secures a debt for domestic support obligations. The avoidance of the lien, however, does not extinguish a valid security interest or statutory lien upon which the judicial lien is based.

The second power permits the debtor to avoid certain security interests in consumer goods, health aids, and tools of trade to the extent that the lien interferes with the exemption. Possessory and purchase-money security interests are specifically excluded from the power to avoid. The consumer-goods provision is limited to household furniture and goods including clothing, books, animals (pets may be retained) and crops, musical instruments, and jewelry. Section 522(f)(4)(A) defines the term *household goods.* Cars and other motor vehicles are notably absent, but a debtor may be able to protect them as a tool of the trade.

13. CONVERSION OF CASES

Conversion refers to the transfer of a case from one chapter of the code to another. A successful conversion creates an order for relief under the chapter to which the case is converted but otherwise does not usually change the commencement date of the case.

A debtor may convert an original Chapter 7 liquidation to Chapter 11, 12, or 13 at any time, as an absolute right. A creditor generally must establish cause to convert at a hearing. The rules are summarized below.

Conversion of Chapter 7 (Section 706)

— To Chapter 11: Debtor can so request without showing cause or a hearing.

— To Chapter 12: Only at the request of the debtor; debtor must meet Chapter 12 eligibility requirements.

— To Chapter 13: Only at the request of the debtor; debtor must meet Chapter 13 eligibility requirements.

Conversion of Chapter 11 (Section 1112)

— To Chapter 7: Debtor may transfer under certain circumstances; creditors must show cause.

— To Chapter 12: At the request of the debtor, if conversion is equitable and the debtor has not received a Chapter 11 discharge.

— To Chapter 13: Only at the debtor's request and only before discharge; debtor must meet Chapter 13 eligibility requirements.

Conversion of Chapter 12 (Section 1208)

— To Chapter 7: At any time at debtor's request, or by the court upon showing of fraud by the debtor.

— To Chapter 11 or 13: Code language provides that a case may be converted only if the debtor may be considered a debtor under those chapters. Recent case law indicates, however, that a Chapter 12 case may not be converted to Chapter 11 or 13 because there is no language under Chapter 12 that specifically allows for conversion to Chapter 11 or 13, or that a case may be converted only if done in good faith.

Conversion of Chapter 13 (Section 1307)

— To Chapter 7: At any time at debtor's request; creditors must show cause.

— To Chapter 11: At request of creditors, before confirmation of the plan and after a hearing for cause.

— To Chapter 12: At the request of the creditor or trustee before confirmation and after notice and hearing; if debtor is a farmer, only at debtor's request.

Double conversions—from an original chapter to another chapter and back again to the original—are allowed only under special circumstances.

14. DISMISSAL OF CASES

14.1 Chapter 7

Section 707 of the Bankruptcy Code provides that the court may dismiss a case only for cause after notice and hearing. Cause to dismiss includes:

— Unreasonable delay by the debtor that is prejudicial to creditors.

— Nonpayment of fees.

— A case involving primarily the consumer debts of an individual debtor when granting relief would be an abuse of Bankruptcy Code provisions. Section 707(b) provides that the court, on its own motion or on a motion by the U.S. Trustee, or any party in interest, may dismiss a case filed by an individual debtor under this chapter whose debts are primarily consumer debts, or, with the debtor's consent, convert such a case to a case under Chapter 11 or 13, if it finds that the granting of relief would be a substantial abuse of the provisions of this chapter.

It should be realized that Section 707(b)(7) precludes any party, including the bankruptcy judge or U. S. trustee, from bringing action for substantial abuse if the debtor and the debtor's spouse's annual income (determined by multiplying the average income for the last 6 months times 12) does not exceed the median state income.

In considering whether the granting of relief would be an abuse of the provisions of this chapter, the court shall presume abuse exists if the debtor's current monthly income (average of the previous six months) reduced by the deductions listed below and multiplied by 60 (number of months in five years) is not less than the lesser of:

a. Twenty-five percent of the debtor's nonpriority unsecured claims in the case, or $ 6,000, whichever is greater; or
b. $ 10,000.

If the debtor's current monthly income reduced by average monthly deduction listed here (difference) exceeds $166.66 ($10,000 divided by 60 months in a five-year time period), it will be presumed that abuse exists. If the difference is less than $100 ($6,000 divided by 60 months), the presumption of abuse does not exist . If the difference is between $100 and $166.66, abuse will exist if the difference is less than 25 percent of the debtor's nonpriority unsecured claims. For example, if the difference is $100, abuse would not exist if the unsecured debt is greater than $24,000 ($24,000 divided by $6,000 or 25 percent).

Deductions allowed include:

1. The debtor's monthly expenses as defined in Section 707(b)(2)(A)(ii), including deductions allowed as living expenses specified under IRS standards; actual expenses in categories not specified by the IRS; expenses paid by the debtor that are reasonable and necessary for care and support of an elderly, chronically ill, or disabled household member or member of the debtor's immediate family and who is unable to pay for such reasonable and necessary expenses; a Chapter 13 debtor's monthly expenses; the actual expenses for each dependent child less than 18 years of age (not to exceed $1,500 per year per child) to attend a private or public, elementary, or secondary school; and an allowance for housing and utilities.
2. The debtor's average monthly payments on account of secured debts divided by 60.
3. The debtor's expenses for payment of all priority claims (including priority child support and alimony claims) shall be calculated as the total amount of debts entitled to priority, divided by 60.

The presumption of abuse may only be rebutted by demonstrating special circumstances, such as a serious medical condition or a call or order to active duty in the Armed Forces, to the extent such special circumstances that justify additional expenses or adjustments of current monthly income for which there is no reasonable alternative.

The bankruptcy judge or U.S. Trustee can also assert abuse if it is determined the petition was filed in bad faith or the totality of the circumstances of the debtors financial situation demonstrate abuse.

14.2 Chapter 13

Section 1307 of the Code provides for dismissal for cause after notice and hearing when there is:

— Unreasonable delay by the debtors to the prejudice of creditors.

— Nonpayment of fees.

— Failure to file a timely plan.

— Denial of confirmation and denial of request for additional time to file another plan.

— Failure to start timely payments or material default by the debtor on a plan.
— Denial of confirmation of a modified plan and revocation of a confirmation order.
— Termination of a confirmed plan by a contingency other than completion of the plan.
— A debtor's request for dismissal if the request is before conversion to another chapter.

14.3 Chapter 11

Section 1112 of the Code provides for dismissal of a Chapter 11 case for cause and after notice and hearing. The court may dismiss if:

— The debtor's estate is of so little value that there is little likelihood of rehabilitation.
— Unreasonable delay by the debtor prejudices the creditors.
— There is a failure by the debtor or other parties to propose a timely plan.
— Confirmation of a proposed plan and request for additional time to present a modified or new plan are both denied.
— There is a revocation of a confirmation order or denial of a modified plan.
— There is an inability to carry out, or a material default on, a confirmation.
— There is inability to effect a plan.
— A plan is terminated by a condition specified in the plan.

14.4 Chapter 12

Section 1208 of the Bankruptcy Code provides for dismissal any time either at the request of the debtor (unless the case has been converted) or at the request of a party in interest for cause after notice and hearing when any of the following circumstances exist:

— Unreasonable delay, or gross mismanagement, by the debtor that is prejudicial to creditors
— Nonpayment of fees
— Failure to file in a timely manner a plan under Section 1221 of the Bankruptcy Code

— Failure to commence timely payments as required by a confirmed plan
— Denial of confirmation of a plan and denial of a request made for additional time in filing another plan or a modification of a plan
— Material default by the debtor with respect to a term of a confirmed plan
— Revocation of the order of confirmation of the plan and denial of confirmation of a modified plan
— Termination of a confirmed plan by reason of the occurrence of a condition specified in the plan
— Continuing loss to or diminution of the estate and absence of a reasonable likelihood of rehabilitation

15. TRANSFERS OF PROPERTY

15.1 Introduction

One goal of the Bankruptcy Code is to use the debtor's assets in a manner that treats creditors within a given class equally. Code provisions that allow a trustee to avoid certain transfers made before or after the petition is filed help to achieve this goal. The term *transfer* is used quite broadly. It includes giving a security interest, attaching a lien, bank deposits, an entry of judgment, sales, and gifts as well as monetary payments. When the trustee is able to avoid the transfer, the property returns to the debtor's estate. Transfers can be divided into two categories: prebankruptcy and postbankruptcy.

15.2 Prebankruptcy Transfers

Prebankruptcy transfers are transfers of property made before petition filing. There are five basic types: preferences, fraudulent conveyances, secret transfers, transfers avoidable under state law, and statutory liens.

15.2.1 Preferences

A *preference* under Section 547 is a prepetition transfer that favors an individual creditor or allows the creditor to get more than the creditor would otherwise get in a Chapter 7 liquidation case. The court may avoid the preference if, under Section 547(b), there is a transfer of the debtor's property:

— To a creditor.
— For a prior debt.
— Made within 90 days before the petition.
— While the debtor is insolvent.
— That allows the creditor to receive more than the creditor would otherwise have received under a Chapter 7 case if the transfer had not been made and the creditor had been paid for the debt to the extent provided under the code.

The trustee or debtor-in-possession has the burden of proving each element. Usually, the trustee will have little or no problem with the first four, because they are easily determined and objective.

The debtor's insolvency is a rebuttable presumption under Section 547(f) if the transfer was made within 90 days before the petition date. The transferee has the burden of rebutting this presumption. There is no requirement that the transfer be out of the ordinary or that the debt be past due. A regular payment on an installment loan may be a preference.

The last element is often difficult to determine. The question is whether the creditor received more by the transfer than the creditor would have received in a Chapter 7 liquidation.

If the trustee establishes all of the elements under Section 547(b), an avoidable preference has been established.

There are seven exceptions to the rule that avoids preferences:

— *Contemporaneous exchanges.* The key factor is that the parties intended the exchange to be simultaneous. A typical contemporaneous exchange occurs when a creditor extends new value to the debtor and the debtor for some reason cannot fully pay for the new value at the time of the transaction. If the debtor returned later the same day, for example, to sign a note or make full payment, the exchange would be contemporaneous and not a preference. Payment by check, unless dishonored, for new value given in exchange is considered a contemporaneous exchange. At some point, the passage of time before payment or security by collateral will make the exchange no longer contemporaneous.
— *Payments in the ordinary course.* The Bankruptcy Code excepts ordinary course of business transactions from the debtor-in-possession's avoidance powers. The transfer must be made in the ordinary course of business or according to ordinary terms. The primary intent of this exception is for the debtor to continue operating with as little interruption as possible, by not penalizing trade creditors who extended normal terms to the debtor during the 90 days before the date the debtor filed its petition.

— *Consumer debts.* Transfer of consumer goods with a value of less than $5,000.

— *Statutory liens.* Statutory liens that are valid under Section 545.

— *Inventory and receivables.* A continuing security interest in changing inventory or receivables is protected except when the creditor's position is improved to the prejudice of creditors holding unsecured claims during the 90 days before the petition. Any improvement in the value of inventory that occurs within 90 days of filing is suspect. For example, assume that 90 days before filing, inventory that is collateral for a debt of $25,000 has a value of $17,000. On the date of filing, the debt remains the same and the value of the inventory on hand at the petition date has increased to $21,000. This $4,000 increase in the inventory improves the position of the creditor whose claim it secures. To the extent that it reduces the value of the debtor's assets available to pay other unsecured creditor claims, it is a preference.

— *Purchase-money security interests.* Security interest granted in exchange for loans when the proceeds are used to finance specific property, provided such interest is perfected within 30 days after the debtor received possession of the property.

— *New value.* Cash payments on a running account if the creditor extends new unsecured credit after the payments are made. Payments are protected to the extent that the new credit is extended. For example, if the debtor owes a creditor $1,000 and pays $600, and the creditor then extends another $800, the $600 payment is protected. Had the creditor extended only $400 in new credit, only $400 of the $600 payments would not be considered a preference.

15.2.2 Fraudulent conveyances

Section 548 of the Bankruptcy Code allows the trustee to avoid transfers of the debtor's property or of obligations incurred by the debtor:

— Made with the actual intent to hinder, delay, or defraud the creditors. The debtor's insolvency need not be proved to avoid this type of transfer.

— Made to a general partner while the debtor was insolvent or from which the debtor became insolvent.

— For which the debtor received less than the reasonably equivalent value for the property and

- That was made while the debtor was insolvent or from which the debtor became insolvent; or

- From which the debtor was left with an unreasonably small amount of capital with which to operate a business; or
- When the debtor intended to incur debts that the debtor knew could not be paid when due.

Only transfers made within two years (one year for petitions filed before April 20, 2006) preceding the petition may be avoided under Section 548. Even though the potentially fraudulent transfer may have been made more than one year before bankruptcy, action may be taken in the Bankruptcy Court to recover the transfer under state law according to Section 544 of the Bankruptcy Code for, depending on state law, a period of up to six years. State laws are generally based on the Uniform Fraudulent Transfer Act (UFTA), Uniform Fraudulent Conveyance Act (UFCA), or statutory common law for states without the UFTA or UFCA.

15.2.3 Unrecorded transfers

An unrecorded transfer is a transfer of property that has not been made a matter of public record. The code requires parties to comply with the recording acts of their states. There are two situations in which the code requires compliance with the state recording acts:

1. Section 547(e) provides that an unrecorded or untimely recorded security interest may become a preference. The security interest, if it is not recorded within 30 days of the transfer, is deemed transferred when it is actually filed. Therefore, if a transfer protected by a security interest is made before the 90-day prefiling preference period but is recorded within 90 days (unless recorded within 30 days of the transfer) before the petition, it becomes a preference if the other requirements for a preference are met. The security interest is avoidable and the creditor is unsecured.
2. Section 548(d) of the Bankruptcy Code concerns the time when a transfer is made for the purpose of invalidating a fraudulent conveyance. Its purpose is to prevent a fraudulent conveyance from becoming good by reason of being kept secret for longer than the two-year time limit. Thus, a fraudulent conveyance (see section 15.2.2 of this chapter for transfers considered by the code to be fraudulent conveyances) made more than two years before filing, but not recorded until within two years of filing, is deemed transferred as of the date of recording and thus falls within the avoiding time limit under Section 548. Section 548 makes the date of recording or perfection the crucial factor, rather than the date of the actual transfer. If, on the date of recording or perfection, the financial condition of the debtor or the debtor's actions would have made

an *actual transfer* of the property on that date a fraudulent conveyance, the transfer becomes a fraudulent conveyance, regardless of whether it was so at the time of transfer. If recorded within two years before filing, the trustee can avoid it.

15.2.4 Transfers avoidable under state law

Section 544(a) grants the trustee the status and thus the avoiding power of a lien holder as of the commencement of the case. The trustee's powers are derivative and hypothetical, not requiring the existence of an actual creditor. The lien creditor's status in all but one state (Louisiana) derives from Article 9 of the Uniform Commercial Code. The hypothesized lien extends to any property that could be subject to a lien under the applicable state law.

Article 9 of the Uniform Commercial Code grants the lien creditor priority over unperfected security interests; any power of the lien holder to avoid transfers of property under this provision is thus granted to the trustee. The primary impact of this power is to allow the trustee to avoid the transfer of unperfected security interests in personal property. In addition, Section 544 allows the trustee to avoid a variety of unfiled, imperfectly filed, and incomplete transfers of interest.

A second provision under Section 544(a) grants the trustee the status of a bona fide purchaser of real estate. Thus, where a recording act exists and a grace period is inapplicable, the trustee may avoid transfers that are not recorded or perfected before the bankruptcy petition.

Section 544(b) allows a trustee to stand in the shoes of actual, as opposed to hypothetical, unsecured creditors who exist at the date of the petition and to avoid any transfers that are avoidable by them. This provision does not strip creditors of this state-created power but rather shifts it to the creditor's representative. The importance of this power, however, is severely limited because of the restricted rights of the unsecured creditor. These avoidance powers will thus have no impact on security interests perfected before the petition filing.

15.2.5 Statutory liens

A *statutory lien* is one that arises automatically by virtue of statute and is not based on contract or judicial action. Section 545 of the Bankruptcy Code allows the trustee to avoid certain statutory liens. In general, Section 545 provides that the trustee may avoid a statutory lien that (1) first becomes effective upon the insolvency or bankruptcy of the debtor, (2) is not perfected or unenforceable against an existing or hypothetical bona fide purchaser at the time of the commencement of the case, or (3) is for rent or for the seizure of property for nonpayment of rent.

15.3 Postpetition Transfers

The commencement of a case creates an estate in the debtor's property. Property acquired before the day of filing becomes part of the estate, while property acquired after commencement generally belongs to the debtor. During the tenure of an interim trustee, after commencement but before a permanent trustee is selected, the debtor usually has control of and possession of the estate assets. Any transfer made by the debtor during this period is subject to Section 549.

Section 549 protects certain transferees. The consideration received by the debtor from the transfer becomes part of the estate. A transfer is protected if the postpetition transfer was authorized by the court. Transfers after commencement of an involuntary case, but before the order for relief is entered, are valid to the extent of the value given to the debtor. Transfers of realty by the debtor after filing of a voluntary case and after an order for relief in involuntary cases are valid against a good-faith purchaser at a judicial sale in a county other than that in which the petition is filed. To be protected, the purchaser must also have properly recorded the transfer before a copy of the petition is filed in the county where the land is located.

Section 542(c) protects a third party, such as a bank, that transfers property after the petition is filed if the third party transferred in good faith without knowledge of the petition. In these cases, only the third party or transferor is protected, not the transferee.

15.4 Limitations on the Trustee's Avoiding Powers

Section 546 of the Bankruptcy Code places limitations on the trustee's avoiding powers under certain circumstances. Action to recover property must be brought within two years after the order for relief or, if a trustee is appointed in the second year, within one year after the trustee is appointed. Action must also be brought before the case is closed or dismissed.

Moreover, the trustee may not recover more than the property itself or the value of such property, and he or she cannot get anything further from a transferee who may be jointly liable.

Secured parties who perfect under state or other applicable law that allows the perfection to relate back to an earlier date are protected from the trustee's avoiding powers granted under Sections 544, 545, and 549. For example, a creditor with a mechanic's lien covering materials sold to the debtor that relates back to the time when the materials were first provided to the debtor would be good against the trustee.

A seller who has sold goods in the ordinary course of business to the debtor while the debtor was insolvent may retain those goods, if the goods were received by the debtor within 45 days before the petition was filed and the seller makes a written demand for such goods within 20 days after the bankruptcy petition was filed. The court, however, may deny reclamation to the seller if it grants the seller's claim priority status as an administrative expense under Section 503(b) of the code, or if it gives the seller a lien to secure the claim. Grain producers and U.S. fishermen are specifically given similar reclamation protections under Section 546(d).

The 2005 Act provides that any goods received by the debtor within 20 days before the commencement of the case is considered an administrative expense.

Section 546(e) bars the trustee from avoiding certain margin and settlement payments made in good faith and, before the commencement of the case, by or to a stock or commodity broker, a securities clearing agency, a financial institution, or a forward-contract merchant. Subsection (f) protects margin and settlement payments made by or to a repo participant in connection with a repurchase agreement in a similar manner.

16. CREDITORS' RIGHTS AND PROTECTIONS

16.1 Proof of Claims and Interests

A creditor may file a proof of claim and an equity security holder may file a proof of interest in a bankruptcy case under Chapters 7, 11, and 13 (Section 501). A claim generally refers to a creditor's right to receive a payment of money. The interest of an equity security holder is based on ownership of corporate stock or on a limited partnership.

In a Chapter 7 or 13 case, a creditor must file a proof of claim to receive a distribution from the estate. Filing of a claim in a Chapter 11 case may be optional, since the proof is deemed to be filed for any claim or interest that appears on the debtor's schedules and is not designated as disputed, contingent, or unliquidated; otherwise, a timely proof of claim or interest must be filed in a Chapter 11 case (Section 1111(a)). Of course, the better practice is for a creditor to file a claim whether or not the creditor is listed in the schedules.

If a creditor fails to file a timely claim, a co-obligor, debtor, or trustee may file a claim for the creditor. This right may be useful for the debtor if the creditor's claim is not dischargeable.

16.2 Requirements for Filing

A proof of claim (the requirements for filing a proof of claim are set out in Bankruptcy Rules 3001-3008) in a Chapter 7 or 13 case must be filed within 90 days of the first date set for the creditor's Section 341 meeting. The United States, a state or subdivision, and an infant or incompetent may be granted additional time by the court. Unsecured claims arising from a judgment may be filed within 30 days after a final judgment. Chapter 11 creditors, if they are required to file a claim, must file at a time set by the court.

A proof of claim must be in writing and in the required form. Supporting documents must also be filed if the claim is based on a writing (for example, contract, promissory note, or letter agreement) or security interest. A trustee is likely to object to a claim filed without supporting documents. The claim should indicate principal, interest, and service charges.

16.3 Objections to a Claim

A proof of claim comprises prima facie evidence of the amount and validity of the claim, which is deemed to be allowed unless another party in interest objects to the claim. To overcome the prima facie case, the objecting party must offer specific evidence establishing the basis of the objection. If the court determines that the evidence overcomes the prima facie case, the claimant must prove the validity of the claim by a preponderance of evidence.

An objection to a claim must be in writing and filed with the court. Upon receiving the objection, the court will ordinarily schedule a hearing on the objection. A copy of the objection and a notice of the hearing must be mailed or delivered to the claimant, debtor, and trustee at least 30 days before the date of the hearing. The objection hearing requires judicial resolution by the court.

16.4 Disallowance of Claims

Under Section 502(b) the following claims are disallowed:

- A claim that is unforceable against the debtor by reason of an agreement or applicable law
- A claim for unmatured interest
- An unsecured property-tax claim that exceeds the value of the property

- — A claim for prepetition services of an insider or attorney for the debtor that exceeds the reasonable value of the services
- — A claim for postpetition alimony, maintenance, and support
- — A claim for damage resulting from termination of a lease to the extent that the claim exceeds a formula provided in the code
- — A claim for damages resulting from termination of an employment contract to the extent that the claim exceeds a formula provided in the code
- — A claim that resulted from the reduction, due to late payment, of a credit available to the debtor in connection with an employment tax

Other restrictions on the allowance of claims concern claims by parties that hold assets of the estate or are transferees of avoidable transfers (Section 502(d)) and claims of parties that are co-obligors on debts of the debtor (Section 502(e)).

16.4.1 Reconsideration of disallowed claims

A disallowed claim may be reconsidered for cause and allowed according to the equity of the case. If a previously disallowed claim is later allowed, claimants in the same class who have been paid need not return the payments but will not be entitled to further payments until the holder of the newly allowed claim has received equivalent payment (Section 502(j)).

16.4.2 Estimating contingent and unliquidated claims

Contingent and unliquidated claims may be estimated and allowed if the fixing and liquidation of the claims would not delay unduly the administration of the case. Generally, the bankruptcy judge will estimate the value of the claim, and the court's estimation will not be overturned unless there is a clear abuse of discretion (Section 502(c)).

16.5 Priorities

Priorities are designed to assure payment of certain classes of claim before other classes are paid. Priorities are set by Congress, and the courts are not free to fashion priorities within any given class. Debts falling within each priority must be fully satisfied before debts in the next priority can begin to receive payment. Priorities are established in Section 507.

16.5.1 First priority

Allowed unsecured claims for domestic support obligations that, as of the date of the filing of the petition, are owed to or recoverable by a spouse, former spouse, or child of the debtor, or such child's parent, legal guardian, or responsible relative, without regard to whether the claim is filed by such person or is filed by a governmental unit on behalf of such person.

16.5.2 Second priority

Administrative expenses and fees are given second priority by Section 507(a)(2). Generally, administrative expenses include all the expenses necessary to administer the estate or conduct business incurred after the order for relief is granted. Salary and reimbursement for necessary expenses are allowed under this priority to an accountant who renders services after the commencement of the case to preserve the debtor's estate. Other expenses and fees include court fees and taxes incurred during the administration of the estate.

16.5.3 Third priority

Involuntary "gap" creditors with unsecured claims receive third priority under Section 507(a)(3). An involuntary gap creditor is one who has extended credit or sold goods or services to the debtor after the filing of an involuntary bankruptcy petition but before an order for relief is entered and a trustee is appointed. Creditors in this category include government units that have claims for tax liabilities incurred during the gap period. These gap claims must be unsecured.

16.5.4 Fourth priority

Fourth priority under Section 507(a)(4) is granted to individuals who have allowed unsecured claims for wages, salaries, and commissions earned within 90 days before the date of petition filing or as of the date the debtor ceased business, whichever is earlier. The maximum allowed on such a claim is $10,000 per individual. The term wage is quite broad and includes withheld income and Social Security taxes as well as vacation, severance, and sick-leave pay. Holders of wage claims who live in states that allow unavoidable liens on the debtor's assets for wages due may be granted super-priority status.

16.5.5 Fifth priority

Claims for contributions to employee benefit plans such as pensions or life and health insurance plans, arising from services rendered within

180 days before the date of petition filing or as of the date the debtor ceased business, whichever is earlier, are accorded fifth priority under Section 507(a)(5). The value of these claims must not exceed $10,000 times the number of employees covered, minus the amount paid in wages. Amounts that exceed this limit must be pro-rated between employees.

16.5.6 Sixth priority

Sixth priority under Section 507(a)(6) is granted to certain persons who produce and raise grain and who have allowed unsecured claims against a debtor who owns or operates a grain-storage facility. Commercial fishermen with claims against a debtor who is operating a fish-produce storage or processing facility are also included in the fifth priority. Claims in these two categories are limited to $4,925 per individual.

16.5.7 Seventh priority

An individual consumer who has made deposits for undelivered goods or services from the debtor is entitled to seventh priority under Section 507(a)(7). Claims in this category must have arisen in a consumer transaction and may not exceed $2,225 per person.

16.5.8 Eighth priority

Taxes are afforded eighth priority. The types of taxes due include income and gross receipts taxes; property taxes; employment and Social Security taxes; federal, state, and local excise taxes; and customs duties. Penalties related to tax claims are given priority only to the extent that the penalty is compensation for actual pecuniary loss. Priority taxes are covered under Section 507(a)(8) and are quite specific. That section should be examined for additional details.

16.6 Super-Priorities

Under certain circumstances the code provides "super-priority" status to some creditors. Claims that have super-priority status have priority over all the Section 507 priorities.

16.6.1 Super-priority to secured creditors

Under Section 507(b), a secured creditor has super-priority in a case in which the trustee (or the debtor in possession in a Chapter 11 case) has given the creditor inadequate protection of the creditor's interest.

The creditor is given an administrative expense claim under Section 503(b)(1)(A) that is superior to other claims in this class. Inadequate protection would result from a limitation in the value of the secured creditor's collateral because of an automatic stay under Section 362; from the use, sale, or lease of the collateral under Section 363; or from the granting of a lien under Section 364.

A trustee can provide adequate protection by:

— Making one or more cash payments to the creditor to the extent that the value of the creditor's collateral is diminished.

— Providing the creditor with an additional or replacement lien to the extent of the decrease in value of the creditor's collateral.

— Granting some other relief that serves to give the creditor the value of the diminution in value.

Super-priority status is given to the creditor to the extent that the three preceding provisions are inadequate. To be eligible for Section 507(b) benefits, the creditor must have made a timely request for adequate protection.

16.6.2 Super-priority when there is conversion

A second super-priority arises when a case is converted from Chapter 11 or 13 to Chapter 7. In this circumstance, the administrative expenses incurred in the Chapter 7 case have priority over the expenses incurred before conversion (Section 726(b)).

16.6.3 Debts incurred by a debtor-in-possession or trustee

A third super-priority arises from debts incurred by a trustee as authorized by the court when the trustee has failed in all other efforts to obtain unsecured credit (Section 364(c)(1)). In many Chapter 11 cases where debtor-in-possession financing is obtained, the lendor receives a super-priority over other administrative expense holders.

16.7 Involuntary Petitions

Nearly all bankruptcy cases are begun by debtors, but creditors may commence an involuntary case under Chapters 7 and 11. Involuntary petitions under Chapter 13 and against farmers and nonprofit corporations are prohibited. The governing code section is Section 303.

16.7.1 Filing an involuntary case

An involuntary case is commenced by filing a Chapter 7 or a Chapter 11 petition with the bankruptcy court. The petition must include all required supporting documents. Upon filing, a summons will be sent to the debtor. A hearing is then set to establish the propriety of the petition or the presence of both the requisite number and value of claims and the grounds for relief. A debtor must answer the petition, and there may be discovery and other prehearing activity. The time period between initial filing and resolution of the petition is referred to as the *involuntary gap period.*

16.7.2 Prerequisites of filing

The petition must be filed by at least three creditors if there are twelve or more creditors, and by at least one if there are fewer than twelve. Petitioners must also show that the debtor owes an aggregate of at least $12,300 in unsecured claims to be eligible to file an involuntary petition. Creditors who do not, by themselves, meet these requirements may also establish their claims after the petition has been filed. Holders of contingent claims—claims that will require payment only upon the occurrence of certain extrinsic events—are ineligible.

A claim may be eligible for relief under an involuntary petition but may not be included in the count of the requisite number of creditors. These claimants are the debtor's employees, insiders of the debtor, and recipients of avoidable transfers. A holder of more than one claim is counted only once.

16.7.3 Grounds for relief in an involuntary petition

Creditors must show one of two grounds for relief. The first is that the debtor is generally not paying debts as they become due. There is no precise number or value established to prove that a debtor is not paying debts. This determination is made on the facts of each case.

The second ground for relief is the fact that a custodian has been appointed or has already taken substantial control of the debtor's property within 120 days of the petition. Petitioning creditors may also be required by the court to post bond for expenses to the debtor if the petition is dismissed for cause. Cause usually requires evidence of bad faith, improper motive, or little chance of success on the petition.

16.7.4 Involuntary gap period

During the involuntary gap period the debtor is generally free to conduct his or her business or financial affairs. The court may, however, impose restrictions or limitations on the debtor if there is a fear that the debtor may fail to preserve estate assets. Debtors may also transfer property during the gap period for a debt, but the trustee may be able to avoid such transfers on prepetition debts.

16.7.5 Appointment of an interim trustee

An interim trustee may be appointed under Section 303 in Chapter 7 cases. To appoint an interim trustee in Chapter 11 cases, the requirements of Chapter 11 must be met (Section 1104). The interim trustee may be appointed only after notice to all parties in interest, and creditors requesting an interim trustee must post a bond to indemnify the debtor. Similarly, if the debtor wishes to remove an interim trustee, the debtor must post a bond sufficient to indemnify the state against waste and/or mismanagement during the gap period.

16.7.6 Resolving the involuntary petition

The involuntary petition will result in either an order for relief or dismissal. If an order for relief is granted, the case will proceed in the same manner as a voluntary case. If the case is dismissed, the court may award the debtor costs, attorneys' fees, and proximate and punitive damages when applicable. An involuntary petition may also be dismissed before a hearing determination in certain circumstances. These are usually the consent of all petitioning creditors or a sudden improvement in the financial condition of the debtor, making the petition pointless. A dismissal under these circumstances must be preceded by a notice to all creditors and a hearing.

17. INCOME TAX IMPLICATIONS

Transfers of property generally have certain income tax consequences. Taxable gains or losses are normally determined by computing the difference between the sale proceeds and the taxpayer's basis in the property conveyed.

Discharge or cancellation of indebtedness is also normally included in taxable gross income under Internal Revenue Code Section 108. This income is reported in the taxable year in which the debtor's obligation is canceled or discharged. Taxable income is not realized to the extent that payment of the debt would have given rise to a deduction (such as forgiveness of accrued interest in the case of a cash-basis taxpayer). The amount of debt discharge income is simply the difference between the debt reduction and the consideration paid to obtain that amount of reduction.

The Internal Revenue Code provides a number of special provisions applicable to transfers of property and cancellation of indebtedness activity conducted by insolvent and bankrupt taxpayers.

17.1 Bankruptcy

The Bankruptcy Tax Act of 1980 added Internal Revenue Code Section 1398, which states that, for individuals, a bankruptcy petition creates a new taxable entity. This separate taxable entity for federal income tax purposes is created in bankruptcy filings under Chapters 7 and 11 but not under Chapters 12 and 13. A separate tax entity is *not* created when a corporation or a partnership files for bankruptcy (IRC Section 1399).

These rules have the following consequences:

— In the case of a corporation under bankruptcy, any income or loss from transfers of property or debt discharge income should be reported on its regular income tax return.

— In the case of an individual, any income or loss from prepetition property transfers or prepetition debt writedowns should be reported on the debtor's individual income tax return. Any tax liability on this individual return cannot necessarily be eliminated by just a bankruptcy filing at a later date. If the tax is a priority tax and is not paid during the bankruptcy, it cannot be discharged.

— The filing of a Chapter 7 or 11 bankruptcy creates a separate taxable entity, and the estate consists of the property (except exempt property) belonging to the debtor before bankruptcy. Any transactions involving this estate property or debt while the bankruptcy is open should be reported on the bankrupt estate's fiduciary income tax return.

— Any tax liability created in the bankruptcy estate is an administrative expense of the estate. The tax obligation is not a debt of the debtor, but of the estate. Upon termination of the estate, any remaining tax liability that is unpaid because of insufficient assets does not revert to the debtor.

— Special tax provisions permit the debtor to elect to close the tax year upon commencement of the bankruptcy. This would necessitate filing two short-year returns during the calendar year in which the petition begins. The major advantage of this election is that it allows a debtor to use individual tax attributes on the initial short-year return. Without the election, any individual tax attributes (such as net operating loss carryovers) would flow to the fiduciary income tax return of the estate and would not be available to offset any of the debtor's taxable income during the year the debtor files bankruptcy. An exception would occur if a debtor's tax attributes exceeded the reportable income (including debt discharge income) in the tax return of the bankruptcy estate, in which case remaining unused attributes would be passed from the estate back to the debtor. The 2005 Act provides that tax issues related to state and local taxes are governed by the Internal Revenue Code of 1968. For example, the same principles that applied to the establishment of a separate estate for federal tax purposes also apply for state and local tax purposes.

17.2 Insolvency

Income or loss on the transfer of property by an insolvent taxpayer outside of bankruptcy is reported on the taxpayer's income tax return just as a solvent taxpayer would report the income or loss. However, income from the discharge or cancellation of debt is treated differently depending upon whether a taxpayer is solvent or insolvent.

Internal Revenue Code Section 108 provides the general rule that income from the discharge or cancellation of indebtedness is included in taxable gross income. If any one of the following situations exists, income from the discharge or cancellation of indebtedness can be excluded from income:

- The debtor is in bankruptcy under Title 11 of the United States Code.
- The debtor is insolvent. *Insolvency* is defined as the excess of liabilities over the fair market value of assets. To exclude income, the taxpayer must be insolvent before and after the discharge of indebtedness. To the extent that the taxpayer becomes solvent because of the discharge, the taxpayer will need to report the debt cancellation as taxable income. Exempt property can be excluded in determining the fair value of the assets. The exclusion of cancellation of indebtedness income causes certain tax attributes to be reduced. The tax attributes that need to be reduced include:
  - Net operating loss carryovers.
  - Credit carryovers.
  - Capital-loss carryovers.
  - Basis in the taxpayer's remaining assets (both depreciable and nondepreciable). However, the aggregate basis of the debtor's remaining assets cannot be reduced below the total amount of the taxpayer's remaining undischarged liabilities at the time of discharge.

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Employee Retirement and
Deferred Compensation Plans

EMPLOYEE RETIREMENT & DEFERRED COMPENSATION PLANS

See also CD Toolkit for updates, links and additional resources.

1. OVERVIEW OF RETIREMENT PLANNING

This chapter provides an overview of qualified and nonqualified retirement plans typically implemented by small and medium-sized employers. Throughout this chapter, there are many references to the Economic Growth and Tax Relief Reconciliation Act of 2001, otherwise known as EGTRRA. EGTRRA provided for substantial changes to many areas of pension law and brought about many opportunities for practitioners to assist clients in planning for retirement. EGTRRA was designed to enhance the attractiveness and cost/benefit for employers to adopt retirement plans, and many of the provisions may entice employers who had been opposed to maintaining a retirement plan to now set up plans.

The Pension Protection Act of 2006 further enhanced the attractiveness and cost/benefit for employers to adopt retirement plans. Besides adding several additional attractive provisions to those initially enacted by EGTRRA, the Pension Protection Act made all of the pension provisions of EGTRRA a permanent part of the Internal Revenue Code (the EGTRRA provisions had been scheduled to sunset on December 31, 2010).

Sections 1 to 6 are written to help the accountant review the steps taken to evaluate a client's need, implement a plan, and handle the normal year-end administration. Section 7 reviews the requirements for tax qualification of a plan and the basic Internal Revenue Service (IRS) and Department of Labor (DOL) annual reporting requirements. In Section 11, the material summarizes the general rules applicable to nonqualified deferred compensation plans. That material is intended to provide an overview by comparing the structure required for qualified plans to the requirements of a nonqualified plan.

On October 22, 2004, the American Jobs Creation Act (AJCA) was signed into law. As part of this legislation, new IRC Section 409A was enacted, dealing with the treatment of nonqualified deferred compensation plans. These new rules generally became effective on January 1, 2005, although the IRS has provided transitional guidance in IRS Notice 2005-1 (see section 11.5 for a detailed discussion of the new rules). The IRS has also issued regulatory guidance regarding IRC Section 409A.

The reader should note that this material is designed to serve as a practical guide on deferred compensation for use by accountants in dealing with a client's plan. As a result, defined-contribution plans are described in greater detail than defined-benefit plans. Special attention is given to the design and administrative considerations of the most popular defined-contribution plans (for example, profit-sharing, money-purchase pension, and employee stock ownership plans, and

401(k) cash or deferred arrangements). Unless otherwise noted, all references are to the Internal Revenue Code (IRC).

Qualified plans existed before the Employee Retirement Income Security Act (ERISA) of 1974, but ERISA altered the ways that plans are administered. ERISA required, for the first time, that plans be subject to minimum participation, vesting, and funding of any promised retirement benefits. ERISA required that plan assets be placed in a formal tax-qualified trust and also established new fiduciary standards for the management of the trust. ERISA and the IRC have been amended more than two dozen times since then to create the regulatory scheme currently controlling qualified pension and profit-sharing plans (see Appendix 1). These requirements are monitored by three governmental agencies: the IRS, the DOL, and the Pension Benefit Guaranty Corporation (PBGC). In addition, the Pension and Welfare Benefit Administration (PWBA), a division of the DOL, oversees the annual Form 5500 filing requirements for pension and welfare plans.

1.1 Qualified Versus Nonqualified Plans

The key difference between qualified and nonqualified plans, in terms of ERISA, is that qualified plans are funded (meaning that assets are deposited into an independent trust) and nonqualified plans generally are not. That distinction causes nonqualified plans to generally be limited to a "select group of management," while qualified plans must cover a broad group of employees. (Note that some nonqualified plans use a rabbi trust, which is not separate and apart from other corporate assets.)

Qualified pension and profit-sharing plans must adhere to the provisions of IRC Sec. 401(a) and must be funded through a trust operated in compliance with IRC Sec. 501. (Note that a few qualified plans use a custodial arrangement or are funded solely through annuities.) In general, a qualified plan must be established and maintained for the exclusive benefit of participants and must not discriminate in favor of highly compensated employees (HCEs). (See section 3.2.6 of this chapter.) If plans follow the rules of IRC Sec. 401(a), they are deemed to be qualified plans and entitled to the following tax benefits:

— Plan participants are not taxed on contributions accumulating for their benefit until these benefits are received as distributions.

— Investment earnings on the funds accumulated in the trust of a qualified plan are also not taxed until distributed as benefits.

— Most distributions are permitted to be rolled over to an IRA or other plan, and certain distributions are eligible for favorable income tax treatment.

— Employer contributions are currently deductible, while not being currently taxable to participants.

— Employee contributions under a 401(k) program are excluded from income subject to federal income taxes.

By contrast, nonqualified plans are not subject to any nondiscrimination rules. Nonqualified plans have different tax benefits. The first is that employer deductions are permitted only when the employee is taxed. Generally, employee benefits are not subject to income taxes until they are paid or made available. Vested benefits are subject to Federal Insurance Contribution Act (FICA) and certain other payroll taxes. The accumulations are typically held by the employer and benefits can be fully taxable to participants if they are subject to constructive receipt or they bestow an economic benefit on the participant.

Since nonqualified plans cannot be "funded" without becoming currently taxable to the employee, the accumulations are subject to risk of forfeiture if the employer goes bankrupt. These benefits have no ERISA protections and can be provided only to a selected group of management employees. Nonqualified plans can be less expensive to adopt and operate, and because they are intended to meet a growing need to provide special incentives to management, employers have wide latitudes in their design. Nonqualified plans typically involve a delay in the vesting of benefits until some future date and are often seen as golden handcuffs. Dramatic new rules affecting nonqualified plans were enacted by the AJCA, generally effective January 1, 2005. These new rules are discussed in detail in section 11.5.

2. CHOOSING A PLAN: KINDS OF QUALIFIED PLANS

Just where does the practitioner start in helping a client choose the best retirement plan? Probably the first step is to match the client's needs and objectives to the unique features of specific plan designs. This section compares and contrasts the most common kinds of qualified plans permitted under IRC Sec. 401(a) in an attempt to distinguish between plans and plan structures.

Basically, there are two distinct classes of qualified plans: individual account plans (defined-contribution plans) and defined-benefit pension plans. Defined-benefit plans are always pension plans—a kind of guaranteed benefits—and, as a result, require minimum funding. The required minimum annual contribution for a defined-benefit plan is determined by an actuary based upon the plan's benefit formula and reasonable actuarial assumptions. Defined-contribution plans can be either pensions (with required funding) or discretionary funded plans (profit-sharing plans). Under a defined-contribution plan, the annual contribution formula is defined in the plan document; hence its name. Typically, the annual contribution is a percentage of eligible pay (say, 10 percent of each participant's pay). Profit-sharing plans do not have contribution formulas, but instead have allocation formulas defined in the plan document (for example, the contribution is allocated pro-rata, based on the employees' pay).

2.1 Defined-Contribution Plans

A defined-contribution plan is another name for an individual account plan. These plans measure retirement benefits in terms of each participant's account balance. A participant's benefit, under a defined contribution plan, is the vested value (meaning, the percentage that is nonforfeitable) of his or her separate account. These accounts reflect annual changes from employer and/or employee contributions, net investment income, benefit payments, and any transfers in or out during the year. If the plan permits, the accounts may also receive reallocations of forfeited account balances of terminated participants.

Generally, the assets of all participant accounts are commingled within a single trust fund, rather than invested in separate accounts. However, a number of plans, such as 401(k) plans, let employees select the investment mix of the assets in their separate accounts; these are referred to as earmarked or self-directed accounts.

Note that although defined-contribution plans provide each participant with an annual statement of the lump-sum value of his or her account, these plans may require that participants or their beneficiaries first be offered a monthly annuity when benefits are paid. The amount of the annuity is determined based on the value of their account balance. If they waive that right to an annuity and, if married, their spouse agrees, the lump sum or another form of benefit can be paid. Because the annuity is based upon the benefit that the money in their account will purchase, another common form of defined-contribution plans is money-purchase plans.

These annuity provisions are part of the Retirement Equity Act of 1984, which created special benefits for the spouses of married participants and are applicable to all pension plans and many profit-sharing plans. In general, all pension plans (and some profit-sharing plans) require the participant and spouse to waive a right to a joint and survivor annuity before any other payment can be made. The requirements for distribution and any optional forms of benefits are specified in the plan document. Rules in IRS Notice 2002-3 specify that when a participant and spouse waive an annuity option, they be provided comparative examples showing the benefits they will be waiving. Following are common kinds of defined-contribution plans.

2.1.1 Profit-sharing plans

— Profit-sharing plans, including age-weighted allocation and cross-tested plans,

— 401(k) cash or deferred plans (before-tax employee contributions), and

— Thrift or savings plans (after-tax employee contributions).

Another type of defined contribution plan is a stock bonus plan that operates very much like a profit-sharing plan, except that distributions are typically made in employer stock.

2.1.2 Pension plans

— Money-purchase pension plans, generally providing for a level percentage of pay as a contribution

— Target benefit plans, a hybrid type of money-purchase pension plan that provides greater contributions for older participants

Retirement benefits available to be paid from an individual account plan depend upon the successful investment of the employer's and employee's contributions, with the participant bearing the risk of poor investment returns.

Employers have a great deal of flexibility in designing a defined-contribution plan: The funding can be made mandatory or discretionary; the contribution can be based on pay, tenure, or the participant's age; benefits can be paid as a lump sum (if profit sharing) or as an annuity; and the employees may be given the right to direct the investment of the plan's assets. However, for 2007, contributions per participant are generally limited to the lesser of 100 percent of eligible pay or $45,000 (see Appendix 2). Beginning in 2002, all defined-contribution plans became subject to a deduction limit of 25 percent of total eligible compensation, up from 15 percent of total eligible compensation in previous years. In addition, salary deferrals to a 401(k) plan are not included in this deduction limitation. Compensation of up to $225,000 (2007 amount) may be used in this computation.

Planning Tip:
The ability to receive a larger contribution amount and the exclusion of salary deferrals from the deduction limits have increased the ability

of small employers to fund larger amounts in 401(k) plans. Additionally, since sponsors of 401(k) plans can now deduct up to 25 percent of total eligible compensation plus all salary deferrals, 401(k) plans will be much more attractive for employers to establish.

2.2 Defined-Benefit Plans

A defined-benefit pension plan is any plan that is not a defined-contribution plan (IRC Sec. 414(j)). Defined-benefit plans promise a defined level of monthly benefits for participants when they reach their normal retirement age under the plan. The amount of annual contributions is based upon the amount required at retirement to pay for the promised benefit, as opposed to the defined annual contribution requirement of a money-purchase pension plan. An enrolled actuary must determine and certify the annual contribution of a defined-benefit pension plan.

Participants in a defined-benefit pension plan typically receive a benefit at retirement that is a percentage of pay multiplied by some years-of-service factor. For example, a plan could provide a monthly benefit at retirement age equal to 2 percent of pay for each year of participation capped at 25 or 30 years. Since benefits are defined as monthly benefits, distributions are normally paid as monthly annuities for the life of a participant. In the case of married participants, benefits are payable for the joint life expectancy of the participant and his or her spouse. Some defined-benefit pension plans permit a lump-sum payment as an optional form of benefit, if participants (and their spouses) waive in writing the right to an annuity. When annuities are distributed, commercial annuities are generally purchased and distributed, but some plans covering 500 or more employees may make the payments directly from the trust.

The plan's actuary identifies the minimum and maximum levels of annual funding by using one of the actuarial methods approved by the IRS. Funding varies, depending on the method used. While the Pension Funding Equity Act of 2004 provided temporary two-year relief for defined benefit plans impacted by low interest rates by replacing the 30-year Treasury bond rate used in actuarial computations with a four-year average of conservative long-term investment grade corporate bonds, the Pension Protection Act of 2006 extended these replacement interest rate provisions through plan years beginning before January 1, 2008 (IRC Sec. 412(b)(5)(B)). Also, the IRS issued guidance in Notice 2004-32 to identify the corporate bond indexes that can be used to establish the prescribed interest rate, while also publishing a monthly notice to identify the permissible range of rates. Ultimately, all methods are intended to provide for level funding over the working lifetime of the participants. Since most benefits under defined-benefit pension plans are guaranteed by a governmental agency, the Pension Benefit Guaranty Corporation (PBGC), minimum funding is required regardless of the employer's financial condition. Certain waivers of that funding are permitted if the employer can show that the missed funding can be properly contributed in the future. The PBGC provides insurance for employers that go bankrupt before funding all promised benefits. This protection is provided by PBGC premiums paid by the employer sponsoring a defined benefit pension, but ultimately the unfunded liability may fall on the federal government. (Note that this insurance is not available to the plans of small professional service corporations and plans covering only the owner of the business.)

Because of the desire to provide guaranteed benefits at retirement, defined-benefit pension plans had originally been the traditional medium for retirement planning. However, with the mandate for annual contributions and the increasing complexity of the rules governing these plans, small and medium-sized employers had all but abandoned them in favor of the less complex defined-contribution plans after the law changed in 1986. Now many small employers are again adopting a defined-benefit plan because of the favorable provisions of EGTRRA.

Defined-benefit pension plans for small professional service employers—those with fewer than 25 participants—and plans covering only family members are not covered by PBGC insurance. As a result, these plans do not pay the annual insurance fee and are not subject to the strict procedures for terminating a defined-benefit pension plan requiring DOL permission.

In contrast to defined-contribution plans, the risk of poor investment performance under a defined-benefit plan ultimately lies with the employer, who must provide sufficient funding to pay accrued benefits. If investment returns are poor, employers contribute more. The annual accrual of benefits in a defined-benefit plan tends to favor older employees. Defined-benefit plans provide less valuable benefits for younger employees. The resulting skewing of benefits to the older employee is one reason why many professionals nearing retirement adopt defined-benefit pension plans.

Many defined-benefit pension plans provide benefits based upon service before the adoption of the plan. These benefits, which favor the tenured employee, are called past service credits, and are normally funded over the remaining employment of the participant.

Defined-benefit plans are often identified as not fitting with our mobile society, because few employees remain with an employer long enough to accrue any valuable benefits. For large employers, these plans frequently provide the least amount of employer funding as a percentage of participants' pay compared with the funding in other plans.

2.2.1 Cash balance plans

A cash balance plan is a hybrid plan that contains attributes of both a defined-contribution and a defined-benefit plan. Contributions are typically made for each participant into a "hypothetical account" that is based on a percentage of current year compensation, and the benefit payable at retirement is based on the increasing value of that hypothetical account, the defined-contribution characteristics of the plan. The defined-benefit characteristics are derived from the way interest is credited on hypothetical accounts; it is a rate guaranteed in the plan document and not tied to the plan's actual investment yield. In addition, the value of the hypothetical account balance is provided to the participant at retirement as a lump-sum distribution or as an annuity based on certain conversion factors defined in the plan document. Thus, the accumulation phase of a cash balance plan looks very much like a defined-contribution plan to the employee, while providing a benefit through the interest rate credit and contribution guarantees. Almost 60 percent of the Fortune 100 companies have converted their traditional defined-benefit plans to cash balance plans or have implemented a new cash balance plan. In addition, a wide range of personal service entities with multiple owners now view these plans as a way to increase annual funding beyond the $45,000 defined-contribution limit for 2007. This is accomplished without the confusing methodology of calculating benefit accruals under a traditional defined-benefit plan that is often difficult to communicate to participants. These cash balance plans can also be used to supplement an employer's other defined-contribution plan.

The design of cash balance plans can take one of several approaches, allowing for an assortment of contribution formulas to the hypothetical account. Basically, these hypothetical allocations (1) must be based on a uniform hypothetical allocation formula (typically a designed-based safe harbor), or (2) must satisfy a modified general nondiscrimination test under Reg. 1.401(a)(4)-8(c)(3)(iii). See IRS Notice 96-8 for information on the design of safe-harbor cash balance plans. Proposed regulations under the Age Discrimination in Employment Act (ADEA) have established new requirements for the design of cash balance plans.

The IRS initially announced a suspension of the processing of determination letter applications by employers who wished to convert existing defined benefit plans to cash balance plans back in 1999. The IRS has now announced in Notice 2007-6 the lifting of the moratorium established in 1999 on determination letter applications for conversions from traditional defined benefit pension plans to cash balance plans. In Notice 2007-6, the IRS also invited comments on several safe harbor provisions for cash balance plans included in the Pension Protection Act of 2006.

2.2.1.1 Uniform hypothetical allocation

An allocation formula is treated under regulations as being a uniform hypothetical allocation if the hypothetical allocations satisfy the defined-contribution's safe harbors if made to a defined-contribution plan for those plan years. That is, the hypothetical allocations to a cash balance plan must be the same percentage of plan-year compensation or the same dollar amount each plan year. Such a plan may utilize many of the design features permitted for uniform formulas in a defined-contribution plan. These include the following:

1. The hypothetical allocation may be integrated with Social Security (though few are).
2. The plan can use dual entry dates and measure contributions on compensation earned after these dates.
3. The annual hypothetical allocation can be conditioned on the employees' employment on the last day of the plan year or employees having completed a minimum number of hours of service in the plan year (not to exceed 1,000).
4. The plan can limit contributions to the maximum defined-contribution dollar limit or percentage of compensation.
5. The allocation may provide for a dollar allocation per uniform unit of service [Reg. 1.401(a)(4)-8(c)(3)(iii)(B)].

Note that while many large corporations design their plans to satisfy the uniform allocations (or so-called safe harbor) to avoid annual testing, the plans adopted by the typical service entity and smaller employer tend to be designed to satisfy the requirements of general nondiscrimination testing (as modified for cash balance plans). With these non-safe-harbor plans, the benefit formula must provide for a hypothetical allocation that would satisfy Reg. 1.401(a)(4)-2(c). Nondiscrimination testing basically treats the hypothetical allocations as if the cash balance plan were a defined-contribution plan for the plan year, as long as certain interest crediting is met by the plan [Reg. 1.401(a)(4)-8(c)(3)(iii)(C)].

2.2.1.2 Crediting interest in the hypothetical account

The value of the benefit payable to a terminated participant is based in part on the interest credited to the hypothetical account each year. Some large company's cash balance plans even permit participants to elect asset allocation groups that set the crediting for that employee.

However, this design results in a benefit that can greatly exceed the hypothetical account and is not typically found in smaller plans. The plan must contain a crediting formula that is automatically adjusted at least annually and continues to normal retirement age [Reg. 1.401(a)(4)-8(c)(3)(iv)(A); IRS Notice 96-8].

However, these plans are defined-benefit plans and, as a result, the lump-sum value of the annuity payable at normal retirement age is based on the General Agreement on Tariffs and Trade (GATT) rates under IRC Sec. 417.

Selecting an interest rate for crediting of the hypothetical allocation that is above the current GATT rate to determine the projected value of retirement benefits can result in a "whipsaw" effect. For example, consider the effect of crediting the hypothetical account at 8.5 percent per year to produce a projected benefit over an assumed GATT rate of 6.26 percent. The former will provide a larger projected hypothetical account and, therefore, a larger annuity benefit. However, when the present value of that projected benefit is determined for purposes of making a distribution, the present value of the projected benefit is to be based on the GATT rate. When the crediting rate exceeds the GATT rate, the present value of the benefit will be more than the hypothetical account. This whipsaw produces a lump sum that is greater than the hypothetical account.

To avoid this problem, the IRS issued guidance that makes the hypothetical account the benefit, avoiding this whipsaw effect [IRS Notice 96-8]. This guidance also allows the allocations to the cash balance to be tested as a defined-contribution plan. Under this guidance, the hypothetical account is the benefit when the interest crediting under the plan document for all employees is any one of the following:

1. The rate on three-month Treasury bills
2. The rate on six-month Treasury bills
3. The rate on one-year Treasury bills
4. The yield on one-year Treasury constant maturities
5. The yield on two-year Treasury constant maturities
6. The yield on five-year Treasury constant maturities
7. The yield on 10-year Treasury constant maturities
8. The yield on 30-year Treasury constant maturities
9. The GATT rate under IRC Sec. 417(e) [Reg. 1.417(e)-1(d); IRS Notice 96-8]

The choice of which rate to use will be based on the sponsor's determination about which will produce the least volatility. And note that the participant's benefit is based solely on the hypothetical allocation and the interest crediting, and has no relation to the investment returns.

Investment gains and losses are amortized over five years; however, gains may trigger a full funding limitation.

A cash balance plan is a defined-benefit plan and, as a result, is subject to the benefit limitation of IRC Sec. 415(b) (dealing with defined-benefit plans) and not IRC Sec. 415(c) (dealing with defined-contribution plans). Note that with the repeal of IRC Sec. 415(e), an employer may sponsor both a defined-benefit and a defined-contribution plan that provides the maximum limits in both plans. However, where a single individual participates in both plans, the 25 percent-of-pay deduction limits of IRC Sec. 404(a)(7) apply.

A cash balance plan may provide, in addition to the annuity benefit, a lump sum option.

3. STATUTORY REQUIREMENTS FOR QUALIFIED PLANS

3.1 Qualification Requirements

To be qualified, a plan and trust must satisfy, in form and operation, the following requirements identified under IRC Sec. 401(a).

3.1.1 General rules

- The plan must be funded through a trust or equivalent entity created or organized in the United States. However, certain custodial arrangements as well as certain insurance/annuity only plans are permitted (IRC Sec. 401(a)).
- The plan must be in writing and communicated to employees (Reg. 1.401-1(a)(2)). This requires that the written plan be amended to reflect changes in tax law to maintain that qualification.
- The plan must be intended as a permanent program (Reg. 1.401-1(b)(2)). A rule of thumb is that a plan is considered permanent once it has been in existence for at least three years. The IRS generally disregards sudden terminations caused by the employer's financial problems as evidence that the plan was not permanent.
- The plan and trust must be adopted in writing before the end of the first plan year (Reg. 1.401-1(a)(2) and ERISA Secs. 402 and 403). Note that only simplified employer pension (SEP) plans may be adopted after the end of the tax year. SEP plans are discussed in Section 8.

— The plan must be a stock bonus, pension, or profit-sharing plan established and maintained by an employer for the exclusive benefit of its employees or their beneficiaries. Frozen plans (plans that have been terminated but still hold plan assets) generally are permitted under certain limited conditions (IRC Sec. 401(a)).

— Plan assets must not be used for or diverted to purposes other than the exclusive benefit of employees and their beneficiaries before the satisfaction of all liabilities with respect to employees and their beneficiaries. Reversions of any part of the trust assets to the employer are severely limited (IRC Sec. 401(a)(2) and ERISA Sec. 401(a)).

— Contributions, benefits, or any rights under the plan must not discriminate in favor of officers, shareholders, or HCEs (IRC Secs. 401(a)(4) and (5) and 414(q)).

— In the case of a plan's merger, consolidation with, or transfer of assets or liabilities to another plan, each participant must be entitled to receive, immediately after the transaction, no less than he or she would have received immediately before the transaction if the plan had then terminated (IRC Sec. 401(a)(12)).

— Death benefits payable to a participant's beneficiary, which are in addition to the vested benefits and from insurance benefits, must be incidental to the primary purpose of providing retirement benefits. Generally, not more than 50 percent of a participant's contribution can be used to purchase whole life insurance, nor more than 25 percent for term insurance or other forms of insurance.

— Plan benefits cannot be assigned or alienated, with certain minor exceptions. For example, benefits payable pursuant to a qualified domestic relations order (QDRO) that is part of a marital separation are permissible assignments (IRC Secs. 401(a)(13) and 414(p)).

— A defined-benefit pension plan document must specify the actuarial assumptions used for determining alternate forms of benefits in a way that precludes employer discretion (IRC Sec. 401(a)(25)).

3.1.2 Operational rules

— The participants must satisfy certain minimum participation requirements for entry into the plan. Generally, the limits cannot exceed one year of service and cannot specify a minimum age of more than age 21 (IRC Secs. 401(a)(3) and 410).

— The plan must satisfy certain minimum vesting requirements. Full vesting is required after seven years if vesting starts at 20 percent in year three (IRC Secs. 401(a)(7) and 411) for all employer contributions other than employer matching contributions as defined in IRC Sec. 401(m)(4)(A). A maximum six-year schedule, with 20 percent vesting in year two, is required for matching contribution accounts in plan years beginning after December 31, 2001.

— If the plan is top-heavy, it must provide minimum benefits or contributions and have full vesting at three years or follow the six-year vesting schedule applicable to matching contributions (IRC Secs. 401(a)(10) and 416).

— If the plan is a defined-benefit pension plan, forfeitures cannot be used to increase benefits and must instead be used to reduce future employer contributions or plan administrative expenses (IRC Sec. 401(a)(8)).

— The plan must satisfy certain minimum distribution requirements. This generally requires that payments begin by April 1, following the year when a participant turns age 70½ and within five years after the date of death (IRC Sec. 401(a)(9)). Individuals who are not 5 percent owners can delay the commencement of plan benefits until they cease to be employed by the company providing the benefits if the plan is drafted to provide that delayed payout option.

— Defined-benefit pension plans, defined-contribution pension plans, and certain profit-sharing plans (those that elect) must distribute benefits in the form of an annuity. For married participants, the annuity must be paid as a joint and survivor annuity based upon the lives of the participant and spouse.

A plan subject to the annuity requirement may permit the married participant to elect an optional form of benefit and an alternate beneficiary with the written consent of the spouse. Profit-sharing plans may pay benefits in a nonannuity form (for example, lump sum or periodic); however, death benefits must be paid to the surviving spouse (IRC Secs. 401(a)(11) and 417). (Note that many profit-sharing plans are drafted with the joint-and-survivor annuity requirement.)

— Benefits must commence, unless the participant elects otherwise, within 60 days after the later of

- The earlier of the participant's 65th birthday or the normal retirement age under the plan
- Ten years of participation
- The participant's termination of employment (IRC Sec. 401(a)(14))

— Benefits must not be reduced because of changes in Social Security benefits or the Social Security wage base after a participant starts receiving benefits or has separated from service (IRC Sec. 401(l)).

— The plan may not provide benefits or contributions that exceed the following annual limits for 2007:

- For defined-contribution plans, annual contributions (and other annual additions) to all employees cannot exceed the lesser of $45,000 or 100 percent of pay (IRC Sec. 415(c)).
- For defined-benefit pension plans, annual benefits at Social Security retirement age cannot exceed the smaller of $180,000 or 100 percent of the participant's average compensation for the highest three years (IRC Sec. 415(b)(1)(A)) (see Appendix 2).

— The plan may not provide for forfeitures of benefits that have become vested (IRC Secs. 401(a)(19) and 411).

— The plan cannot force an employee to take a lump-sum distribution before retirement age unless the value of the benefit is $5,000 or less (IRC Sec. 411(a)(11)).

— A fiduciary must discharge his or her duties with respect to the plan solely in the interest of the participants and beneficiaries (ERISA Sec. 401).

— The Pension Protection Act of 2006 expanded the list of exemptions to prohibited transactions by allowing investment advice to be provided to participants through an eligible investment advice arrangement, where such advice is given to participants and beneficiaries of a defined contribution plan who direct the investment of their accounts under the plan, along with beneficiaries of IRAs. This expansion allows investment advice to be provided, along with the sale of a security or other investment transactions pursuant to the advice, and the direct or indirect receipt of fees or other compensation in connection with providing the advice or the investment transaction pursuant to the advice. The additional exemption is effective for investment advice provided after December 31, 2006 (IRC Sec. 4975(d)(17)).

— An annual report must be filed (Form 5500 Series) and participants must be provided with information disclosing the plan's financial transactions and their account balances (ERISA Sec. 101). The participant disclosure requirement is met by the annual distribution of a participant statement and a Summary Annual Report.

The preceding rules generally apply to business and professional entities of all sizes. Plans covering collective bargaining units and governmental units may have special rules or exemptions that will not be covered in this material, except where noted.

3.2 Eligibility to Participate

Plans for small and medium-sized employers generally cover all full-time employees. Nevertheless, a plan may exclude certain employees as long as the plan's coverage can satisfy certain nondiscrimination rules. The coverage provisions are identified in the plan document and must adhere to the statutory requirements for minimum participation. In the past, few, if any, participants of small plans have been excluded from participation. However, because of the rising cost of plans, some small employers are now excluding groups of employees. To be nondiscriminatory, the covered group must meet three separate tests, as discussed later. Larger entities may also choose to maintain separate plans for separate lines of business under the separate lines of business (SLOB) rules (IRC Sec. 414(r)). A plan document may permit a covered employee to begin participation on his or her date of hire; however, most plans restrict an employee's eligibility to enter the plan until completion of a period of service and attainment of a minimum age. Eligibility restrictions generally fall into two general categories: statutory exclusions, which refer to age and service, and certain nonstatutory workforce exclusions, which generally require testing to demonstrate nondiscrimination in favor of the HCEs.

3.2.1 Age and service requirements

As a general rule, a plan must permit employees meeting its age and service requirements to enter the plan within six months of meeting that requirement. (IRC Sec. 410(a)(4)). The minimum age and service limits under the Code are as follows.

— An employee under age 21 can be excluded.

— An employee who has completed less than one year of service can be excluded; see exception to this one-year rule below. Service is generally based on a 12-month period in which the participant is credited with at least 1,000 hours of service.

Entry into the plan may be delayed until the entry date (see section 3.2.3) stated in the plan document following the completion of the age and service requirements (IRC Sec. 410(a)).

If the plan provides employees with full vesting after entering the plan, the service requirement may be extended to two years. (This is not permitted for 401(k) plans.) A plan may no longer exclude participants hired after a specific age (IRC Sec. 401(a)(1)). As a general rule, all service with the employer is counted when determining plan eligibility. Some plans shift the 12-month period to credit eligibility to the first plan year beginning after the employee's date of hire, but plans with a two-year service requirement generally would not typically shift the eligibility computation period to the next plan year.

In measuring the eligibility service period, a plan document may be written to exclude the following:

— A 12-month period commencing with the date of hire in which an employee works fewer than 1,000 hours.

— Certain years before a break in service in the case of employees rehired after the break. Breaks in service are generally defined in a plan as 12-month periods in which a participant is credited with 500 hours or fewer (IRC Sec. 401(a)(5)). This exclusion is permitted only if the employee were never vested in the plan.

Large plans frequently utilize an elapsed time method of determining eligibility service. Under the elapsed time method, an employee is not required to work any minimum hours of service, but merely to be employed over a specified period of time. For example, under an elapsed time counting method, employees are credited with a year of service if they only work one hour a week for 12 months (DOL Regulation 2530.200(b)).

Years of service for other purposes, vesting, and determining eligibility to receive contributions are frequently based on the plan year. However, some plans are drafted with different 12-month periods and different hour requirements. These will tend to make administration more difficult and probably more costly. There are special rules under DOL Regulation 2530.200(b) that specify how to count hours of service for employees for whom hours of employment are not maintained (for example, full- or part-time salaried employees). These regulations are generally cited in the plan document, giving employees who do not report on the number of hours worked each day a standard number of hours, for example, 190 hours of service for any month in which they work one hour.

3.2.2 Workforce requirements

IRC Sec. 410(b) provides the general rules for accruing a benefit or receiving an allocation in the plan year. In general, a plan must cover (provide benefits for) a nondiscriminatory grouping of participants. For purposes of determining whether a plan meets this rule, employees not meeting the statutory service (one year) and age requirements (age 21) or other statutory exclusions may be omitted in this discrimination testing. These rules are discussed in Section 3.2.4 of this chapter. Restrictions other than those on age and service may be permitted if the general nondiscrimination rules are not violated. Typical workforce restrictions may include the following:

— *Job classification*—However, a plan cannot exclude part-time employees as a class. Certain union groups may be excluded.
— *Required contributions*—A pension plan may exclude from participation anyone not making a required after-tax contribution.
— *Location of employment*—One group of employees at a specific location could be excluded.

For example, an employer may choose to cover only salaried employees, or only employees classified as salespeople. These and other classifications can be acceptable if they have a business purpose and do not operate so they discriminate in favor of individuals determined to be HCEs under IRC Sec. 414(q) (see section 3.2.5).

3.2.3 Entry dates

Employees satisfying a plan's age and service requirements must enter the plan no later than six months after satisfying these requirements, but in no event later than the first day of the next plan year (IRC Sec. 410(a)(4)). Although entry can be deferred for as long as six months after satisfying the requirements for one year of service and age 21, participation can occur at the date of hire. Any date between the date of hire and the last day permitted by law is acceptable. However, for ease of administration, most small plans generally provide for entry on semiannual dates based on the first day of the plan and the first day of the seventh month following the completion of one year of service (with 1,000 hours) and attaining age 21.

The following are three basic minimum requirements for plan coverage:

1. The age and service requirement, previously discussed (IRC Sec. 410)
2. The 40 percent, two-employee test (only for defined-benefit plans) (IRC Sec. 401(a)(26))
3. The nondiscriminatory coverage—who is eligible for contribution allocation or accrues a benefit after entering the plan (IRC Sec. 401(a)(4))

3.2.4 Minimum participation—IRC Sec. 401(a)(26)

IRC Sec. 401(a)(26) requires that each defined-benefit pension plan of an aggregated employer group (for example, a controlled group) must cover the lesser of 50 employees or 40 percent of all employees.

This requirement cannot be met by considering two plans as one. If there are only two employees meeting the statutory age and service requirements, both must be covered. Employees not meeting the statutory age and service requirements that are excluded from participation can be excluded from this participation threshold. All related employers must be aggregated when determining minimum participation. This aggregation includes affiliated service groups (IRC Secs. 414(m), (n), (o), and (p)), and controlled groups (Sec. 414(b)). Note that plans not benefiting any HCEs are exempt from this requirement.

The rules affect any business with two separate operating units under common control (for example, IBM could not set up a defined-benefit pension plan covering 45 employees if one was an HCE). Violations of this rule result in the taxation of the HCE for all vested and funded benefits. If this is the only requirement that cannot be met, the plan generally will not be considered disqualified; however, all vested benefits of the HCEs will be immediately taxed.

3.2.5 Minimum coverage

Probably one of the most significant changes after the Tax Reform Act of 1986 (TRA 1986) was the rewriting of the nondiscrimination requirements. The prohibited group was defined in new IRC Sec. 414(q) as HCEs. Other employees are non-highly-compensated employees (NHCEs). (See section 3.2.6 for a definition of the highly compensated.) Before the legislation, two separate sets of nondiscrimination rules applied, one for minimum coverage (under IRC Sec. 410(b)) and a second for nondiscrimination of benefits and contributions (under IRC Sec. 401(a)(4)). TRA 1986 formulated a new participation requirement that, in part, was determined on the basis of the amount of contributions made or benefits accrued. Thus, the requirements for eligibility and benefit coverage were linked in a single, uniform set of rules. TRA 1986 also identified for the first time who made up the prohibited group (the HCEs).

Employee coverage and benefits are linked under IRC Secs. 401(a)(4) and 410(b). This linkage is accomplished by requiring that a plan not discriminate in favor of HCEs (see section 3.2.6, herein) in either coverage eligibility or the amount of benefits or contributions (or both) that are provided. To demonstrate that a plan does not discriminate regarding benefits or contributions, in either form or operation, the following three general nondiscrimination requirements must be satisfied:

1. The plan does not discriminate in favor of the HCEs in the amount of contribution or benefits, and any plan can be tested under a benefits test or a contribution test.

2. Every option, subsidy, or other right or feature under the plan is available on a nondiscriminatory basis.
3. Plan amendments or terminations do not significantly discriminate in favor of the HCEs.

3.2.5.1 Safe-harbor formulas

While these rules are somewhat difficult to apply, the following provides an overview.

— *Safe-harbor formulas.* When a plan satisfies the minimum coverage requirements of IRC Sec. 410(b) it will not need to be tested for prohibited nondiscrimination if the benefit or contribution formula satisfies the safe-harbor design provisions of the regulations under IRC Sec. 401(a)(4).

— *Testing under the general tests.* Plans that do not have a safe-harbor formula will need to be tested under the general nondiscrimination tests of IRC Sec. 401(a)(4). To demonstrate that benefits or contributions do not discriminate in favor of the HCEs, a non-safe-harbor plan must satisfy the three following requirements.
  1. It must meet one of two minimum coverage tests: the ratio percentage test or the average benefit percentage test.
  2. Each level of benefit (or contribution) available to an HCE is available to a group of NHCEs that satisfies IRC Sec. 410(b), and the plan satisfies the average benefit percentage tests.
  3. It must show that benefits, rights, and features under the plan do not discriminate in favor of the HCE employees.

The Pension Protection Act of 2006 added a provision allowing 401(k) plans to provide for an automatic enrollment arrangement for employees, resulting in the plan being treated as meeting the ADP test with respect to elective deferrals and the ACP test with respect to matching contributions, effective for taxable years beginning after December 31, 2007. In addition to the automatic enrollment feature, the plan must also provide for automatic deferral percentages, matching or nonelective contributions (similar to the way such contributions are required under safe-harbor formulas), withdrawal and vesting requirements, and required notice to employees. 401(k) plans consisting exclusively of contributions made pursuant to a qualified automatic enrollment feature are also not subject to the top-heavy rules.

Planning Tip:

Employers should compare the existing safe-harbor formulas to the new automatic enrollment alternative that becomes available starting in 2008. Each alternative has its own requirements and unique provisions, but the ability to avoid the ADP and ACP testing with the new automatic enrollment plans, while also avoiding the top-heavy rules, appears to be quite attractive.

3.2.5.2 Ratio percentage test (general test)

The ratio percentage test is sometimes called the 70 percent test. If the plan's coverage passes this test and the plan document incorporates a safe-harbor formula, no further testing is required and the plan will be deemed to be not discriminatory. If the plan does not meet this test or does not use a safe harbor, it requires more elaborate testing under the average benefits test (also called the general test).

The ratio percentage test compares the percentage of NHCEs eligible for and receiving benefits to the percentage of HCEs eligible for and receiving benefits. If this ratio is 70 percent or more, the plan passes the 70 percent benefit coverage test (Prop. Regs. 1.410(b)-2 and 4).

In the following example, the plan document provides that certain employees do not participate because they work for an excluded division of the company and all employees receive the same percentage of pay as a contribution (a safe-harbor formula):

	*Eligible for Plan**	*Participating***	*Percentage*
HCEs	10	5	50%
NHCEs	100	36	36%

$$\frac{\text{Percentage of NHCEs participating}}{\text{Percentage of HCEs participating}} = \frac{36\%}{50\%} = 72\%$$

*Employees meeting the age, service, and other statutory provisions of the Code are included in this testing even if not eligible for plan benefits.

**Some employees do not participate because they work for a division or employee group that the plan document excludes.

This coverage is nondiscriminatory because it meets the 70 percent test. If one more NHCE were excluded, it would not pass.

— *Other limitations.* Certain employees are excluded from these percentage calculations. Statutory exclusions include employees not meeting the plan's minimum age or service requirement, nonresident aliens, and certain employees covered under a collective bargaining agreement. Special, but limited, rules are available for testing employers operating with distinct and separate lines of business (Reg. 1.410(b)-6(g)).

— *Terminated employees.* Terminated participants with more than 500 hours of credited service are not excluded from ratio percentage testing for years after 1989. Thus, a plan covering only one HCE and three NHCEs, one of whom was excluded under the terms of the document solely due to the fact that he or she did not work the required 1,000 hours of service (assuming that the employee worked over 500 hours), would not pass the 70 percent benefit test. The percentage of NHCEs participating would be 66.6 percent. Rev. Proc. 93-42 permits an employer to test for nondiscrimination on any day of the year. Under this "snapshot testing," the test is made on the basis of employees actually working on that day. Some practitioners hold that this snapshot testing on the last day of the year does not apply to small plans. In fact, the IRS holds that the selected day must represent typical plan coverage during the entire year (Reg. 1.410(b)-6(f)).

3.2.5.3 Average benefit percentage test

Plans failing the ratio percentage test must meet the two testing components of the average benefit percentage (ABP) test. In general, the ABP tests the amount of benefits or contributions that are "earned annually" by each eligible participant. It requires that—

1. The plan meet a nondiscriminatory classifications test regarding plan coverage (Reg. 1.410(b)-4).
2. The plan satisfy that the average benefit for the NHCEs be 70 percent of the average benefit for the HCEs and the ABP test (Reg. 1.401(a)(4)-2, 3). Note that all benefits or contributions under all plans of the employer are tested under this component.

The nondiscriminatory classification component requires that the eligibility criteria be both reasonable and nondiscriminatory. Any classification must be based upon objective business criteria that identify the category of employees who benefit under the plan (Reg. 1.410(b)-4). Then, the plan must demonstrate that the percentage of NHCEs benefiting under the plan divided by the percentage of HCEs benefiting under the plan must be at least equal to the safe harbor percentage of Reg. 1.410(b)-4.

The mechanics of the ABP test can be demonstrated by the following example of a defined-contribution plan covering two groups of employees, some of whom do not receive an allocation of a contribution—for example, a plan covering employees in two states. This example shows all eligible participants.

Allocation in Current Year

		Employees Receiving 5 Percent of Pay	*Employees Receiving 0 Percent of Pay*
Group A	HCEs	1	
	NHCEs	5	
Group B	HCEs		2
	NHCEs		20

Only one group of employees is benefiting

	Employees Benefiting: Receiving at Least 5 Percent of Pay
HCEs	1 (1/3 = 33.3%)
NHCEs	5 (5/25 = 20%)

Total eligible in all plans: 28

This group satisfies the mandatory classification thresholds if the percentage of NHCEs participating in the rate group is at least 50 percent of the percentage of HCEs participating in the rate group. The regulations also permit a lower percentage threshold that is based on the workforce concentration of NHCEs.

Percentage Benefiting:

$$\frac{\text{Percentage of NHCEs}}{\text{Percentage of HCEs}} = \frac{20\%}{33.3\%} = .60, \text{ pass}$$

The plan must also satisfy the 70 percent average benefit percentage test. One HCE receives 5 percent; two have no benefit. The HCE average benefit is 1.67 percent. Five NHCEs receive 5 percent; 20 have no benefit. The NHCE average benefit is 1 percent. The average for the NHCEs divided by the average for the HCEs is 1 percent divided by 1.67 percent, or 60 percent. This plan does not satisfy the 70 percent average benefits percentage test. It could pass if the contribution for the NHCEs was raised to 6 percent for the five NHCEs.

Note: The concentration percentage is 25/28, or 89 percent (the number of NHCEs divided by the total number of those receiving a contribution). According to a table found in Reg. 1.410(b)-4(c)(4), the midpoint of the safe-harbor/unsafe-harbor levels is 24.12 percent. The plan in this example passes because each of the contribution levels (2 percent of pay and 5 percent of pay) produced testing rates that are above the 24.12 percent associated, in the table, with a concentration percentage of 89 percent.

The regulations provide specific rules for aggregating plans, excluding certain categories of employees and adjusting for Social Security integration. Specific exclusions are provided for certain types of plans that are tested under separate and distinct tests—disaggregation.

3.2.5.4 Nondiscrimination testing

After a plan demonstrates that it satisfies the minimum coverage requirements of IRC Sec. 410(b), it must either have a safe-harbor formula or satisfy the rate group testing of IRC Sec. 401(a)(4). This testing basically allows the employer to test on either a benefits or contribution basis. A rate group is established by each level of benefit (or contribution) available to an HCE. Thus, each participant is assigned to one or more rate group, based upon contribution allocations or benefit accruals, as a percentage of current-year pay. Next, the employee groups are restructured to identify varying levels of participation at each rate group. Then, the percentage of HCEs and NHCEs in each rate group is compared. In general, the percentage of NHCEs participating divided by the percentage of HCEs participating at each rate group level must meet the midpoint of the safe-harbor/unsafe-harbor percentage found in the regulations (Reg. 1.410(b)-4). The midpoint of safe-harbor/unsafe-harbor percentages is determined based on the concentration percentage (percent of NHCEs who satisfy the plan's age and service requirements). Finally, the 70 percent average benefit test is applied. The regulations greatly expand the application of these basic steps, but such coverage is beyond the scope of this chapter.

Planning Tip:
There has been much discussion regarding the fate of the "cross-tested" or "new-comparability" profit-sharing plan, which must meet the complicated nondiscrimination testing procedures previously discussed. However, EGTRRA made no changes that would affect the ability to implement this type of plan. Then in 2002, the IRS finalized regulations that established minimum allocation gateways for plans that use cross-testing, confirming the status of these plans. Practitioners should discuss with clients the possibility of implementing this type of allocation formula to maximize the current year contribution and deduction amounts in favor of the more highly compensated business owners.

3.2.6 Highly compensated

A highly compensated employee in 2007 is any 5 percent owner in the current or prior plan year or an individual who earned more than $100,000 (adjusted for cost of living increases) in the prior year (after adding back IRC Sec. 401(k), 125, and other nontaxable elective contributions in determining the $100,000 threshold). Employers are permitted to apply the $100,000 threshold to only the top 20 percent of employees under an election permitted by the regulations.

3.2.7 Compensation limits

The maximum compensation for any employee used to calculate benefits in a test for nondiscrimination for 2007 is the IRC Sec. 401(a) limit of $225,000 (see Appendix 2). A plan utilizes the calendar limit applicable on the first day of the plan year (IRC Sec. 401(a)(17)).

3.3 Discriminatory Contributions or Benefits—Special Rules

In general, a plan cannot provide benefits or contributions that discriminate in favor of the prohibited group. All plans of an employer and all employees are, generally, aggregated for testing. However, certain special rules apply. They include those for the following.

- For 401(k) and 401(m) plans, the portion of a plan that comprises elective contributions and qualified nonelective contributions (QNECs) is tested under the ADP test. After-tax employee voluntary contributions and matching employer contributions are tested separately under the ACP rules (see section 3.3.2 of this chapter).
- Employee stock ownership plan (ESOP) and non-ESOP portions of a plan, which are tested as two separate plans (see section 3.10 of this chapter).
- Employers meeting specific separate line of business (SLOB) criteria, who may test plans separately (Reg. 1.414(r)-1).
- For coordination of coverage under Social Security, an employer is permitted to coordinate retirement coverage under Social Security with a qualified plan (Reg. 1.401(l)) (see section 3.4 of this chapter).

TRA 1986 extended nondiscriminatory rules to those 403(b) plans in which employer and employee contributions are nonelective. Safe-harbor rules are provided in IRS Notice 89-23.

3.3.1 Special allocation formulas

Each defined-contribution plan must contain a formula for allocating employer contributions (Reg. 1.401-1(b)(1)(ii)). The general nondiscrimination rules applicable to defined-contribution plans are under Reg. 1.401(a)(4)-2.

The following three design-based safe harbors exist for defined-contribution plans:

1. The uniform formula
2. Plans integrated with Social Security (permitted disparity)
3. Formulas weighted for age or service (point allocations)

To satisfy any of these safe harbors, the retirement age, allocation formula, vesting provisions of the plan, and definition of compensation for all participants must be uniform. Under the uniform safe harbor, contributions must be allocated to all participants as the same percentage of plan year compensation, or each participant must receive the same dollar amount. With an integrated safe harbor, the employer contribution is split into two parts, the base amount and the excess amount. The excess amount is a contribution equal to a percentage of pay (not to exceed 5.7 percent) that exceeds a dollar level (not to exceed the Social Security wage base). The base amount is a percent of total pay with that percent being not less than the excess percentage.

A more limited safe harbor is permitted under a point formula that weights allocations on age and service. For example, points may be created for up to each $200 of compensation, and one point for each year of service. A participant would receive an allocation based on the points credited to his or her account compared to the total points credited for all participants that year. This safe harbor, however, requires that the average rates for the HCEs must not exceed the average rates for the NHCEs. The age and service safe harbor of Reg. 1.401(a)(4)-2 is not to be confused with the currently popular age-weighted allocations permitted under Reg. 1.401(a)(4)-8.

Under the uniform point formula safe harbor, a plan is not permitted to use integration under IRC Sec. 401(l). See section 3.4 of this chapter for additional information on permitted disparity (integration). A document is also permitted to exclude compensation before entry into the plan (IRC Sec. 414(s)).

Exhibit 3.1: Point Allocation Formula

A plan grants 200 points for each year of service and 1 point for each $200 of compensation. (No points are awarded in this plan for a participant's age.) The employer contributes $20,000, to be divided among the participants based on each employee's share of the credited points.

The following table shows the total points and contribution allocation granted for each employee.

	Pay	*Age*	*Years of Service*	*Points Credited*	*Allocation of Contribution*	*Contribution as Percentage of Pay*
A	100,000	51	5	1,500	2,817	2.8%
B	50,000	42	20	4,250	7,981	15.9
C	50,000	35	2	650	1,221	2.4
D	30,000	35	10	2,150	4,038	13.5
E	20,000	35	10	2,150	3,943	19.7
	250,000			10,700	20,000	

The point allocations for Employee A and Employee D are shown below:

Employee	*Compensation*	*Service*	*Total*
A	500	1,000	1,500
D	150	2,000	2,150

Note that the average contribution for the HCE does not exceed the average contribution for the NHCEs.

3.3.2 Employee and matching contributions

Defined-contribution plans permitting employee salary deferrals are tested solely under a separate set of nondiscrimination rules of IRC Sec. 401(k), while the nondiscrimination requirements of IRC Sec. 401(m) apply to matching employer contributions and after-tax employee contributions. The maximum salary deferral for 2007 is increased to $15,500, plus a catch-up contribution of $5,000 if the individual is age 50 by December 31, 2007. Employee electives (salary deferrals) must satisfy the actual deferred percentage (ADP) test. The actual contribution percentage (ACP) test is required for any after-tax voluntary contributions and matching contributions. Under the ADP test, the deferral percentage of each participant is determined by dividing the amount deferred (less any catch-up contributions) by the participant's eligible compensation. An average deferral percentage (deferral divided by compensation) is developed for the HCE participants and compared to the average for the NHCEs. The plan is not discriminatory if the average for the HCE does not exceed the average for the NHCE by the greater of the following:

1. 125 percent of such NHCE percentage, or
2. The lesser of the following:
   —200 percent of such NHCE percentage
   —Two percentage points more than the NHCE percentage

The following chart demonstrates the permissible average deferral percentages for the HCEs.

Exhibit 3.2: Nondiscrimination Table IRC Section 401(k)

Elective Deferrals Average-Deferral Percentage of Non-highly-Compensated Employees	*Maximum Permissible Average-Deferral Percentage for Highly Compensated Employees*
1%	2%
2	4
3	5
4	6
5	7
6	8
7	9
8	10
9	11.25
10	12.5

Thus, if the average ADP for the NHCEs is at 3.5 percent, the average ADP for the HCEs must not exceed 5.5 percent. For purposes of calculating the average percentages, eligible participants not making deferrals are included in the test at 0 percent.

An employer may calculate this test using either current-year compensation and deferral for the NHCEs and HCEs, or the current-year compensation and deferral for the HCE and the NHCE ADP percentage for the first plan year when the plan is tested in a prior year. An employer may assume the NHCE ADP was 3 percent for the prior year basis.

3.3.2.1 Determining the deferral ratio

Deferral ratios are determined by dividing the elective deferrals by the participant's compensation. Compensation for purposes of this test must not discriminate in favor of the highly compensated. Typically, it will be compensation used to test for annual additions under IRC Sec. 415(c) (for example, gross compensation or compensation subject to withholding). Employers may elect to exclude the participant's tax-exempt salary deferrals in compensation when calculating the deferral percentages permitted in the plan document (IRC Sec. 401(k)(9)).

After 1996, an employer may test the current year average for the HCEs either using current-year salary deferrals and compensation for the NHCEs or basing the test on the results of the prior-year testing for the NHCEs. Note that in applying prior year testing, the employer disregards any changes in the NHCEs. That is, if the 2005 average deferral ratio for the NHCEs was 3 percent, that ratio is used to test for the maximum ADP of the HCEs, regardless of whether any NHCE's status changed in the 2006 plan year or if the individual is no longer a participant for 2006. New 401(k) plans or profit-sharing plans that implement a salary deferral option are also entitled to test on a prior year basis. If prior-year testing is used, it can be assumed that the prior year average deferral ratio for the NHCEs is 3 percent. Beginning with the close of the remedial amendment period for the so-called GUST (GUST refers to a series of public laws that amended various plan qualification rules) amendments, the plan document must specify whether prior year or current year testing is to be used. Changes in these procedures must be made through amendment and made on a prospective basis.

Here's the good news with prior-year testing. A 401(k) sponsor will know the maximum average deferrals for the HCEs early in the current year. But if that limit is exceeded, these employers will not be able to change to current-year testing until the next year.

Testing elections. Employers may always elect to amend the plan to change from prior-year testing to current-year testing, but changing back to prior-year testing is not permitted if prior-year testing was used in any of the five prior years.

Correcting a failed ADP and ACP test. Beginning after 1996, employers prepare the ADP and ACP test under one method and then, if the test fails, make corrective distributions under another method. When the ADP test fails, salary deferrals for the HCEs are reduced through either distribution or reclassification, starting with the HCE who has the highest deferral percentage (IRC Sec. 401(k)(8)(B)). Basically, the amount of the excess deferral from a failed ADP test is determined by reducing the deferrals from the HCEs starting with the HCEs with the highest deferral percentage. This reduction is made until the remaining deferrals satisfy the ADP test. Similar calculations apply to the determination of excess amounts under the ACP tests.

This testing is shown for the 2006 year.

Step 1: Determining the excess contribution. Prepare the ADP test and determine the amount of salary deferrals to be distributed to the HCEs for the 2006 plan year. This example assumes that prior-year testing will be used and that ADP for the NHCEs was 4.33 percent and that no catch-up contributions are made. The average deferral for the HCEs is 7.66 percent ([6.00 + 8.25 + 8.75] ÷ 3). This exceeds the amount permitted under the ADP test, which is 2 percent plus 4.33 percent. The employer decides to distribute to correct for the failed test. The Code requires that amounts of deferrals to be reduced start with the HCE who has the highest deferral percentage (Employee C). The amount to be distributed is shown below.

HCEs

Employees	*Before Deferral Pay*	*Initial Deferral*	*Ratio*	*Theoretical Distributed Amount*	*Final Deferral*	*Deferral Ratio*	*Average for Group*
A	$150,000	$9,000	6.00%	<0>	9,000	6.00%	
B	100,000	$8,250	8.25%	<1,750>	6,500	6.50%	6.33%
C	80,000	$7,000	8.75%	<1,800>	5,200	6.50%	
		Total to be distributed $3,550					

NHCEs

For the NHCEs, assume that average deferral ratio for the plan year was 4.33 percent.

This plan initially fails the ADP test, and the plan administrator elects to distribute a portion of the salary deferrals to the HCEs. The amount of the deferrals to be distributed is determined by lowering the deferral percentages of the HCEs until they average 6.33 percent (two percentage points higher than the ADP for the NHCEs).

The total amount of the deferrals to be distributed from the HCEs' accounts is $3,550.

After the testing is completed and the total amount of the deferrals is determined, IRC Sec. 401(k)(8)(C) applies. This confirms that the amount of deferrals is withdrawn from the HCEs with the highest dollar amount of deferrals. There is a leveling process—that is, the highest deferral amount is reduced to the next highest and these are reduced to the next highest, and so on until the total amount determined in the first step is exhausted.

The prior example demonstrates how deferrals are distributed.

Step 2: Distributing excess contributions under IRC Sec. 401(k)(8)(C). The amount to be distributed, $3,550, was determined in Step 1. The amounts are distributed in a leveling method based on the HCE with the largest amount of deferral as shown below.

HCEs

Employees	*Before Deferral Pay*	*Initial Deferral*	*Ratio*	*Theoretical Distributed Amount*	*Final Deferral*	*Deferral Ratio*	*Average for Group*
A	$150,000	$9,000	6.00%	<2,100>	6,900	4.60%	
B	100,000	$8,250	8.25%	<1,350>	6,900	6.90%	6.71%
C	80,000	$7,000	8.75%	< 100>	6,900	8.63%	

Total amount distributed $3,550

The $3,550 is distributed by first lowering the deferral for Employee A until the remaining equals the next highest deferral for an HCE ($8,250 for Employee B); then the deferrals of both A and B are reduced until they equal the amount for the next highest HCE ($7,000 for Employee C); and then all three HCEs have their deferrals reduced until the entire $3,550 is exhausted.

Once this distribution method is applied, the average deferral ratio of the remaining deferrals in the HCEs' accounts is 6.71 percent—an amount that exceeds the average of the NHCEs by more than 2 percentage points. It might appear that another round of tests must be applied to bring the two percentages into the ranges required by IRC Sec. 401(k)(3). This is not the case. No further testing is required; the plan will be deemed to have passed the ADP test. Note that if employee A is age 50 by December 31, 2006, employee A is entitled to a catch-up contribution in 2006 of $5,000. Then no excess contribution would need to be distributed to Employee A; $5,000 could be retained in the plan as a catch-up contribution.

3.3.2.2 Safe-harbor 401(k) plans

Beginning in 1999, an employer may adopt a safe-harbor 401(k) plan or convert an existing 401(k) plan to a safe-harbor 401(k) plan. With a safe-harbor 401(k) plan, the employer can avoid a need to pass the ADP and ACP testing as long as certain notices are provided to participants and when either certain fully vested matching or nonelective contributions are made to the plan.

— *Avoiding the ADP test.* A plan sponsor can avoid the necessity of satisfying the annual ADP testing when the plan document is written to require one of three fully vested safe-harbor contributions. The plan drafter may choose from one of two safe harbor matching contributions or a nonelective 3 percent pro rata contribution. In addition to amending a plan to become a safe-harbor 401(k) plan, the employer must notify participants before the start of the plan year about which safe-harbor contribution will be made and whether any additional employer contributions (for example, matching contributions) may be made.

In determining the amount of either the safe-harbor match or the safe-harbor nonelective contribution, the participant's compensation must be based on the IRC Sec. 415(c)(3) definition of compensation, but can be based on compensation after entry into the plan.

Note: None of these safe-harbor employer contributions can be conditioned on a participant completing a year of service (that is, being credited with 1,000 hours) in the plan year or being employed on the last day of the plan year. A plan that provides for one of the two safe-harbor matching contributions and limits the amount of any discretionary matching contribution to no more than 4 percent of the participant's compensation also satisfies the ACP test.

The two permitted safe-harbor contributions include:

1. **Safe-harbor matching contributions.** These are fully vested matching contributions that are either:
   a. The basic match, at 100 percent of each participant's salary deferrals equal to 3 percent of the participant's compensation, plus 50 percent of deferrals equal to the next 2 percent of participant's compensation, or
   b. The enhanced match, in which a match at any rate that at least equals the basic match at a lower level of salary deferral (for example, 100 percent of first 4 percent of salary deferrals) and the rate of match does not increase as the rate of deferrals increases. No HCE may receive a rate of match that exceeds a rate of match for an NHCE, who defers at the same rate. The enhanced match may not be based on deferrals in excess of 6 percent of the participant's compensation.

Note: The ACP test for such a plan is met if the plan has a fixed match or a discretionary match that is not based on deferrals in excess of 6 percent of pay, and that meet certain additional requirements.

2. **Safe-harbor nonelective contribution.** This is a fully vested pro rata contribution of 3 percent of each eligible participant's "compensation" (applying the $225,000 limit) that causes the plan to satisfy the ADP test. Unlike the safe-harbor matching contributions that are made only to participants who make salary deferrals, the nonelective contribution is made to all eligible participants.

Note: A plan using the safe-harbor nonelective contributions also satisfies the ACP safe harbors if any fixed or discretionary matching contributions are based on deferrals that do not exceed 6 percent of a participant's pay and that do not result in a rate of match for any HCE. Any discretionary match may not exceed 4 percent of compensation.

— *Avoiding the ACP test.*

1. *Safe-harbor matches.* As previously noted, either of the two safe-harbor contributions causes the plan to satisfy both the ADP and ACP tests as long as other fixed or discretionary matching contributions meet certain requirements. Plans with matching contributions that do not meet these requirements must satisfy the ACP testing under traditional testing. That is, the ADP test is deemed met, but all the matches are to be tested as a non-safe-harbor plan.

— *Plan design requirements, advanced notice.* The utilization of a 401(k) safe harbor generally requires that the document be amended to reflect the required contribution before the start of the plan year. Thus, a taxpayer cannot wait until the end of the year to decide whether to make a safe-harbor match (or select which safe-harbor match to make) or the nonelective contribution. Under certain conditions, an employer may cease making the safe-harbor matching contribution if proper advance notice is given. Participants must also be advised of the type and amount of safe-harbor contribution to be made for the upcoming plan year at least 30 days before the start of the plan year. For the new 401(k) plan, the notification must be provided before the date when any individual participates in the plan. An employer utilizing the nonelective safe-harbor contribution must advise participants if a discretionary match may also be made to the plan.

Note: There is no flexibility in the selection of whether to use a match or nonelective contribution after the start of the plan year. An employer may establish the safe-harbor nonelective contribution as a conditional contribution. Under such a safe-harbor plan, the employer may reserve the right to make the safe-harbor contribution until the end of the plan year and therefore avoid the ADP and possibly the ACP testing. However, the employer must notify all participants 30 days before the start of the plan year of the conditional contribution, and also notify participants no more than 30 days before the end of the plan year that a safe-harbor nonelective contribution will be made.

— *Plan documentation restriction.* The IRS guidance does not prohibit a year-to-year amendment of the plan to change from the nonelective contribution to the safe-harbor match or even return to traditional testing if done on a prospective basis. A plan using one of the safe-harbor contributions to satisfy the ADP or ACP testing is treated as being tested on a current-year basis. Thus, a change to traditional testing in a subsequent year with a change to prior-year testing within five years will generally be restricted.

Note: The IRS guidance does permit the plan sponsor to impose certain restrictions on making salary deferrals that will, in some cases, be used by plan sponsors to discourage participation by the NHCEs (for example, no loan provision, no election changes during the plan year, no participant investment direction, and no hardship distributions). Caution is the watchword in applying such restrictions where they are discriminatory in favor of the HCEs. An employer with a safe-harbor 401(k) plan may have other plans. The safe-harbor plan may limit coverage to a group of employees as long as that group satisfies the requirements of IRC Sec. 410(b). A 401(k) safe-harbor plan may limit the times when a participant may elect to begin, end, or modify the amount of the elective contribution. For example, a plan could require the election once made to remain in force for the full year, or only permit a reduction in the participant's election.

— *Required notice to participants.* The IRS guidance makes it clear that an employer can use the so-called GUST remedial amendment period to retroactively document the conversion of an existing 401(k) plan to a 401(k) safe-harbor plan. However, the guidance is clear that such a plan must be operated as having met all of the requirements for a safe-harbor plan, including the timely delivery of the employee notices. After the close of the GUST remedial amendment period, a plan must be amended before establishing the safe-harbor feature. A salary deferral and the safe-harbor nonelective contribution can be added to an existing profit-sharing plan, if employees are notified and salary deferrals begin no later than three months before the close of the plan year. Participants must be advised of their right to make salary deferrals and be fully informed about which safe harbor applies. Generally that notice is to be made at least 30 days before the start of the plan year and no more than 90 days before that date.

— *Top-heavy contribution and safe-harbor 401(k) plan.* For plan years before 2002, the 3 percent nonelective safe-harbor contribution satisfied any top-heavy contribution. A 401(k) plan using the safe-harbor match was also required to make any required top-heavy contribution. However, beginning in 2002, EGTRRA excludes from the definition of a top-heavy plan any 401(k) plan utilizing the safe-harbor match that meets the safe-harbor requirements for ADP and ACP testing, as long as no other employer contributions are made to the plan.

Planning Tip:
Small employers that did not establish 401(k) plans in the past due to possibly having to make both a match and top-heavy minimum contributions may now reconsider the adoption of a safe-harbor 401(k) plan. Safe-harbor 401(k) plans, using the safe-harbor match and with no profit-sharing contributions, are exempt from the top-heavy contributions, beginning in 2002. With the safe-harbor match, employer contributions are limited to matching contributions to those employees who make elective deferrals.

Plan year requirement for safe-harbor 401(k) plans. A safe-harbor 401(k) plan, other than a newly formed plan (for example, not a successor plan), must utilize a 12-month plan year. Existing IRS guidance makes no exception to this requirement for mergers or other corporate changes.

3.3.2.3 Automatic enrollment arrangements

Effective for taxable years beginning after December 31, 2007, the Pension Protection Act of 2006 added a provision allowing 401(k) plans that contain a qualified automatic enrollment feature to be treated as meeting the ADP test with respect to elective deferrals and the ACP test with respect to matching contributions. Additionally, these plans consisting solely of contributions made pursuant to a qualified automatic enrollment feature are not subject to the top-heavy rules.

— *Qualified automatic enrollment feature.* A qualified automatic enrollment feature must meet specified requirements with respect to the following:

- Automatic deferral percentages.
- Matching or non-elective contributions.
- Withdrawal and vesting requirements.
- Notice to employees.

— *Automatic deferral percentages.* Plan participants are considered to have elected a percentage that does not exceed 10%, but is at least:
  - 3% of compensation for the first year the automatic enrollment applies.
  - 4% of compensation during the second year the automatic enrollment applies.
  - 5% of compensation during the third year the automatic enrollment applies.
  - 6% of compensation during any later plan year.

Observation:
Employees may affirmatively elect not to have any contributions made, or to make elective contributions at a different percentage amount.

— *Matching or non-elective contributions.* To qualify under the automatic enrollment feature, the employer is required to make either a matching contribution or a non-elective contribution for all employees as follows:
  - The matching contribution minimum is 100% of the employee elective contributions up to 1% of compensation, plus an additional 50% of elective contributions from 1% to 6% of compensation.
  - The non-elective contribution rate is 3% of employee compensation, disregarding any elective contribution amounts made by employees.

— *Withdrawal and vesting requirements.* Employees who have completed at least two years of service are required to be 100% vested with respect to employer contributions, with the normal rules regarding distributions from 401(k) plans applying with respect to all employer contributions.

— *Notice to employees.* Employees must be given a written notice within a reasonable time prior to the beginning of each plan year explaining, among other issues, the right of the employee to elect not to have elective contributions made and how contributions made under the automatic enrollment feature are invested if no investment election is made by the employee.

3.3.3 Defined benefit—nondiscrimination

Alternative design-based safe harbors are provided for defined-benefit plans under Reg. 1.401(a)(4)-3. Plans not meeting one of these safe harbors must meet the general nondiscrimination test annually (see Section 3.2.5.3). In general, this testing must demonstrate that employer-provided benefits under the plan are not discriminatory in favor of the HCEs. A defined-benefit plan may also show that the equivalent contributions under the plan are nondiscriminatory.

Various methods are permitted to satisfy these tests. An employer is permitted to establish rate groups under the plan, and then test each rate group under the ratio percentage test of IRC Sec. 410(b). Rate groups are determined by grouping HCEs and NHCEs with the same or equivalent accrual rates (Reg. 1.401(a)(4)-3).

When a defined-benefit plan is structured as a safe-harbor plan, it must also satisfy minimum coverage under IRC Sec. 410(b). The first safe harbor applies to unit credit plans, which contain a benefit formula that accrues annually, for all participants with the same number of years, the same dollar amount of benefit, or the same percentage of compensation.

The second defined-benefit safe harbor applies to plans using the fractional accrual method, and, in general, must convert to an equivalent of the first safe harbor. A typical formula would provide for some percent of pay for each year of participation, or a fixed dollar amount for each year of participation.

The third safe harbor is for flat benefit plans, which provide a flat percentage of pay benefit at retirement age. These plans accrue benefits under the fractional method, over the service of the participant. In general, these plans are required to have a design that equates to unit credit type accruals. Such a formula could be 50 percent of pay at normal retirement, reduced 1/25 for each year of participation less than 25. (This is similar to a 2 percent per year of participation formula.) A minimum number of years is required to avoid acceleration of benefits for the older participant. These design-based safe harbors cover both the ultimate benefit and the annual accrual.

The fourth safe harbor is for flat benefit plans and requires that the average accrual of NHCEs as a group must be at least 70 percent of the average rate of the highly compensated employees as a group (Reg. 1.401(a)(4)-3).

Under any of the safe harbors, compensation must be determined on a uniform basis and tied to the definition of compensation under IRC Sec. 414(s). Special safe harbors are also available for certain insured defined-benefit plans described in IRC Sec. 412(i).

3.3.4 Testing under benefit and contribution rules

Where a defined-contribution plan does not satisfy by design one of the safe harbors under Reg. 1.401(a)(4)-2, it must be tested to demonstrate that either the contributions or benefits do not discriminate in favor of the HCEs. The final regulations provide techniques for cross-testing of defined-benefit or contribution plans (see section 3.2.5.3).

For example, certain defined-benefit plans with characteristics of individual account defined-contribution plans, can be tested on a basis of contribution credits (Reg. 1.401(a)(4)-8(c)(3)). Floor offset plans are arrangements in which the benefits under a defined-benefit plan are offset by the benefits under the same employer's defined-contribution plan. These plans may satisfy special tests under Reg. 1.401(a)(4)-8(d)(1) to demonstrate that the plan does not discriminate in favor of the HCEs.

3.3.5 Defined benefit—accruals

Reg. 1.401(a)(4)-3 generally prescribes rules for nondiscriminatory benefit accruals in a defined-benefit pension plan. The Code also specifies that defined-benefit plans must satisfy certain minimum accrual rules under IRC Sec. 411(b)(1).

Participants accrue benefits under a defined-benefit plan in accordance with the benefit formula in the plan. These generally follow one of several benefit accrual standards (IRC Sec. 411(b)(1)):

— *3 percent method.* Under this standard, each participant's accrued benefit upon termination of employment must be at least 3 percent of the normal retirement benefit that the employee would have received if participation commenced at the earliest age and continued until age 65 or the normal retirement age in the plan, if earlier, multiplied by the employee's years of participation (maximum: 33 1/3).

— *133 1/3 percent rule.* Under this standard, the accrual rate for any year must not exceed 133 1/3 percent of the accrual rate for any prior year.

— *Fractional rule.* Under this standard, each participant's accrued benefit upon termination must be at least equal to a fraction of the participant's actual years of participation to potential years of participation if he or she had served until normal retirement age, multiplied by the normal retirement benefit.

For purposes of determining the benefit accruals for these tests, years of participation may be used. Accordingly, years of service before entry into the plan as a participant can be ignored. A year of service is a 12-month period in which the participant is required to be credited with not more than 1,000 hours of service. Years in which less than 1,000 hours are completed can be ignored for benefit accrual purposes. Unlike a defined-contribution plan, a defined-benefit plan must provide accrued benefits if a participant works 1,000 hours during the year, even if he or she is not employed at year end.

3.4 Permitted Disparity (Integration With Social Security)

Although contributions and benefits under a plan cannot discriminate in favor of HCEs, a safe-harbor plan may provide certain additional benefits to the HCEs if the plan meets the permitted disparity rules under IRC Sec. 401(l). The concept behind permitted disparity, traditionally called Social Security integration, is that it is a means to achieve equalized retirement benefits under an employer's plan and under Social Security.

As a part of the Social Security system, employers are required to make contributions that ultimately provide retirement benefits. However, retirement benefits under Social Security are limited based upon the taxable wage base set each year as the base for FICA taxes. As a result, higher paid employees (those above the Social Security wage base) receive a smaller percentage of their compensation as a retirement benefit from Social Security than do lower paid employees. With a plan structured for permitted disparity, an employer's plan can make up for this disparity by providing for additional benefits to the employees whose wages are above the Social Security wage base.

Two separate sets of rules apply to permitted disparity, one for defined-contribution plans and one for defined-benefit plans. In the following two subsections, permitted disparity is referred to by its more common name, integration.

3.4.1 Integration of defined-contribution plans

Defined-contribution plans can be integrated relatively easily. The following table was provided for integrating for plan years beginning after 1988.

Exhibit 3.3: Integration Percentages and Levels for Defined-Contribution Plans

Integration Level	*Maximum Percentage of Excess Benefit*
If the integration level used is less than 20 percent of the Social Security wage base (see Appendix 2), the maximum integration percentage rate is	5.7%
If the integration level is at least 20 percent of the maximum allowable level but less than 80 percent of the Social Security wage base (see Appendix 2), the maximum integration percentage is	4.3%
If the integration level is at least 80 percent of the maximum allowable level but less than 100 percent of the Social Security wage base (see Appendix 2), the percentage rate is	5.4%
If the integration level is at the maximum allowable Social Security wage base (see Appendix 2), the maximum allowable percentage is	5.7%

A defined-contribution plan is integrated under the following format: X percent of total pay plus Y percent of pay above a dollar amount. X is the total percent and Y is the excess percent. The dollar amount is the integration level of the plan. The integration level (maximum allowable level) and the excess percentage are determined in Exhibit 3.3, shown above. The dollar amount of the integration level can be any amount up to the Social Security taxable wage base in effect at the beginning of the plan year. In addition, the excess percentage may not exceed the lesser of the base percentage or the amount under the chart above.

3.4.2 Integration of defined-benefit plans

The integration rules applicable to defined-benefit plans were revised under TRA 1986. Final regulations under Regs. 1.401(l) and 1.401(a)(4)-7, released in the fall of 1991, control the requirements for integrating a defined-benefit pension plan.

In general, a plan using a nondiscriminatory definition of *compensation* that satisfies the Section 401(l) integration regulations must satisfy one of the nondiscrimination safe harbors. Integration for defined-benefit pension plans is defined under both a unit credit benefit formula and flat benefit formula. The maximum integration formulas are reduced for the following:

— Retirement before an individual's Social Security age

— Normal form of benefit other than a life annuity

— Ancillary death or disability benefits

— Averaging compensation over less than five years

3.5 Vesting

When employer-funded benefits cannot be forfeited by the employee, that employee is then said to be vested. Employer-funded contributions or benefits funded can be vested under a schedule in the plan document that is based upon the participant's years of credited service. For most employer-funded contributions, full vesting is required after six years of service. The basic vesting rules are as follows:

— Participants must be fully vested at the normal retirement age (IRC Sec. 411(a)).

— Participants must always be vested in their own contributions (IRC Sec. 411(a)(1)).

— To the extent that benefits have been funded, employees must be vested if the plan terminates, or on complete discontinuance of contributions to a profit-sharing or stock bonus plan (IRC Sec. 411(d)(3)).

— Partial terminations occur when a large portion of the workforce is terminated through some action of the employer. At the time of a partial termination, terminated participants are deemed fully vested.

— For all employer-funded contributions other than matching contributions, a participant must be fully vested in an employer's contributions after completing service required under one of three statutorily permissible vesting schedules. The three permitted vesting schedules are the following.
  — Five-year cliff vesting. Under this schedule a participant is fully vested only after completing five years of service.
  — Three- to seven-year vesting. Vesting begins upon being credited with three years of service (20 percent) and increases at 20 percent per year to 100 percent at seven years.

Years of Service	*Vested Percentage*
3	20%
4	40
5	60
6	80
7	100

  — Special schedule for multiple employer plans. Multiemployer plans must provide 100 percent vesting after 10 years of service (IRC Sec. 411(a)(2)(C)).

In most cases, when an employer changes a vesting schedule, employees credited with at least three years of service will continue to be subject to the more favorable vesting schedules. Plans requiring two years of service before participation must provide 100 percent vesting after entry into the plan (IRC Secs. 411(a)(10) and 410(a)(1)(B)).

Note that small employer plans that become top heavy are subject to shortened vesting schedules (see Section 3.8).

EGTRRA accelerates the minimum vesting schedules of a participant's nonforfeitable right in employer's matching contributions. As with the prior law, there are two alternative vesting schedules that can be used for matching contributions.

Under the first minimum vesting schedule, the five-year cliff schedule allowed for other contribution types is reduced to a three-year schedule. Employees with three years of service must be 100 percent vested in employer matching contributions.

The second minimum vesting schedule reduces the seven-year graded schedule to a six-year graded schedule. Under the six-year schedule, a participant will be 20 percent vested after two years of service, with 20 percent increases each additional year of service until the participant is 100 percent vested upon completion of six years of service.

The accelerated vesting schedule of 100 percent vesting after three years and six-year graded vesting applies to **all** employer contributions to defined contribution plans for contributions for plan years beginning after December 31, 2006, per a provision in the Pension Protection Act of 2006.

The new vesting provisions for matching contributions only apply to an employee after he or she has been credited with one hour of service under the plan in any plan year beginning after December 31, 2001.

3.5.1 Vesting—years of service

As a general rule, all service beginning with the employee's date of hire is included in determining the vested percentage. If the plan so provides, the following years may be excluded:

— Any 12-month period provided in the plan in which the participant works fewer than 1,000 hours

— Years worked before age 18

— Years when the employee does not make a required contribution to the plan

— Years worked before adoption of the plan or a predecessor plan

— Certain years worked before a break-in-service in the case of employees rehired after the break who were never vested in any benefits.

3.6 Funding Obligations

Pension plans, whether defined benefit or defined contribution, are subject to mandatory funding obligations not imposed on profit-sharing and stock bonus plans. Contributions are due not later than 8½ months after the end of the plan year. Failure to satisfy the pension funding obligations will subject an employer to a nondeductible 10 percent excise tax for each year the deficiency continues (IRC Sec. 4971). An employer liable for the 10 percent excise tax is required to file IRS Form 5330 and pay the tax within seven months after the end of its plan year. Under certain temporary conditions, an employer may request a waiver of the current year funding from the IRS if requested within 2½ months after the close of the plan year. Waived amounts are required to be amortized under a fixed schedule. The annual funding requirement of a defined-contribution pension plan is equal to the amount determined under the contribution formula in the plan document.

Certain employers maintaining a defined-benefit plan are required to make equal quarterly contributions during the plan year if the plans do not meet certain asset-to-liability thresholds (IRC Sec. 412(m)). The required amount of the quarterly contribution is the lesser of 100 percent of the amount required in the prior year or 90 percent of the current-year funding requirement. Failure to make these contributions will subject the employer to a penalty that is paid to the plan and, if the participants are not notified, a plan disqualification. The penalty is contributed to the plan and is based on interest at 175 percent of the federal midterm rate, or the rate in the plan, if higher.

3.6.1 Funding defined-benefit pension plans

Funding of a defined-benefit pension plan is determined by an actuary under methods defined under IRC Sec. 412. This funding has developed into an elaborate and technical process that attempts to preclude small business employers from accumulating too much too rapidly and larger business employers from not contributing enough to meet emerging liabilities. Thus, an actuary must calculate liabilities under various approaches under the plan's assumptions and government-defined rates. These liabilities are compared to the plan assets to determine if a plan is underfunded or at a funding limitation. Under these rules, it is possible to have an underfunded plan based upon the plan's actuarial factors, while at the same time the employer is unable to make a deductible contribution.

Subject to certain limitations, an employer may make deductible contributions up to a plan's full funding limitation. The full funding limitation is the excess, if any, over the plan's assets, or the lesser of 160 percent of current liability or the accrued liability (including normal cost) under the plan (IRC Sec. 412(c)(7)). If the plan's liabilities cannot be directly determined under its funding method, they must be determined under the entry age normal funding method. The value of the plan's assets is the lesser of the assets' fair market value or the assets' value determined under the rules in IRC Sec. 412(c)(2). Current liability is defined under IRC Sec. 412(1)(7) to mean all liabilities to employees and their beneficiaries under the plan as determined under IRC Sec. 401(a)(2) as if the plan had terminated. The Treasury is empowered to prescribe full funding limitations based on factors other than current liability (IRC Sec. 412(c)(7)(D)).

In the operation of a defined-benefit pension plan, a funding standard account is established, and certain charges and credits are made to determine whether there is an accumulated funding deficiency (IRC Sec. 412(b)(1)). The funding standard account is reflected on Schedule B of the Form 5500 annual filing. In the case of single-employer plans, the funding standard account is charged with the following:

— The normal cost for the plan year

— The amount necessary to amortize in equal annual installments
  - The unfunded past service liability over 30 years (40 in the case of plans in existence on January 1, 1976)
  - Any increase in unfunded past service liability arising from plan amendments over 30 years
  - Any net experience loss (that is, adverse actual experience in relation to the actuarial assumptions) over 15 years; any net loss arising from changes in the actuarial assumptions over 30 years

— The amount necessary to amortize any waived funding deficiency over 15 years

The funding standard account is credited with the following:

— The contributions, including forfeitures, for the year

— The amount necessary to amortize in equal annual installments
  - The net decrease in unfunded past service liability arising from plan amendments over 30 years
  - The net experience gain over 15 years
  - The net gain resulting from changes in actuarial assumptions over 30 years

— The amount of any waived funding deficiency for the year

The Omnibus Budget Reconciliation Act of 1987 modified the IRC Sec. 412 minimum funding requirements by increasing the amount that is charged to the funding standard account of any underfunded plan. The increase is not to exceed the amount necessary to increase the funded current liability to 100 percent. The increase is (1) the unpredictable contingent-event amount for the plan year plus (2) the excess of the deficit reduction contribution over the amount necessary to amortize past service liability, each waived funding deficiency, certain amounts credited in the case of an employer's previously using the alternative minimum funding standard account, reduced by the amounts necessary to amortize decreases in past service liability (IRC Sec. 412(l)). Unpredictable contingent events include, but are not limited to, facility shutdowns and reductions in workforce. The increase charged to the standard account is not to exceed the amount necessary to increase the funded current liability percentage to 100 percent.

Observation:
Before 2002, these funding rules do not apply to plans that had 100 or fewer participants on each day during the preceding plan year. EGTRRA expanded the application of these funding rules to all defined-benefit plans, including plans with fewer than 100 participants for years after December 31, 2001.

In a number of cases, if the fair market value of plan assets exceeds the total accrued liabilities under the plan because of, for example, a substantial increase in the value of its investment portfolio, no contribution is due. This occurs when the full funding limitation is reached, even if there would otherwise be an accumulated funding deficiency.

3.7 Limitations on Contributions and Benefits

Limitations are imposed on the amounts of benefits that can be provided from defined-benefit plans and the amounts of annual contributions that can be made to defined-contribution plans (IRC Sec. 415). These limitations are determined on a participant basis. In 2007, the maximum annual benefit payable in a defined-benefit pension plan at age 62 or later is $180,000, with scheduled cost-of-living increases to be applied in $5,000 increments.

The maximum annual addition under a defined-contribution plan for 2007 is the lesser of $45,000 or 100 percent of the individual's compensation. Annual additions include all employee contributions (before tax and after tax) and employer contributions or forfeiture reallocations credited to the participant's account. Any catch-up contributions made to a 401(h) or other eligible plan are not included in this calculation.

Profit-sharing plans are also subject to a deduction limit that is based on the total compensation of all eligible participants paid in the employer's tax year and is 25 percent for years beginning after 2001. Employers maintaining both a defined-contribution pension and profit-sharing plan are subject to an overall 25 percent of eligible pay limit (IRC Secs. 404(a)(3) and 404(a)(7)). For years beginning after December 31, 2001, elective deferral contributions to a 401(k), SARSEP, 403(b), or SIMPLE plan are no longer deemed employer contributions for determining the 25 percent deduction limit calculation (IRC 404(n)). Also, any catch-up contributions are not included in this deduction limit.

3.7.1 Defined-benefit plan limits

A defined-benefit plan may not provide a participant an annual benefit in excess of the lesser of $180,000 for 2007 or 100 percent of the participant's average compensation for his or her high three consecutive years (see Appendix 2). The maximum limit is available at age 62 and may be based on compensation up to $225,000 in 2007. The dollar limit is reduced actuarially when benefits begin before age 62 (instead of the Social Security age under the prior law) and increased for benefits beginning after age 65 (IRC Sec. 415(b)(2)).

Planning Tip:
A 62-year-old who began receiving benefits in 2007 would have a benefit limit of $180,000, and the limit would not be decreased due to the commencement of benefits before the individual's Social Security normal retirement age. This combined higher benefit and ability to receive the maximum annual benefit as early as age 62 has increased the funding of benefits for small business owners by as much as 60 percent, making these plans an attractive alternative for the baby boomer wanting to maximize his or her retirement savings.

This primary limitation requires that the plan's normal form of benefit be in the form of a level monthly annuity payable over the life of the participant. Other forms of benefits can be paid if they are the actuarial equivalent of the life annuity. However, this maximum limitation is adjusted if any of the following occur.

— The normal form of benefit is in any other form. A 100 percent joint and survivor annuity can be provided without a reduction in the IRC Sec. 415 amount.

— The employee is required to contribute to the plan. The benefit begins at an age other than the individual's normal Social Security retirement age.

— The participant has less than 10 years of participation. The maximum annual accrual of a participant's benefit is 1/10 of the $180,000 limit (IRC Sec. 415(b)).

3.7.2 Defined-contribution plan limits

While the benefit limit for defined-benefit plans is based on the annual benefits provided at retirement to a participant, defined-contribution plans are limited to the total annual additions allocated to each participant's account each year. A participant's annual additions cannot exceed the lesser of $45,000 for 2007 or 100 percent of compensation (see Appendix 2 for cost-of-living adjustments (COLA)). Annual additions include a participant's share of the current employer and employee contributions (before- and after-tax) and forfeiture reallocation. An account's share of investment earnings, rollover contributions, or the direct transfer of assets between plans is not included in determining the participant's annual addition (Reg. 1.415-6(b)(3) and IRC Sec. 415(c)).

3.8 Top-Heavy Plans

Plans are subject to additional requirements if the employer's plans, when considered together, are top-heavy. A top-heavy plan is one in which more than 60 percent of the present value of current benefits or account balances is attributable to the key employees. The determination of top-heavy status is generally made as of the last day of the prior plan year. For new plans it is determined at the end of the first plan year.

Distributions to a key employee made due to separation of service, death, or disability, and made during the prior plan year are added back for purposes of determining top-heavy status. If a distribution is made to a key employee for a reason other than these three reasons, a five-year look-back period applies, bringing in all distribution to key employees (IRC Sec. 416(g)(3)(B)). If an individual has not performed services for the employer during the one-year period ending on the last day of the prior plan year, the accrued benefit or individual's account is not required to be added back in. This test is based on the present value of accrued benefits for defined-benefit plans and the account balances for defined-contribution plans (cash-basis accounting). Testing is based upon the values of the participant's accounts on the last day of the prior plan year (IRC Sec. 416(g)).

Compensation includes all pretax elective contributions to plans qualified under IRC Secs. 401, 403(b), 125, and so on.

For plan years beginning in 2002 and thereafter, the definition of a key employee has been modified in several ways.

An employee is considered a key employee if, during the preceding plan year, the employee was (1) an officer with compensation in excess of $145,000, (2) a 5 percent owner, or (3) a 1 percent owner with compensation in excess of $150,000. Top-heavy plans must satisfy two additional requirements:

1. Vesting is accelerated.
2. Minimum benefits or contributions must be provided.

A top-heavy plan must provide full vesting under one of two schedules: either full vesting after completion of three years of service or graduated vesting in accordance with the schedule that follows. The years of service that are to be included in determining this vesting schedule are the same as those under the general vesting rules. See Section 3.5 of this chapter (IRC Sec. 416(b)).

Years of Service Vested	*Percentage*
2	20%
3	40
4	60
5	80
6	100

A top-heavy defined-benefit plan must provide a minimum benefit for each non-key participant equal to the lesser of (1) the maximum total benefit provided to any key employee or (2) 2 percent of the participant's average compensation, up to 20 percent (10 years). Average compensation is based on a five-year average. The minimum benefit is offset by any employer-provided benefits accrued to date. The minimum required benefit can be paid in the form of a single-life annuity commencing at the plan's normal retirement age (IRC Sec. 416(c)(1)).

A top-heavy defined-contribution plan must provide a minimum contribution for each non-key participant equal to the lesser of (1) the greatest percentage of allocation to any key employee or (2) 3 percent of compensation (IRC Sec. 416(c)(2)). For purposes of determining whether these minimum benefits or contributions have been provided to the non-key employee, a non-key employee's salary reduction amounts may be taken into account. However, EGTRRA has added a provision that allows employer matching contributions to be taken into account in determining if the minimum benefit requirements have been satisfied where permitted under the plan (IRC Sec. 416(c)(2)(A)). As a result of this provision, employer matching contributions may be taken into account for purposes of both the ACP (and maybe the ADP) and top-heavy tests after December 31, 2001. In some cases, if the employer maintains both a defined-benefit and defined-contribution plan that are top heavy, the minimum contribution may be increased above the 2 percent and 3 percent limits mentioned above.

Where non-key employees are covered under both a defined-contribution and a defined-benefit plan, which are together top-heavy, the top heavy may be provided in either, but not both, plans. For example, where a defined-contribution plan provides for a minimum contribution of at least 5 percent of the annual compensation, the employer's defined benefit need not provide any minimum benefit. (Reg. 1.416-1, M-13).

EGTRRA creates a new safe harbor for 401(k) plans that are top-heavy where the plan adopts a safe-harbor matching contribution. These plans are deemed to have met the top-heavy minimum contribution requirements if no contributions permitted under the safe harbor are made (for example, no profit-sharing contribution). A safe-harbor

401(k) plan using the safe harbor nonelective contribution is specifically excluded from the definition of a top-heavy plan.

3.9 Section 401(k) Cash or Deferred Arrangements

A cash or deferred arrangement (CODA) is a 401(k) plan under which an employee can elect to receive an employer contribution as cash or have it deposited to a qualified plan. These contributions are discussed under section 3.3.2 of this chapter. Only the portion actually received in cash is considered taxable income. IRC Sec. 402(a)(8) provides a special exemption from taxation to the participant with elective contributions.

The maximum calendar-year deferral or elective contribution is the lesser of (1) the maximum salary deferral to a 401(k) and SEP salary reduction plan (the 402(g) limit) or (2) 100 percent of predeferral compensation (IRC Sec. 402(g)). The maximum deferral for 2007 is $15,500. Note that 401(k) plans are subject to the following additional requirements:

- No more than one year of service may be required for participation.
- Amounts deferred from taxation by payment into the qualified trust may not be paid out without penalty before the employee's termination of employment, retirement, or death, except in the case of disability, hardship, attainment of age 59½, or termination of the plan without establishment of a successor plan (IRC Sec. 401(k)(2)(B)).
- Elective contributions are fully vested (IRC Sec. 401(k)(2)(C)).

EGTRRA added a provision that allows for employees who are age 50 and older before the end of the plan year to make an additional annual catch-up elective deferral in excess of the 402(g) limits. The additional amount permitted to be made by an eligible individual participating in the plan is the lesser of:

1. The applicable dollar amount, or
2. The participant's compensation for the year reduced by any other elective deferrals for the year (IRC Sec. 414(v)(2)).

The applicable dollar amount for 401(k) plans is $5,000 for the 2007 tax years.

Catch-up contributions are not subject to any other contribution limits and are not taken into account in applying other contribution limits (IRC Sec. 421(v)(4)). Additionally, if all plan participants are allowed to make the same election for catch-up contributions, these contributions are not considered for purposes of the IRC Sec. 401(a)(4) nondiscrimination rules. An employer is allowed to make matching contributions on the catch-up contributions.

Planning Tip:
Older HCEs who may have been limited in the amount of elective deferrals that could be made in prior years due to failure of nondiscrimination testing now can catch up on these lost deferral amounts. Since these catch-up contributions are not considered in a plan's current year discrimination testing, the catch-up contributions will not be limited due to failure of the tests. For employers who do not currently maintain a 401(k) plan due to the elective deferral limitations on HCEs, this change presents the opportunity for older business owners to defer income without regard to nondiscrimination testing limitations.

A CODA arrangement must be part of a profit-sharing or stock bonus plan. However, employers are not required to have current or accumulated profits to make contributions to any profit-sharing plan (IRC Sec. 401(a)(27)). Tax-exempt or government employers may adopt a CODA (IRC Sec. 401(k)(4)(B)). CODAs that are part of a money-purchase plan in existence on June 27, 1974, that included a salary reduction agreement, are grandfathered under prior law.

An employer may not condition an employer plan's contributions or plan benefits, except for matching contributions, upon participants' making or not making an elective deferral.

3.9.1 Hardship distributions

Because of the restrictions on making in-service distributions of elective contributions, employers are required to monitor any hardship distributions that are permitted when certain conditions are met to assure continued qualification of the plan. An in-service distribution is a distribution made to a participant who is still employed by the plan sponsor, and has not met the plan's eligibility for retirement. A distribution of elective contributions qualifies as a hardship distribution only if permitted in the plan document and when two conditions are made:

1. The distribution is made on account of an immediate and heavy financial need of the employee.
2. The distribution is necessary to satisfy such financial need.

There are two methods to determine whether a distribution qualifies as a hardship distribution. The first is a determination based on the facts and circumstances, and the second is based on distributions meeting certain safe harbors. For most employers, the safe harbors will permit a more uniform administration of distributions, even if those requirements are more limiting. An in-service distribution of salary deferrals that does not meet the requirement of a financial hardship is a qualification failure.

3.9.1.1 Facts and circumstances

In using the facts and circumstances method, an employer needs to develop uniform rules to apply in the determination of hardship distributions and maintain records to support each decision. The regulations permit the employer to identify reasonable criteria when evaluating whether a request meets the definition of "an immediate and heavy financial need" of the participant (Reg. 1-401(k)-1(d)(3)).

To satisfy the second criterion of a hardship distribution under the facts and circumstances, Reg. 1.401(k)-1(d)(3)(iii) provides that certain steps be followed before completing the distribution. These requirements provide assurance that the distribution is not in excess of the amount required to satisfy the financial need. In general, an employer can rely on the participant's representation that other financial sources are not available from any one of the following sources:

— Through reimbursement of compensation of insurance or otherwise

— By reasonable liquidation of the participant's assets

— By ceasing the participant's elective or voluntary contributions under the plan

— By making all available withdrawals or nontaxable loans from any qualified plan

— By borrowing from commercial sources on reasonable terms

3.9.1.2 Safe-harbor hardship distributions

There are two steps in determining if a distribution qualifies as a safe-harbor hardship distribution. In addressing the first criterion, "an immediate and heavy financial need" of the participant, Reg. 1.401(k)-1(d)(3) identifies the following six financial needs as meeting the definition:

1. Payment of medical expenses of the employee, spouse, or dependents
2. Purchase of a participant's principal residence, but not including mortgage payments
3. Payment of annual tuition of postsecondary education for the participant, spouse, children, or dependents
4. Expenditures to stave off eviction or foreclosure of a mortgage on the employee's principal residence
5. Payments for prescribed funeral or burial expenses.

6. Payments for repairs to a principal residence that would otherwise qualify as casualty loss amounts.

In applying the safe-harbor rules to the second criterion (that the amount does not exceed the amount necessary to satisfy the financial need), all of the following requirements must be satisfied:

1. The participant has made all available withdrawals (other than hardship withdrawals) and all nontaxable loans currently available under any plan maintained by an employer.
2. All elective deferrals under any plan maintained by the employer must be suspended for at least six months after the hardship distribution.

Note: The requirement that the maximum salary deferral of a participant be reduced by the amount of the portion of the current-year deferral that is part of the hardship distribution has been removed.

3.9.2 Roth elective deferral plans

Starting in 2006, plan participants are allowed to elect to have all or a portion of their elective deferral contributions to 401(k) plans and 403(b) tax-sheltered annuities treated as Roth contributions (IRC Sec. 402A(a)). The Roth deferrals are required to be maintained in a separate account established by the plan sponsor, with deferrals treated under the Roth alternative included in the income of the participant in the year the amounts are deferred. However, distributions from such Roth accounts are normally not taxable, similar to the manner in which Roth IRA distributions are handled.

To be non-taxable in the year of distribution, the distribution must be made after the end of a specific non-exclusion period, as defined below, and either:

- Made on or after the date the participant reaches age 59½.
- Made to a beneficiary, or the participant's estate, after the participant's death.
- Made to the participant due to the participant's disability.

The non-exclusion period is the five-year tax period beginning with the earlier of:

- The first tax year for which the participant made a Roth contribution to any Roth qualified plan account under the plan.
- The first tax year the participant made Roth contributions to the other plan if the participant made a rollover contribution from another plan with Roth contributions made to it.

The annual dollar limitation on a participant's Roth contributions is the annual limitation on elective deferrals ($15,500 in 2007), reduced by the elective deferrals of the participant not designated as Roth contributions. Catch-up contribution amounts for taxpayers age 50 or older also apply ($5,000 in 2007).

There is no income limit or net worth limit on elective deferrals into these Roth accounts, although distributions from the accounts are subject to the minimum distribution rules, similar to other pre-tax elective contributions. However, the minimum distribution rules can be avoided by rolling the Roth elective deferral account into a Roth IRA at retirement or separation from service, where no minimum distribution rules apply until after the death of the account owner.

Practice Tip:
These Roth elective deferral accounts may be particularly attractive to high income employees, who have been precluded in the past from making Roth IRA contributions due to the income limits that apply for Roth IRA contributions. These higher income taxpayers are allowed to contribute the 2007 maximum elective deferral amount of $15,500 to a Roth elective deferral account, plus an additional $5,000 of catch-up contributions if the taxpayer is age 50 or older. Additionally, taxpayers qualifying under the income limits for Roth IRA contributions are allowed to make such contributions in addition to the Roth elective deferral contribution, assuming participant cash flow permits.

3.9.3 Credit for elective deferrals

To encourage low- and middle-income taxpayers to establish or maintain private savings accounts, EGTRRA established a nonrefundable credit for elective contributions to 401(k) and other qualified retirement savings plans (IRC Sec. 25B). The amount of the credit for a tax year is equal to the applicable percentage times the amount of savings contributions (not to exceed $2,000) made by an eligible individual. The applicable percentage is determined by the taxpayer's filing status and adjusted gross income. The contribution amount must be reduced by any distributions received from the plan during the year. The credit may be used against both regular and alternative minimum tax liability. The maximum credit rate is 50 percent, which is completely phased out at $50,000 for joint filers, $37,500 for head of household, and $25,000 for single and married filing separately filers (IRC Sec. 25B(b)). These amounts are indexed for inflation in $500 increments starting in 2007. To be eligible for the credit, an individual must be at least age 18 as of the close of the tax year and cannot be claimed as a dependent on someone else's tax return.

The credit for elective deferrals is applied after the credit for child and dependent care and the child tax credit. Since the elective deferral credit is a nonrefundable credit it cannot reduce a taxpayer's liability below zero. Because of this, employees should be encouraged to take advantage of any tax-preferred flex plan offered by their employer to help cover the cost of child and dependent care. This will allow them to avoid claiming a dependent care credit and possibly losing the benefit of the elective deferral credit.

The credit is effective for tax years beginning after December 31, 2001, and was made permanent by the Pension Protection Act of 2006 (IRC Sec. 25B(g)).

Planning Tip:

The credit for elective deferrals should motivate lower-paid employees to contribute to their employer's savings plan. Employers that have historically had difficulty in passing nondiscrimination tests should market this new credit to employees to increase levels of participation and, in turn, help to correct actual deferral percentage (ADP) testing failures.

3.10 Employee Stock Ownership Plans

In recent years, particular attention has been given to ESOP plans. An ESOP is a defined-contribution plan that is qualified as a stock bonus plan or a combination of a stock bonus and money-purchase plan. The plan(s) must be designed to invest primarily in qualifying employer securities (IRC Sec. 4975(e)(7)). Qualifying employer securities can be common stock readily tradable on an established securities market or common stock not readily tradable. Special rules apply to stock not meeting the readily tradable definition. Such stock is required to have the highest voting power and the greatest dividend rights (IRC Sec. 409(l)). Annual valuation is required by an independent appraiser (IRC Sec. 401(c)(28)(C)).

3.10.1 Employee incentives

ESOPs are designed to place the employer's stock ownership in the hands of a qualified trust for the benefit of the employees and their beneficiaries, thereby presumably creating an incentive for better job performance. In addition to their use as employee incentives, ESOPs can—

— Broaden the base of stock ownership.

— Help resist unfriendly takeover attempts.

— Implement spin-offs of divisions.

— Assist the employer corporation in raising capital and provide a tax deduction without any immediate cash outlay.

On the other hand, potential disadvantages with ESOPs include the following:

— Dilution of the present owners' control

— Difficulty in valuing stock (if closely held)

— Employee resentment if good earnings are not achieved

Voting rights of the employer's stock are passed through to the participants in the plan, depending on the kind of stock and issue to be voted. A distinction is made between registration-type securities and other securities. Registration-type securities are generally required to be registered under Section 12 of the Securities Exchange Act of 1934. For registration-type securities, each participant must be allowed to direct how his or her allocated securities will be voted (IRC Sec. 409(e)(2)). If the employer has no such securities, each participant must be allowed to direct the vote on corporate matters with respect to approval or disapproval of merger, consolidation, recapitalization, reclassification, liquidation, dissolution, sale of substantially all assets, or similar transactions (IRC Sec. 409(e)(3)).

3.10.2 Diversification and distributions (ESOPs)

TRA 1986 added a diversification requirement to these plans for participants age 55 or older and with at least 10 years of participation. These participants must be allowed to direct the investment of at least 25 percent of their account balances during the five-year period beginning with the plan year after the participant attains age 55. This amount is later increased to 50 percent (IRC Sec. 401(a)(28)(B)).

Unless elected otherwise by the participant, distributions from an ESOP must begin not later than one year after the close of whichever plan year is one of the following:

— The year in which the participant separates from service because he or she has attained normal retirement age, or because of disability or death.

— The year that is the fifth year following the separation, if for other reasons.

Securities in the participant's account that were part of a qualified loan under IRC Sec. 404(a)(9) are exempt from this requirement until the loan is repaid (IRC Sec. 409(o)(1)(A)).

Unless the participant elects otherwise, distribution of ESOP benefits must be made in substantially equal payments over a period not longer than the greater of one of the following:

— Five years

— Five years plus one additional year (but not more than five additional years) for each $180,000 (2007) by which the participant's account balance exceeds $915,000 (2007) (IRC Sec. 409(o)(1)(C)) (see Appendix 2)

Participants entitled to a distribution from the plan have a right to demand that benefits be distributed in the form of employer securities (IRC Sec. 409(h)(1)). If the securities are not readily tradable, the employer must be ready to repurchase them or provide a 60-day put option (IRC Secs. 409(h)(1)(B) and 409(h)(4)). In certain cases, however, cash may be an acceptable medium for distribution (IRC Sec. 409(h)(2)).

3.10.3 Seller incentives

In addition to the employee incentive, tax incentives are also available to the seller. Persons selling qualified securities to the plan may elect nonrecognition of long-term capital gain if, immediately after the sale, at least 30 percent of each class or of the total value of the corporation's stock is held by the plan (IRC Secs. 1042(a) and (b)). For this purpose, qualified securities are employer securities issued by a domestic corporation that have no readily tradable stock outstanding (IRC Sec. 1042(c)(1)). To obtain these tax benefits, certain written statements must be provided to the IRS, and the seller of the securities must then purchase qualified replacement property. Sellers of S corporation stock are not eligible for the special IRC Sec. 1042 rollover treatment.

Employers are also subject to a 10 percent excise tax for certain changes in stock ownership made within three years of a sale that qualifies for 1042 treatment to the ESOP.

Dividends of C corporations paid in ESOP owned stock are deductible by the paying corporation maintaining the ESOP where the dividend is:

— Paid directly to the plan participants or their beneficiaries,

— Paid to the plan and then distributed to the participants or their beneficiaries, or

— Paid to the plan to make payments on a loan incurred to purchase employer securities to the extent the dividends are paid on employer stock acquired with the loan

One of the most significant features of using an ESOP loan to purchase employer stock is that contributions made to a plan to pay the principal of the loan become deductible to the corporation.

EGTRRA allows C corporations to deduct, at the election of the plan participants, dividends paid to an ESOP and reinvested in qualified employer securities. Thus, EGTRRA expands the dividend deduction allowable to include dividends that are voluntarily reinvested in employer stock. This provision eliminates the savings disincentives concerning ESOPs by allowing dividends paid to an ESOP to be kept in the plan without the loss of the dividend deduction.

Planning Tip:
The Conference Committee Report to EGTRRA provides guidance on what is considered a "reasonable" dividend for purposes of reinvested dividends. A dividend paid on common stock that is primarily and regularly traded on an established securities market should be considered reasonable. For employers that do not have their stock traded on an exchange, the reasonableness of a dividend is determined by comparing the dividend rates for similar corporations whose stock is traded. Relevant characteristics, such as industry, corporate size, earnings, debt/equity structure, and dividend history, also determine whether or not a corporation's dividend is reasonable.

4. DEDUCTION LIMITS

Contributions to a qualified plan that would otherwise be deductible pursuant to IRC Sec. 162 are not deductible unless specifically permitted under IRC Sec. 404. Contributions deposited to a plan before the end of the plan year and in an amount in excess of the deduction limitation are subject to a 10 percent excise tax. Nondeductible amounts may be carried over to a subsequent year and are deductible in that year if permitted. There is an annual penalty for each year that amounts remain nondeductible (IRC Secs. 404 and 4972(c)). Employers should note that a contribution that is not deductible may not be withdrawn from the plan and redeposited in the employer's account, unless the plan document so permits, and most plans do not. To do otherwise is a violation of ERISA's "exclusive benefit" requirement.

The Code requires that the compensation of an individual must be reasonable to be deductible. This determination aggregates plan contributions and compensation (IRC Sec. 162).

Defined-contribution pension and profit-sharing plans are subject to two separate limitations in determining the maximum annual contribution deduction. Defined-benefit pension plans are subject to a separate set of deduction limits.

4.1 Pension Plans

The maximum tax deduction for contributions to a defined-benefit pension plan is determined under any one of three alternative standards.

1. *Minimum funding.* The amount necessary to satisfy the minimum funding standard for the plan year ending within or with the employer's taxable year (or for any previous plan year).
2. *Level funding.* The amount necessary to provide all participants their remaining unfunded cost of past and current service credits distributed as a level amount or a level percentage of compensation over the remaining service of the employee. If more than 50 percent of the remaining unfunded costs is attributable to any three participants, the amounts attributable to such participants must be spread over at least five years.
3. *Past service funding.* The amount equal to the normal cost of the plan plus an amount necessary to amortize past service credits in equal annual installments over 10 years.

The selection of the applicable standard is made on a year-by-year basis; that is, the employer can use whichever standard results in the largest deduction (IRC Sec. 404(a)(1)). A separate deduction limit applies when an employer maintains both a defined-benefit and defined-contribution plan. (See section 4.3.)

4.1.1 Deductions: Contributions to defined-benefit plans

The funding of a defined-benefit plan is determined under one of the IRS-approved level cost methods. In general, an employer can deduct the amount necessary to fund the present and past service cost. This amount is generally calculated to spread the cost of the benefits over the working lives of the participants.

For purposes of determining the annual funding and plan liabilities of a defined-benefit pension plan, the projected benefits cannot exceed the maximum permissible benefit limits. The maximum annual benefit at retirement is the lesser of $180,000 for 2007 (plus COLA), or 100 percent of the participant's average compensation (see Appendix 2; IRC Sec. 415(b)). For a Planning Tip related to this increase, see section 3.7.1.

4.1.2 Deductions: Contributions to defined-contribution plans

The annual deduction limit for a defined-contribution pension plan is 25 percent of the total eligible compensation paid in the employer's tax year. This limitation is in addition to the annual additions limit that is applied to each participant for the limitation year. If the plan year and the limitation year coincide, basically an employer can deduct the sum of the required contributions for each participant (IRC Sec. 415(c)). For the 2007 plan year the annual additions limit is capped at the lesser of $45,000 or 100 percent of compensation in the "limitation year" (which is usually the plan year). The 100 percent limitation is applied to gross compensation (for example, add 401(k) salary deferrals and Section 125 salary reductions to taxable compensation). This allocation limitation is applied to each individual's total allocation of employer contributions, forfeiture reallocations, and employee contributions (both before-tax and after-tax) in the limitation year. For most defined-contribution pension plans, forfeitures of nonvested accounts are used to reduce the required employer contribution, are not reallocated, and reduce the employer's contribution deduction. A few plans permit, and some require, after-tax employee contributions (now subject to the ACP tests of IRC Sec. 401(m)), which are part of the annual addition limits but are deductible as compensation, not contributions. (IRC Secs. 404(a) and 415(c)).

When the plan year and employer's tax year coincide, the employer will deduct the contributions made to the plan year coinciding with the tax year. When the employer's tax year and the plan year do not coincide, the employer may deduct the plan contributions for the plan year ending in, or beginning in the tax year. The employer may also deduct a pro rata portion of the two plan years that overlap the employer's tax year. However, the taxpayer must apply the method on a consistent basis. Note that while the amount of the tax deduction is based on compensation in the tax year, compensation for purposes of calculating the annual additions limit is based on compensation paid in the limitation year (IRC Sec. 414(q)).

The deduction limitation may include compensation that is not used to determine the allocation of contributions. For example, if the plan allocates contributions only on compensation after entry into the plan, the employer may use the participant's full compensation for the tax year in determining the maximum deduction.

For purposes of determining the maximum deduction under any defined-contribution plan, employers may count only the compensation of participants who received a meaningful contribution. For example, the pay of a participant who is excluded from receiving a contribution solely because he or she terminated employment or did not work 1,000 hours cannot be used to determine the maximum deduction. If a plan bases the contribution allocation on some amount less than the employee's gross pay (say, base pay), however, that individual's gross compensation for the tax year may be used in the deduction calculation (Reg.

1.404(a)-9(b)). When an employer maintains more than one profit-sharing or stock bonus plan, or a profit-sharing plan and a stock bonus plan, the maximum deduction limitation is applied to all such plans on a combined basis (IRC Sec. 404(a)(3)).

4.2 Deductions: Profit-Sharing or Stock Bonus Plans

Profit-sharing and stock bonus plans are subject to the same deduction limit and annual additions limit described in Section 4.1.2 with one exception for 401(h) plans. That is, the maximum tax deduction is 25 percent of total eligible compensation paid in the employer's tax year.

For years beginning after December 31, 2001, elective deferral contributions to a 401(k), SARSEP, 403(b), or SIMPLE plan are no longer deemed employer contributions and are therefore excluded from the 25 percent of pay deduction limit calculation (IRC Sec. 404(n)). That is, only the employer contribution is subject to the 25 percent of pay deduction limit.

Beginning in 2002, participants in a 401(k) plan, a SARSEP, 403(b), 457, and SIMPLE plan who have attained age 50 may elect to make a catch-up contribution. Like other salary deferrals, these are not counted in the 25 percent of pay deduction limit.

Planning Tip:
With the increase in the deduction limit for profit-sharing plans to 25 percent of eligible compensation, there is no longer a need to maintain tandem money-purchase and profit-sharing plans to maximize the employer's deduction. In fact, if employers wish to increase the deduction limits, they will want to add a 401(h) salary deferral feature to the plan. Employers who sponsor a 401(k) plan will potentially have greater deductible amounts available to contribute since elective deferrals are no longer considered in calculating the deduction limits.

Profit-sharing plans generally provide for discretionary annual contributions and thus do not have a required funding formula. The Code, however, requires a profit-sharing plan to have a specific formula for allocating the employer's annual contribution. For discretionary corporate plans (profit-sharing plans), the amount of contribution is determined by the board of directors, but need not be set into the corporate minutes before the end of the plan year. TRA 1986 removed the requirement that an employer's contributions be contingent upon the existence of current or accumulated profits (IRC Sec. 401(a)(27)). Now non-profits or failing corporations can make contributions to a profit-sharing plan even if the contributions are not deductible because no profits exist. For purposes of determining the maximum defined-contribution deduction, forfeiture reallocations do not affect the calculation. Compensation for purposes of determining deductible contributions cannot exceed $225,000 for 2007. Gross compensation (for example, taxable pay plus 401(k) or 125 elective contributions) is used in the deduction calculations. Refer to Appendix 2 for the COLAs.

Profit-sharing plans are generally required to allocate the entire employer contribution, up to the annual additions limitations, unless the document provides otherwise. Thus, a profit-sharing plan may not carry any unallocated contributions or forfeitures in suspense unless each participant has received an allocation of the maximum annual addition amount, unless the document specifies otherwise.

4.3 Combined Plan Deduction Limits

When an employer maintains both a defined-benefit and a defined-contribution plan, the deduction limits are modified. The maximum deductible contribution is the greater of the following: (1) the amount required to be funded for the defined-benefit plan or (2) 25 percent of the total eligible compensation paid in the employer's tax year, excluding all salary deferrals to a 401(h), 403(b), SARSEP, SIMPLE, or 457 plan (IRC Sec. 404(a)(7)). Compensation for this purpose is gross compensation.

This 25 percent limit applies only if at least one employee participates in both plans. Thus, if the employer maintains two plans for two distinct groups of employees, the 25 percent limitation does not apply.

Nondeductible contributions are subject to a 10 percent excise tax (IRC Sec. 404(a)(7)). Thus, an employer may be forced to make contributions to a money-purchase plan that is maintained along with a defined-benefit pension plan that are not deductible and are subject to an excise tax. Any nondeductible amounts may be carried forward to a subsequent year when deductible.

4.4 Deductions: Plans for Self-Employed Persons and Other Owner Employees

So far, this chapter has addressed the rules and limitations of qualified plans set up by corporate employers. Self-employed individuals and partnerships may also sponsor a qualified retirement plan. The rules relating to the adoption and operation of a plan for a self-employed individual or partnership are generally the same as those for corporate employers. Note that a plan covering a partner must be adopted by the partnership. A self-employed individual may only participate in a plan if the individual has earned income for the taxable year and also is one of the following:

1. Would be self-employed except that the trade or business carried on by this individual had no net profits for the year
2. Has been a self-employed individual for any prior taxable year (IRC Sec. 401(c)(1)(A))

The plan requirements that apply to partners in a partnership also apply to members in a limited liability company (LLC) taxed as a partnership.

Earned income is the net earnings from self-employment in a trade or business in which the personal services of the taxpayer are a material income-producing factor (IRC Sec. 401(c)(2)(A)).

The contributions for the self-employed are more difficult to determine than for common-law employees because contribution limits are based on earned income after subtracting the contribution for the self-employed individual and one-half of the individual's self-employment taxes. In concept, the maximum 25 percent defined contribution for a self-employed individual is 20 percent of gross earned income after subtracting one-half of the self-employment taxes. Plans covering self-employed participants are subject to the same overall limits of IRC Sec. 415 that apply to corporate employers (see Section 3.7 of this chapter). A special rule adds back the individual's salary deferral to a 401(k) plan. The maximum annual benefit under a defined-benefit pension plan at retirement is the lesser of the IRC Sec. 415(b) limit, dealing with the defined-benefit plan limitation, or the plan participant's average earned income (IRC Secs. 415(b) and (c)).

Thus, the contribution for the self-employed individual may not create a loss unless the plan is a defined-benefit pension plan. However, when the contribution for the common-law employees is greater than the earned income, the expense is treated as any other expense and may result in a net loss for tax purposes.

After EGTRRA, self-employed individuals are permitted to have participant loans (IRC Sec. 4975). The rules covering participant loans are discussed in section 5.8 of this chapter.

A partnership that conducts a trade or business may cover a member who has "net earnings from self-employment" under a qualified plan that it sponsors (PLR 9432018; IRC Sec. 401(c)(2)(A); Reg. 1.1402(c)-1. A general partner's distributive share of the partnership's income is "net earnings from self-employment," whether or not the general partner renders services to the general partnership (IRC Sec. 1402(a)). However, for IRC Sec. 401(a) purposes, the net earnings of an individual include only trade or business income of a partnership if a material amount of the partnership's income is produced by personal services provided by the taxpayer (IRC Sec. 401(c)(2)(A)(i)).

As a result, only those members who provide services to the partnership in the conduct of the partnership's trade or business may participate in the partnership's qualified retirement plan (Reg. 1.401-10(c)(3); **Frock**, 56 TCM 1368 (1989); **Ugh**, 49 TCM 748 (1985); **Frock**, 50 TCM).

Relevant Tax Code Sections

IRC Sec. 401(c)(1)(A)	A self-employed individual is treated as an employee for plan purposes.
IRC Sec. 401(c)(1)(B)	A self-employed individual is an individual who has *earned income* as defined in Sec. 401(c)(2)(A).
IRC Sec. 401(c)(2)(A)	The term *earned income* means "net income from self-employment" as defined in Sec. 1402(a) with respect to a trade or business in which personal services factor, and after a deduction for one-half of Self-Employment Contributions Act (SECA) taxes allowed under Sec. 164(f).
IRC Sec. 401(c)(3)	An owner-employee is any "employer" who owns 100 percent of an unincorporated trade or business or more than 10 percent of either the profits interest or capital interests in a partnership.
IRC Sec. 401(c)(4)	The employer of a sole proprietorship is the individual owning 100 percent of the trade or business. The employer of the partner in a partnership is the partnership.
IRC Sec. 401(c)(5)	*Contribution on behalf of owner-employee.* The phrase "contributions on behalf of an owner-employee" includes contributions under the plan made by the employer for an owner-employee and by the owner-employee.
IRC Sec. 401(c)(6)	A contribution for an owner-employee may be made only with respect to the earned income of such owner-employee derived from the trade or business for which the plan is established.
IRC Sec. 1402(a)(2)(A)	The phrase "net earnings from self-employment" is basically defined as gross income from any trade or business carried on by the individual.
RC Sec. 1402(a)(4)	No deduction for a net operating loss as defined under IRC Sec. 172 is permitted in the calculation of net earnings from self-employment.
IRC Sec. 1402(a)(12)	*Calculating self-employment taxes.* In lieu of the deduction permitted under IRC Sec. 164(f) for one-half of the self-employment taxes, an alternative calculation is permitted. Without this exemption, the calculation would be circular, and most difficult to calculate. The determination of earned income for self-employment taxes can be based on .9235 (1 minus one-half

the SECA tax rate) multiplied by the taxpayer's net earnings from self-employment before this calculation applies.

Example. An individual's earnings from self-employment in 2007 are $120,000. The SECA taxes are calculated as follows:

Adjustment under IRC Sec. 1402(a)(12) in lieu of IRC Sec. 164(f) deduction	$120,000 × .9235 = $110,820
Social Security taxes @ 12.4% up to $97,500	12.4% × $97,500 = $12,090
Medicare	2.9% × $110,820 = $3,214
Total SECA taxes	$15,304

4.4.1 Partnership versus corporate plans

In general, any qualified plan that may be adopted by a C corporation may be adopted by the partnership. In some cases, the amount of a deductible contribution for members of a partnership may be more limited than contributions for an employee of a C corporation.

4.4.1.1 Contribution and "compensation"

The overall contribution and benefit limitations that apply to a partnership-sponsored plan and a corporate plan are controlled by IRC Sec. 415. IRC Sec. 415(c) limits the annual amount that an "employer" may contribute to a defined-contribution plan (or combination of plans) on behalf of any participant, including a member in an LLC taxed as a partnership, to the lesser of $45,000 or 100 percent of "compensation" for the 2007 plan year. There is no statutory limit on the amount that may be contributed to a defined-benefit plan; rather, IRC Sec. 415(b) limits the maximum benefit payable to a participant under the defined-benefit pension plan. These limits basically apply in the same way to both corporate and noncorporate entities. However, two exceptions apply:

1. A partner may not deduct an operating loss that is attributable to a required contribution of a plan maintained by a partnership.
2. The plan compensation for a partner is determined on earned income after a deduction for one-half SECA taxes and the contribution attributable to the partner, thereby slightly lowering the overall contribution when compared to the amount available for similar compensation of an employee under a corporate plan.

Qualified compensation in any plan is limited to $225,000 for 2007 as adjusted for cost of living. Thus, regardless of the actual compensation payable to an employee, or a member's earnings from self-employment from a partnership, the partnership cannot consider compensation or earnings from self-employment after the plan contribution in excess of the limit. Remember, this calculation is made after subtracting one-half of the self-employment taxes and the contribution for the self-employed individual (IRC Sec. 401(a)(17)).

In determining how the limitations apply to contributions on behalf of a member, a member's net earnings from self-employment are reduced by—

1. The actual amount of the contribution made on behalf of the self-employed individual.
2. The member's tax deduction for one-half of the SECA paid by the individual member.

See the Note in Section 4.4.1.2 for a discussion of an alternative to the calculation of SECA taxes illustrated in footnote 1 in this example (IRC Secs. 415(c)(3)(B), 401(c)(2)(A)(v) and (vi)).

Example 2007. Compare the take-home pay of an employee of a corporation and member of a partnership taxed as a partnership. The employer wishes to maximize the employee's contribution to a pension plan:

	Corporate Employer	*Partnership*
Income before compensation to owner or member and contribution	$132,495	$132,495
SECA taxes		(15,638)[1]
Compensation to owner	(100,000)	
Maximum plan contribution	(25,000)	(24,935)[2]
Employer portion of FICA	(7,495)[3]	
Corporate taxable compensation	0	
Net income to member		0
Take-home (after employee's FICA withholding)	$ 92,505	$ 91,922[4]

[1]SECA taxes 12.4% of $97,500 plus 2.9% × .9235 × $132,495
$132,495 × .9235 = $122,359
Social Security portion = 12.4% up to $97,500 = $12,090
Medicare 2.9% × $122,359 = $3,548
Total SECA taxes + $12,090 + $3,548 = $15,638

[2]Contribution is .20 × ($132,495 − (.5 × $15,638)) = $24,935
(factor for contribution is .2)

[3]Social Security 6.2% of $97,500 = $6,045 plus
Medicare taxes 1.45% of $100,000 = $1,450

[4]Net income from self-employment less all SECA taxes and plan contributions

4.4.1.2 Sub S difference

Contributions by a corporation to a pension plan on behalf of a shareholder-employee are not subject to FICA or Medicare taxes, whereas all of a partnership's members' distributive share of the partnership after the .9235 adjustment is subject to SECA taxes (subject to the annual cap) and unlimited Medicare tax. The flow-through income to an S shareholder cannot be used to determine the contribution for the S shareholder (*Durando,* 9th Cir.). A partner with earnings from self-employment does not receive salary, but may use all of the distributive share of income in calculating the contribution.

Note: The Code allows a deduction in determining the earned income subject to SECA taxes under IRC Sec. 1402(a)(12). In lieu of deducting one-half of the actual SECA taxes (as permitted under IRC Sec. 164(f)), the taxpayer is allowed a deduction developed by multiplying the net earnings before SECA taxes by one-half the SECA tax rate (that is, 7.65 percent). This is applied to self-employment income by multiplying that earned income by (1 – 7.65%), or .9235. This adjustment is generally more favorable than the deduction under IRC Sec. 164(f).

4.5 Deductions: Employee Stock Ownership Plans

Deductible employer contributions to ESOPs, whether pension or profit sharing, are subject to the general limits for these types of defined-contribution plans. However, for certain ESOPs (called leveraged ESOPs) that have purchased employer stock with a plan-held note, additional deductions are permitted. Employer contributions to a qualified ESOP that are applied to the repayment of such loans are deductible under the following two rules:

1. Principal payments are deductible up to 25 percent of the total eligible compensation (IRC Sec. 404(a)(9)(A)).
2. The full amount of the interest payment on the leveraged ESOP note is deductible (IRC Sec. 404(a)(9)(B)).

See Sections 3.10 and 9.2 of this chapter for additional information on ESOPs.

4.6 Deductions: Timing and Form

To be deductible, contributions must be made either during the employer's taxable year or up to the time for filing the employer's income tax return, including valid extensions. This payment rule applies to both cash- and accrual-basis taxpayers. It is no longer necessary, formally, to recognize the accrual before year end to support the deduction to pension or profit-sharing plans (IRC Sec. 404(a)(6)). The IRS deems that the filing of the tax return is sufficient to validate the accrual.

Payment of the employer contribution generally must be made in cash. Certain transfers of employer-owned securities, third-party notes, or property (called in-kind contributions) of the employer may be eligible for a deduction to a profit-sharing plan, but only if the property is unencumbered. However, a contribution of the employer's promissory note does not entitle the employer to a deduction. Although certain noncash contributions of property may be deductible, they will trigger taxable gain equal to the value of the appreciated property over its cost, and could result in a party-in-interest prohibited transaction (IRC Sec. 267, ERISA Sec. 408(a), and DOL Opinions 81-69A and 90-05A). No transfer of property is permitted for contributions to any pension plan or where contributions to a profit-sharing plan are other than discretionary. When such a transfer is made, a prohibited transaction has occurred. See DOL Interpretive Bulletin 94-3 and IRS Announcement 95-14 for rules on in-kind contributions (see Section 6.2.1 of this chapter).

4.7 Contribution Withdrawals

In an effort to avoid the 10 percent nondeductible excise tax or to avoid an unintended allocation of contribution in a profit-sharing or stock bonus plan, an employer may be tempted to withdraw the excess contribution from the plan. Such a withdrawal would likely violate a requirement that plan benefits must be for the exclusive benefit of participants. Such a withdrawal and return to the employer is permitted for only a few limited exceptions and only when permitted in the plan document. These exceptions include the following:

— Contributions made on account of a mistake of fact. Such withdrawals are restricted and must be within one year of the date that the deposit was made, and, generally, are only available for defined-benefit plans. The plan document must specify that such a withdrawal may be made (Rev. Proc. 90-49) (PLR 9436045).

— Reversions in a defined-benefit pension plan, which generally are subject to a 50 percent excise tax. If a portion of the reversion is contributed to a defined-contribution plan, the excise tax is reduced to 20 percent if either of the following requirements is met:
  1. At least 25 percent of the maximum reversion is transferred to the defined-contribution plan, or
  2. Provides a pro rata increase in terminated participants in terminated plan of 20 percent

— Deposits that are made conditional on the deductibility of the contribution, where the contribution is not deductible, and the plan permits a withdrawal if the deposits are not deductible. This is generally available for employers adopting a plan making its initial deposits, before the IRS has completed the determination letter process, that is denied and the deposits are returned.

Unauthorized withdrawals may subject the plan to penalties and disqualification (Rev. Rul. 85-6; Committee Reports ERISA, 1974, Section 403).

Certain employee withdrawals are permitted. See the discussion of hardship withdrawals in Section 3.9.1 of this chapter.

4.8 Credit for Plan Start-Up Costs of Small Employers

Employers with 100 or fewer employees will receive a tax credit for some of the costs of establishing new retirement plans, effective for costs incurred in tax years beginning after December 31, 2001. The credit equals 50 percent of the start-up costs incurred to create or maintain a new retirement plan (IRC Sec. 45E(a)). The credit is limited to $500 in any tax year and may be claimed for costs incurred in each of the three years beginning with the year the plan becomes effective.

An eligible retirement plan is a new defined-benefit plan, defined-contribution plan, SIMPLE plan, or SEP plan. Additionally, the plan must cover at least one NHCE for the sponsor to qualify for the credit.

To be eligible for the credit, an employer must not have employed more than 100 employees who received at least $5,000 in compensation in the preceding year.

The credit is only available for new plans established after December 31, 2001. Therefore, if an employer maintained a qualified plan during the three-tax-year period immediately preceding the first year in which the new plan is effective, the sponsor will be disqualified from receiving the credit (IRC Sec. 45E(c)(2)). Aggregation rules apply in determining whether a prior plan existed. Therefore, the credit will be disqualified for a member of a controlled group in which a member maintained a plan during the three-tax-year test period.

Qualified start-up costs are any necessary and ordinary expenses incurred to establish or administer the plan or educate employees about retirement planning. The credit is limited to the first $1,000 of qualified costs incurred in each of the first three years. To avoid a double tax benefit, costs are not deductible to the extent they are offset by the tax credit (IRC Sec. 45E(e)(2)).

The credit is claimed as part of the general business credit for the tax year in which the plan becomes effective (IRC Sec. 38(b)(14)). However, at the employer's election, the credit may be claimed in the year immediately preceding the year in which the plan is effective (IRC Sec. 45E(e)(3)).

5. TAXATION OF DISTRIBUTIONS

The following three basic rules govern the income taxation of distributions from a qualified plan.

1. If the participant realized no taxable income when the employer contributed to the plan, tax is incurred when a distribution is made.
2. If the participant incurred tax when the contribution was made to the plan (for example, a salary deferral of an HCE that is treated as an after-tax employee contribution to satisfy the ADP test), the distribution of these funds is tax-free.
3. For qualifying distributions, it is possible to defer the imposition of income tax at the time of distribution by transferring all or a part of the distribution to another "eligible" retirement plan or a rollover IRA.

Special rules apply to the income taxation of distributions and the availability of rollovers. The rollover rules were greatly simplified starting in 2002.

The form of a distribution is determined under the plan document and may differ from plan to plan. The most common forms of distribution from a pension or profit-sharing plan are as follows:

- A single-sum payment of all of the participant's account balance
- A series of periodic payments based upon the participant's account balance
- An annuity (if married, a joint and survivor annuity)
- A combination of the preceding three

Each of these forms of distribution is subject to a separate set of requirements that can affect their taxability, as well as the participant notification requirements. Special rules apply to married participants.

Benefits under a pension plan (defined benefit or defined contribution) must be paid as an annuity, unless the participant affirmatively elects otherwise. If the participant is married, that election must be consented to by his or her spouse.

5.1 Lump-Sum Distributions: What Are They?

For the most part, participants include the taxable portion of any distribution with the participants' other income to determine the amount of income taxes due. Individuals who were age 50 or older on January 1, 1986 are permitted to apply 10-year averaging (using 1986 rates) for qualifying lump-sum distributions. A lump-sum distribution is a complete payment of the participant's entire balance after the participant attains age 59½ or dies and if the distribution also satisfies the following requirements.

— The distribution is made within a single tax year of the recipient.

— The participant must also receive a lump-sum distribution from all similar plans. Similar plans are divided into three groups: profit-sharing plans, stock bonus plans, and pension plans (both defined contribution and defined benefit).

— The distribution is made on account of one of the following triggering events:
  - The participant's death
  - The employee's attainment of age 59½
  - The participant's termination of employment, an option that is not available to self-employed participants
  - A self-employed participant's becoming totally and permanently disabled (IRC Sec. 402(d)(4)(A))

In addition, the employee must have been a participant in the plan for five or more taxable years. This five-year restriction does not apply to lump sums paid as a death benefit (IRC Sec. 402(e)(4)(h)).

Distributions from an IRA are not eligible for lump-sum distribution treatment. Thus, any qualified plan distribution rolled over to an IRA loses this favorable tax treatment.

5.1.1 Lump-sum distributions: How are they taxed?

For individuals who were age 50 or older on January 1, 1986, single-sum distributions that qualified as lump-sum distributions permitted the recipient to elect one of the following methods of taxation:

1. To have the entire distribution taxed as ordinary income in the year of receipt
2. To treat the distribution as ordinary income subject to a special 10-year forward averaging computation using the 1986 rates
3. To defer the income tax by transferring all or a part of the distribution to another qualified plan or IRA through a direct rollover, if completed within 60 days of receipt

If the individual also participated in a plan before 1974, capital gain treatment of a portion of the distribution is available at a flat 20 percent.

Employees electing special forward averaging must apply the averaging to all lump-sum distributions received in the same year. Thus, a portion of one distribution cannot be rolled over while another portion is treated to the special tax averaging (IRC Sec. 402(e)). IRS Form 4972 is used to compute the tax on a lump-sum distribution using one of the methods previously described.

5.1.2 Lump-sum distributions at death: How are they taxed?

Spousal beneficiaries, generally, are permitted to choose from all the distribution options available to a deceased participant. A spousal beneficiary may roll over a lump-sum distribution, even if the participant had been receiving retirement distributions before death (IRC Secs. 402(c)(9) and 402(e)(4)). If the participant has an IRA with the spouse as sole beneficiary, the spouse may treat the IRA as his or her own.

Death benefits that are paid from a plan as proceeds of a life insurance policy are entitled to an exclusion from income tax if the equivalent insurance costs have been paid by the participant (called PS 58 costs). This exclusion is equal to the excess of the face value of the policy over the policy's cash value. To receive the proceeds tax-free, the participant must include as taxable income the annual cost of the insurance. The total amount reported as taxable income each year is treated as basis and cannot be rolled over. These costs (the PS 58 costs) are determined from a table of values; see Rev. Rul. 55-747 and 66-110 (IRC Sec. 101 and Reg. 1.72-16(b)).

5.2 Direct Rollovers

EGTRRA rewrote the way distributions from a plan could be rolled over. The net effect of the law change is to enable just about any kind of distribution, from a plan, an IRA, or 403(b) arrangement or a governmental 457 plan, to be transferred directly to an eligible plan or IRA. The kinds of distributions that are not permitted to be direct rollovers are the following:

1. Minimum distributions on or after age 70½
2. Periodic level distributions that are paid over the participant's life expectancy and for at least 10 years
3. Distributions made because a 401(k) plan failed the ADP and ACP tests

Note that EGTRRA removes the restriction on rollovers of after-tax contributions. For distributions made after December 31, 2001, employees may roll over the entire amount of any distribution, including the amount that represents the after-tax contributions (IRC Sec. 402(c)(2)). To accept rollovers of after-tax contributions, a plan must separately track the pretax and after-tax rollover amounts and any related earnings. Qualified plans, however, are not permitted to accept rollovers of after-tax contributions from IRAs.

Planning Tip:
Before 2002, if a participant cashed out of a plan that held after-tax contributions, the participant had to remove the after-tax portion and could only roll over the pretax contributions. This caused the participant to lose the benefit of tax-deferred earnings accumulation on the after-tax contribution amounts. For 2002 and forward, participants should take advantage of the rollover option for after-tax contributions to continue the accumulation of tax-deferred earnings on these amounts.

Plan distributions that are eligible for rollover are also subject to a withholding requirement of 20 percent of the distributions paid to the participant. No withholding is required of cash distributions from IRAs. A hardship distribution of a salary deferral is no longer treated as an eligible rollover distribution and is therefore not subject to the 20 percent mandatory withholding.

Effective for distributions made after December 31, 2007, the Pension Protection Act of 2006 allows distributions from tax-qualified retirement plans, 403(b) annuities and 457 plans to be directly rolled into a Roth IRA, subject to the same rules that apply to rollovers from a traditional IRA into a Roth IRA. While such rollovers trigger taxable income to the taxpayer, the exception to the 10% premature distribution penalty applies. However, taxpayers with adjusted gross income of $100,000 or more are not allowed to rollover amounts from a tax-qualified retirement plan directly into a Roth IRA, similar to the rules disallowing the direct rollover of a traditional IRA into a Roth IRA for taxpayers with adjusted gross income of $100,000 or more.

Also, effective for distributions after December 31, 2006, the Pension Protection Act of 2006 allows a deceased employee's benefits in an employer-sponsored retirement plan passing to a non-spousal beneficiary to be directly transferred to a traditional IRA, with the IRA then treated as an inherited IRA of the non-spouse beneficiary. Any distributions from the rollover IRA are subject to the normal inherited IRA distribution rules applicable to non-spouse beneficiaries.

Observation:
Prior to this provision in the Pension Protection Act of 2006, a near-immediate payout of the benefit to the non-spousal beneficiary was required upon the death of an employee with an employer-provided retirement plan passing to a non-spouse beneficiary. No IRA rollover was previously allowed.

5.3 Distributions (Recovery of Basis)

Generally, all portions of a periodic distribution are subject to income tax when paid by a plan. However, distributions that include after-tax employee contributions or other "basis" are partially tax-free. Such distributions are taxed based upon whether the distribution is an annuity or a nonannuity distribution. Annuity distributions consist of:

- Non-lump sum payment—the entire payment of the participant's account balance in one year.
- Periodic payments that do not meet these requirements: (1) they begin after the "annuity starting date" for minimum required distributions, (2) they are payable in periodic installments at regular intervals over more than one year, and (3) the total amounts payable are determinable at the start of the payment period. Thus, periodic distribution withdrawals from a participant's account in a defined contribution plan that differs only because of the interest or other income paid on the account are annuity distributions if they commence after the required beginning date.

For nonannuity distributions, the taxable portion of the distribution is determined after calculating a portion of the basis determined under an exclusion ratio. The exclusion ratio is calculated for each withdrawal (with all withdrawals in a year aggregated). The portion of any distribution that is not taxable was the product of the exclusion ratio and the total amount of the distribution for the year. The exclusion ratio is determined by dividing the participant's total basis in the plan by the total value of the account. For example, if the participant in a defined-contribution plan had $1,000 of after-tax contributions in the plan, and the plan account was valued at $10,000, one-tenth of each distribution in the year would be tax-free. The items that make up basis in the plan include loans that were previously deemed taxable, after-tax employee contributions and, under certain conditions, the participant's PS 58 costs. These rules apply only to nonannuity distributions.

The nontaxable portion of an annuity distribution is determined by applying exclusion factors from a table found in IRS Notice 98-2 and IRC Sec. 72(d)(1)(B)(iii). The factors in the table are selected based upon the anticipated period of annuity payments. These payment periods are based on the age of a participant and, if applicable, beneficiary, when the payments commence. The factors are shown below.

Table A (Life Annuity)		*Table B (Joint Life Expectancy)*	
Age of Participant	*Anticipated Payment*	*Combined Ages of Participant and Beneficiary*	*Anticipated Payment*
55 and under	360	110 and under	410
56–60	310	111–120	360
61–65	260	121–130	310
66–70	210	131–140	260
71 and older	160	141 and older	210

The nontaxable portion is determined by dividing the basis in the plan by the factor from the table. This amount is subtracted from each annuity distribution. The difference is taxable to the participant (IRC Sec. 72(b)).

A special exception to the basis recovery rule applies to certain plans in effect on May 5, 1986 that permitted a participant to elect to treat the full amount of the distribution as after-tax employee contributions until all of the employee contributions are withdrawn. The plans are permitted to continue that provision. For these plans, participants may make fully tax-free withdrawals of any after-tax contributions made before December 31, 1986. After that, the exclusion calculation applies based on whether the distribution is an annuity or nonannuity distribution. The plan document must provide for such a withdrawal of employee after-tax contributions (IRC Sec. 72(e)(8)(D)).

In no event can more than the recipient's after-tax contributions be excluded from taxation. If the participant dies before recovering his or her contributions tax-free, the remaining nontaxable amount is deductible on the decedent's final income tax return as a miscellaneous itemized deduction not subject to the 2 percent of AGI limitation (IRS Publication 17).

Before 2002, no portion of an employee's after-tax contribution could be rolled over to another plan or IRA. However, beginning in 2002, after-tax contributions may be rolled over into another plan or IRA (IRC Sec. 402(c)). A rollover between qualified plans must be made through a direct trustee-to-trustee transfer, however (IRC Sec. 401(a)(31)).

5.4 Additional Tax on Premature Distributions

Distributions from a plan or IRA made before a participant's attainment of the age of 59½ are subject to an additional tax, the premature distributions tax, which is an additional tax of 10 percent of the taxable portion of the distribution. The exemptions permitted from this additional tax are described below.

IRAs and Qualified Plans
The following distributions from IRAs and qualified plans are exempt from this early distributions tax:

— Substantially equal payments made over the participant's life. These payments must be made for at least five years and until the individual attains age 59½. See IRS Notice 89-25 and Rev. Rul. 2002-62.

— Distributions after the participant's death

Observation:
In *Gee,* the Tax Court ruled that a taxpayer who rolled over her deceased husband's IRA into her own IRA and then took withdrawals prior to attaining age 59½ was subject to the 10% penalty on premature distributions. Had the taxpayer retained the IRA in her deceased husband's name, the withdrawals would not have been subject to the 10% penalty under the exception that applies to distributions after the participant's death.

— Distribution as a result of disability (in the case of a self-employed individual)

— Certain distributions to the extent of deductible medical expenses

— Distributions rolled over tax-free to an IRA or to another "eligible" plan

— Distributions made to a qualified reservist, defined as a person who by reason of being a member of a military reserve unit was ordered and called to active duty for a period in excess of 179 days or for an indefinite period, where such distribution was made during the period beginning on the date of the order or call to active duty and ending at the close of the active duty period.

Observation:
This provision was enacted by the Pension Protection Act of 2006 for distributions made after September 11, 2001, for individuals ordered or called to active duty after September 11, 2001 and prior to December 31, 2007. Under a relatively short amended return window, taxpayers had until August 17, 2007 to amend returns to obtain a refund of penalty amounts previously paid, despite the fact the statute of limitations had otherwise expired.

— Distributions from a governmental defined benefit pension plan to a qualified public safety employee who separates from service after age 50, defined as an employee of a state or political subdivision of a state if the employee provides police protection, firefighting services, or emergency medical services for any area within the jurisdiction of the state or political subdivision, effective for distributions made after August 17, 2006.

There are additional requirements under the substantially equal payments exclusion identified above. IRS Notice 89-25 provides a detailed description of three methods to calculate such payments. In addition, if the amount of the level payments is changed before the later of age 59½ or within five years, the previous payments will be subject to the additional tax (IRC Sec. 72(t)(4)).

Qualified Plans
The following distributions from qualified plans are exempt from the early distributions tax:

— Payments to an alternate payee under a qualified domestic relations order (QDRO)

— Distributions made to participants that separate from service with the plan sponsor after age 55

— Corrective distributions from a 401(k) or 401(m) plan

— Distribution of excess deferrals under IRC Section 402(g) (that is, the $15,500 salary deferral limit for 2007 or, if age 50 or older, $20,500 for 2007).

5.5 Additional Tax on Large Distributions

The excess distributions tax for distributions that exceed $150,000 (IRC Sec. 4980A) was repealed by the Tax Act of 1997.

5.6 Required Distributions

All plans and IRAs are required to make certain minimum distributions. Generally, distributions of benefits must commence in the calendar year in which a participant attains age 70½. In the first year of the required distribution, the payment can be delayed until the next April 1. However, if the participant is not a 5 percent owner of the employer sponsoring the qualified plan and is employed by the employer sponsoring the plan, the minimum required distribution is not required until the date the employee is no longer employed. A plan is permitted to delay the first required distribution for such an individual until the April 1 following attainment of age 70½, or until the April 1 following actual separation from service. This date is referred to as the required beginning date (RBD). After the RBD, minimum distributions are required by each December 31 (IRC Sec. 401(a)(9)). Note that while the plan may be amended to delay the distribution for such an individual, the sponsor may decide not to amend the plan.

5.6.1 Lifetime distributions

5.6.1.1 Individual account plans

For distributions before December 31, 2000, the amount of the minimum distribution was based upon the joint life expectancy of the participant and any designated beneficiary named on the annuity starting date. The first-year minimum distribution for defined-contribution accounts was calculated by dividing the participant's balance by the life expectancy of the participant and the designated beneficiary, under Table V or VI of Reg. 1.72-9.

For purposes of utilizing the tables, married participants could either use the amount determined as of the first distribution date reduced by one for each year, or recalculate the remaining life expectancy for the participant and spouse. Recalculation in a subsequent year was based upon Table V or VI and reflects the age of the older individual. If the recalculation method was used, then in the year following the death of either the participant or spouse, only the surviving individual's life expectancy was used. The choice of using the subtract one or recalculation method must have been made by the plan's required beginning date. The ability to recalculate or apply the "subtract-one" method must have been stated in the plan. The default method under the Code was recalculation (Reg. 1.401(a)(9)-1).

For distributions in 2001 and after, new proposed regulations simplified the minimum distribution rules. The proposed regulations provided a simple uniform table to be used to determine the required amounts. The required minimum distribution is calculated by dividing the prior year's ending amount balance by the distribution period. If an employee's spouse is the sole beneficiary and the spouse is more than 10 years younger than the employee, the joint and survivor life expectancy could be used to create a longer distribution period.

Final regulations issued in April 2002 reflected even longer life expectancies and reduced even further the required minimum distribution amounts. While the final regulations were required to be used starting in 2003, they optionally could be elected for the 2002 taxable year. However, many qualified plans required amendments to the plan language to reflect the liberalized rules of the new regulations.

5.6.1.2 Defined-benefit plans

Benefits from a defined-benefit plan must be paid at least annually over the life of the participant or the lives of the participant and beneficiary under the option selected by the participant. These distributions are subject to the age 70½ RBD (or later, where the participant is not a 5 percent owner, has not terminated employment with the plan sponsor, and the plan document so permits).

If a qualified plan fails to meet the minimum distribution rules, it may be disqualified. However, for plan years beginning after December 31, 1988, a plan will not be disqualified when there are isolated instances when the distribution rules under IRC Sec. 401(a)(9) are not satisfied. In addition, a 50 percent excise tax is imposed on the recipient for amounts that were required to be distributed but were not (IRC Sec. 4974). A waiver of the penalty may be requested by filing Form 5329, together with a letter of explanation, but only after the excise tax is paid.

5.6.2 Required distributions at death (pre-2001)

Distributions at death are subject to special minimum distribution rules of IRC Sec. 401(a)(9). These requirements are applied based on whether the participant had begun to receive the minimum required distributions upon attaining age 70½ (the required beginning date).

After the required beginning date: If the minimum distributions (for example, for age 70½), had begun, these minimum payments continue to the designated beneficiary under the method already selected. If the participant and spouse had been recalculating the amount of distribution as described above, recalculation would continue, but based on the single life table for the survivor (Prop. Regs. Sec. 1.401(a)(9)-1, Q&A B-4).

Before the required beginning date: If the individual dies before the required beginning date, in general all distributions must be fully paid by December 31 of the fifth calendar year following the date of death. There are two exceptions to the five-year rule:

1. If distributions begin in the calendar year following the date of death, the payments can be made over the designated beneficiary's life expectancy.
2. If the designated beneficiary is the spouse, the spouse may elect to delay the distributions until the participant would have turned age 70½, or to roll over the balance to an IRA in his or her own name.

The minimum lifetime distributions apply separately to each qualified plan. That is, each plan must make the minimum distribution. However, all IRA accounts may be aggregated with payments made from only one IRA.

5.6.3 Required distributions at death (post-2001)

Under the new regulations, the designated beneficiary could be named as late as September 30 of the year following death.

For an employee with a named beneficiary, the same distribution rules apply regardless of whether death occurred before or after the required beginning date. In the case of an employee who dies without a designated beneficiary, the regulations eliminate the requirement that the entire remaining account balance be distributed in the year after death. Instead, a distribution period equal to the employee's remaining life expectancy recalculated immediately before death applies.

Effective for distributions after December 31, 2006, the Pension Protection Act of 2006 provides that the benefits of a deceased employee in an employer-sponsored retirement plan passing to a non-spousal beneficiary may be directly rolled over to an IRA, with the IRA treated as an inherited IRA of the non-spouse beneficiary. Distributions from the inherited IRA become subject to the normal rules applicable to distributions from inherited IRAs of non-spousal beneficiaries. Previous to this change in the Pension Protection Act of 2006, a near-immediate payout of the benefit to a non-spouse beneficiary was required upon the death of an employee with an employer-provided retirement plan passing to the non-spouse beneficiary. No IRA rollover was previously allowed.

5.7 Taxation of IRA Distributions

Distributions from an IRA are included in the recipient's gross income under the annuity rules of IRC Sec. 72. Regardless of the nature of the income earned by the IRA, all taxable distributions are taxed as ordinary income when paid.

If all contributions to the IRA were made pretax, that is, there is no cost basis in the account, 100 percent of any distribution from the account will be included in income in the year of receipt. Otherwise, the taxable portion of a distribution from an IRA is determined using an exclusion ratio.

For IRA distributions, IRS Form 8606 must be filed to claim exclusion for a nontaxable distribution. Instructions accompanying Form 1040 and 1040A contain a worksheet to aid in completion of Form 8606.

Example. Suppose Rose, before the year she takes a distribution, has contributed $10,000 to her IRAs, $300 of which was not deductible. In this year, she makes a nondeductible contribution of $2,000 and, later in the same year, withdraws $5,000. The fair-market value of investments remaining in IRAs at the end of the year is assumed to be $20,000. Rose figures her taxable and nontaxable withdrawal as follows:

1. Add basis at the beginning of the year—$300—to contributions made during the year (or for that year within the allowable period of the following year)—$2,000. It is irrelevant at this stage of the calculations whether the contributions made during the year are deductible or not.
2. Divide the total—$2,300—by fair-market value plus distributions—$20,000 + $5,000. The result is .092 (9.2 percent), which is known as the exclusion ratio. The portion of the $5,000 distribution that is excluded from income is .092 multiplied by $5,000, or $460.

3. To determine the new basis that Rose has remaining in her IRA, deduct \$460 from the old basis, plus this year's nondeductible contributions. The new basis is \$300 + \$2,000 – \$460 = \$1,840.

Note that if this year's contribution had been nondeductible to the extent of \$1,000, the exclusion ratio would still have been .092, and the new basis would be \$840.

If a recipient inherits an IRA from someone not his or her spouse and the decedent had a basis in the IRA, that basis remains an attribute of that identifiable IRA and cannot be aggregated with any other IRAs the recipient may have. A separate exclusion ratio is calculated, and a separate Form 8606 is filed. The same is true for an IRA inherited from a spouse, unless the recipient chooses to treat that IRA as his or her own, in which case it may be aggregated with other IRA accounts of the surviving spouse.

Making after-tax contributions to an IRA establishes a basis. Once all amounts in a recipient's aggregate IRAs have been distributed, any unrecovered basis can be claimed as a loss. The loss is treated as a miscellaneous itemized deduction on Schedule A, subject to the 2 percent floor.

5.7.1 Penalties related to premature distributions

Unless a recipient has reached age 59½, a 10 percent additional tax must be paid on all taxable distributions. This penalty is in addition to any regular income tax that is due on the distribution.

Exceptions from the penalty are available for disability benefits or payments made on account of the death of the recipient, for rollovers into another plan or IRA, and for annuity distributions. Annuity distributions are substantially equal periodic payments made over the life of the IRA owner or plan participant. This payment schedule must be followed for at least five years or until the taxpayer reaches 59½, whichever occurs later, to avoid a retroactive imposition of the 10 percent additional tax.

5.7.2 Penalties related to excess distributions

The Tax Reform Act of 1997 permanently repealed the 15 percent excise tax associated with excess distributions from qualified retirement plans, effective for excess distributions received after December 31, 1996.

5.7.3 Penalties for not making minimum distributions

If the required minimum distributions are not paid, the recipient is subject to a penalty of 50 percent of the deficiency. When the penalty is paid, a refund may be requested in the case of reasonable cause. Form 5329, together with a letter of explanation and the penalty payment, may be used to request a waiver of the penalty.

5.7.4 Distributions from a Roth IRA

After a five-year period, a distribution from a Roth IRA will be free from tax and penalty if it is:

— Made on or after age 59½ or death,

— Made on account of disability, or

— Used for qualifying expenses by a first time homebuyer.

The five-year period begins with the first tax year for which a contribution was made to the Roth IRA. Rollovers may be made to a Roth IRA from a non-Roth IRA or from another Roth IRA. Rollovers are subject to the rollover rules in IRC 408(d)(3). Rollovers before age 59½ from a non-Roth IRA are treated as taxable distributions, although not subject to the present 10 percent penalty.

Observation:
Under a provision of the Pension Protection Act of 2006, the current $100,000 adjusted gross income limitation that prevents some taxpayers from converting traditional IRAs to Roth IRAs is eliminated for taxable years beginning after 2009.

5.7.5 Tax-free IRA transfers to charity

Under a provision enacted by the Pension Protection Act of 2006, IRA distributions made in taxable years beginning after December 31, 2005 and prior to January 1, 2008 are able to be directly transferred to a qualified charity without income recognition for taxpayers age 70½ or older (IRC Sec. 408(d)(8)). Private foundations (described in IRC Sec. 509(a)(3)) and donor advised funds are not allowed as qualified charities. A direct transfer by the IRA trustee to the charity needs to occur; distributions made out of the IRA to the taxpayer and then transferred to the charity represent taxable income to the recipient.

Distributions under this provision count towards the minimum required distribution obligation of taxpayers age 70½ or older. No charitable contribution deduction is allowed for the income portion of the IRA distribution that avoids taxation. Any amounts transferred to charity are deemed to come from income first and from basis second, with any charitable contribution only allowed on amounts from basis. All IRAs of the taxpayer need to be aggregated for this purpose.

The income exclusion for IRA distributions transferred directly to charity is limited to a maximum of $100,000 per year per taxpayer, with a husband and wife each allowed to transfer the maximum $100,000 amount, assuming the IRA balance of each taxpayer so allows. The privilege does not extend to SIMPLE IRAs or simplified employee pension plans (see section 8); rather, the privilege only applies to IRAs. Accordingly, SIMPLE IRAs and simplified employee pension plans, along with other types of retirement plan accounts must first be rolled to an IRA before a non-taxable charitable transfer can be completed. Taxpayers must have attained age 70½ by the date of the distribution from the IRA to the charity. Whereas the initial minimum required distribution of an IRA may be withdrawn at any time during the year a taxpayer turns age 70½, a direct IRA to charity transfer is only excluded from income if made on or after the date the taxpayer attains age 70½.

Planning Tip:
Several situations exist where directly transferring funds from an IRA to a charity can provide significant tax advantage:

- Taxpayers using the standard deduction who would not otherwise benefit by the charitable contribution amount.
- Taxpayers living in states that do not allow the use of itemized deductions or the claiming of charitable contributions.
- Taxpayers with charitable contribution carryovers who would otherwise not benefit or benefit only marginally from charitable contributions.
- Taxpayers wishing to avoid the minimum required distribution amounts resulting from a normal IRA distribution, thus potentially allowing lower taxability of Social Security benefits and other phase-in and phase-out calculations based on adjusted gross income.
- Taxpayers who wish to reduce their IRA balance to reduce or avoid future income-in-respect-of-a-decedent (IRD) amounts.

Observation:
The normal written acknowledgement and quid pro quo rules apply, except taxpayers are not allowed to receive any quid pro quo benefit on the exchange. Accordingly, if the charitable contribution deduction would not be allowed because the donor did not obtain the written acknowledgement or any quid pro quo benefit was received, the income exclusion is disallowed with respect to the entire IRA distribution (IRC Sec. 408(d)(8)(C)).

5.8 Loans Treated as Distributions

The most frequent plans to permit loans to participants are 401(k) plans, where employees are typically granted access to their own account.

The Code places restrictions on the timing of loans, the payback period, the required documentation for a loan and the size of a participant loan. Failure to follow these rules will result in the taxation to the participant in an amount equal to the loan balance to the participant. A plan loan will not result in taxable income to the participant if, when aggregated with other plan loans, it does not exceed the lesser of the following:

— $50,000, reduced by the highest outstanding loan balance during the preceding one-year period, or if greater, the outstanding balance on the date a new loan is made

— The greater of 50 percent of the vested account balance of the employee or $10,000 (IRC Sec. 72(p))

Plan loans must also meet the following requirements:

— Loans must be made according to the terms of the plan document.

— Loans must, by their terms, be repayable within five years, unless they are used to acquire a dwelling unit used as the principal residence of the participant. This rule applies to loans made, renewed, renegotiated, modified, or extended after December 31, 1986 (IRC Sec. 72(p)(2)(B)).

— Loans must be paid in substantially level loan payments, with payment made at least quarterly (IRC Sec. 72(p)). It is best to require repayments of loans through payroll withdrawals to ensure this requirement is met.

— Plan loans must be available to participants on a nondiscriminatory basis (Reg. 1.401(a)(4)-4).

6. FIDUCIARY RESPONSIBILITIES

A plan fiduciary is any individual who exercises discretionary authority over the management or administration of an employee benefit plan or over the management or disposition of its assets. Fiduciaries include any individuals who render investment advice to the plan for direct or indirect compensation (ERISA Sec. 21(A)). A fiduciary may also include any accountant providing discretionary management over the administration of the plan or management of the plan's assets. Fiduciaries are personally liable for any plan losses resulting from a breach of fiduciary duty as well as for surrendering any profits made through the improper use of plan assets. With some exceptions, every fiduciary and every person who handles plan assets must be bonded (ERISA Sec. 412).

A federal court has held that an accountant who recommended an investment to an employee benefit plan was not a fiduciary under the ERISA rules. The court clarified the ERISA rules by establishing that a fiduciary is a person who performs any one of the following three tasks (**Cottrill v. Sparrow, Johnson & Ursillo, Inc.**, No. C.A.94-0118T, Dist. Ct. R.I. 1995):

1. Exercises discretionary authority over a plan or its assets
2. Renders investment advice for a fee
3. Has discretionary authority in the administration of a plan

6.1 Obligations of Fiduciaries

ERISA provides the basis for assessing fiduciary responsibility. Briefly, fiduciaries must discharge their duties solely in the interest of participants and beneficiaries. Fiduciaries must follow four primary requirements in carrying out their fiduciary duty:

— Operate the plan for the exclusive purpose of providing benefits to the participants and their beneficiaries while defraying expenses for administering the plan.

— Exercise the same care, skill, prudence, and diligence used by a person familiar with the conduct of an enterprise with similar character and aims.

— Diversify the investments of the plan to minimize the risk of large losses, unless such diversification is clearly imprudent.

— Administer the plan according to its underlying documents and in a manner that is consistent with ERISA (ERISA Sec. 404).

Where a plan has more than one fiduciary and a breach of fiduciary duties has been made by one of the fiduciaries, it is not sufficient that the other fiduciaries refuse to participate in the breach and then resign; rather, each fiduciary must attempt to remedy the breach (ERISA Sec. 405) (see **Donovan v. Bierwirth**, 680 F2d 263 (2d Cir. 1981), for a discussion of the standards of conduct applying to a plan fiduciary when faced with a potential conflict of interest). An independent auditor of a plan generally does not have discretionary authority to administer the fund and is generally not a plan fiduciary.

Sec. 502(l) of ERISA authorizes the DOL the power and authority to assess a civil penalty to both a plan fiduciary and "any other person" who has knowing participation in a breach of fiduciary responsibility. That penalty is 20 percent of the amount recovered from a fiduciary with respect to a violation settled with the IRS.

6.2 Prohibited Transactions

In addition to being charged with general fiduciary obligations over the administration of the plan and management of plan assets, a fiduciary is restricted from allowing the plan to engage in certain specific transactions identified as either prohibited transactions or party-in-interest transactions. For example, unless a statutory or administrative exemption applies, the fiduciary may not cause the plan to engage in any transaction that constitutes the following, either directly or indirectly:

— Sale, exchange, or leasing of any property between the plan and a party-in-interest (Note that contributions of unencumbered property to any plan other than a discretionary profit-sharing plan is deemed a prohibited transaction.)

— Lending of money or any other extension of credit between the plan and a party-in-interest

— Furnishing of goods, services, or facilities between the plan and a party-in-interest

— Transfer to, or use by or for the benefit of, a party-in-interest of any assets of the plan

— Acquisition, on behalf of the plan, of any employer real property or employer security, except for qualified real property or securities not in excess of 10 percent of plan assets in certain plans (ERISA Sec. 406 and IRC Sec. 4975)

A recurring annual 15 percent nondeductible penalty tax is imposed upon a party-in-interest (disqualified person) participating in any prohibited transaction occurring after August 5, 1997. If the transaction cannot be corrected by placing the plan in a good financial position as if the party-in-interest had acted using the highest fiduciary standards, an additional 100 percent nondeductible penalty may be imposed. The imposition of this penalty is preceded by a 60-day notice (IRC Sec. 4961(a)). The penalty taxes for a prohibited transaction are reported on IRS Form 5330, and the transaction is identified on the Form 5500 Series.

6.2.1 Parties-in-interest

Parties-in-interest include the following:

— Any fiduciary or counsel to the plan; any person providing services to the plan

— The sponsoring employer
— The labor union representing plan participants
— Any employee, officer, director, or 10 percent-or-more shareholder of (1) a service provider, (2) the sponsoring employer, or (3) the labor union
— Certain relatives of other parties-in-interest
— Certain related business organizations and their owners (ERISA Sec. 3(14) and IRC Sec. 4975(e)(2))

Note that because the prohibited-transaction rules cover literally all dealings with parties-in-interest, various statutory and administrative exemptions are provided. The principal statutory exemptions are the following:

— Loans to plan participants (ERISA Sec. 408(b)(1) and IRC Sec. 4975(d)(1))
— Reasonable arrangements for services if no more than reasonable compensation is paid (ERISA Sec. 408(c)(2) and IRC Sec. 4975(d)(10))
— Receipt by a fiduciary of any benefit to which he or she is entitled as a participant (ERISA Sec. 408(c)(1) and IRC Sec. 4975(d)(9))

If a statutory exemption is not available, an administrative exemption may be requested. Certain transactions of a recurring nature have been exempted administratively through so-called class exemptions. Two important class exemptions permit the purchase and sale of life insurance policies between the plan and the insured participant (Prohibited Transaction Class Exemptions 77-7 and 77-8).

6.2.2 Exemptions for participant loans

A loan by a plan to a participant is a prohibited transaction unless the loan:

— Is available to all participants on a reasonably equivalent basis.
— Is not made available to members of the prohibited group in amounts greater than those available to rank-and-file employees.
— Is made in accordance with specific plan provisions.
— Bears a reasonable rate of interest.
— Is adequately secured. The loan can be secured by the participant's vested interest in the plan; however, the loans must not provide in-service distributions from pension plans (ERISA Sec. 408(b)(1) and IRC Sec. 4975(d)(1)). As a result, plan loans from a pension plan should be paid through payroll deductions.

Before 2002, plan loans were prohibited for participants and their family members who were owner-employees or a more-than-5 percent shareholder of an S corporation (IRC Secs. 401(a)(13) and 4975(d)). However, EGTRRA removed the loan prohibition on owner-employees. Loans made after December 31, 2001 to S corporation shareholders, partners in partnerships, and sole proprietors are also exempted from being a prohibited transaction. (IRC Sec. 4975(f)(6)(B)(iii) and ERISA 408(d)(2)(C)). Funds from a loan to a participant that are promptly loaned by the participant to the employer may be considered a prohibited indirect loan by the plan to the employer.

Final nondiscrimination regulations require that all rights under a plan must not be nondiscriminatory in favor of the highly compensated employees. Participants' loans are considered a right under the plan, and thus plans should not establish plan loan guidelines that may be seen as discriminatory. Certain restrictions, such as those specifying a minimum loan amount of $1,000, may be permitted, as long as the restrictions do not discriminate in operation (Reg. 1.401(a)(4)-4).

6.3 Plan Investments

Plan investments are subject to the various fiduciary standards imposed by Title I, Part 4, of ERISA. These standards include the specific requirement to diversify the investments of the plan to minimize a risk of large losses, unless it is clearly prudent not to do so. Subject to the general fiduciary requirements of ERISA, an investment is permissible under Title I of ERISA if it is not specifically prohibited under rules set forth in Section 406 of ERISA. To protect participants, there is generally a requirement that any assets held by the plan must be under the jurisdiction of the U.S. court system.

The Code does not set forth specific rules governing the kinds of investments that may be made by a qualified plan. Nevertheless, the Code sometimes indirectly precludes a particular investment by subjecting its income to tax. For example, an investment in collectibles purchased after 1981 (such as works of art, rugs, antiques, metals, gems, stamps, coins, whiskey) by an individually directed account in a qualified plan is treated as a distribution to the participant. The amount of the distribution is equal to the cost of the collectible (IRC Sec. 408(m)). Collectibles are not precluded as investments in a defined-benefit pension plan or in any defined-contribution plan that does not permit a participant to direct the investment of his or her account; however, they are subject to ERISA's prudence and exclusive benefit requirements. As a practical matter, though, a plan in which the sole participant is also the stockholder and plan trustee would typically not invest in collectibles.

6.3.1 Valuation of nonliquid assets

One troublesome aspect of holding nonliquid assets is the requirement that the assets of the plan be valued at current value each year (IRC Sec. 412(c)(2) and DOL Prop. Reg. 2520.105-2(e)(2)(ii)). For such nonliquid assets, an independent annual appraisal is required. Real estate, like other assets for which a ready market does not exist, tends to fluctuate in value and is not generally income-producing. So, while such an asset may be permitted, fiduciaries are invested with the responsibility to make prudent investments. Finally, because of the custodial problems associated with assets that are not financial instruments and are not easily held by a custodian, these assets can lead to prohibited transactions should they be held by or used by the participant or trustee. Collectibles should be kept in a vault, not on the president's wall. Real estate must not be used by the participants for personal use. Assets that are not valued under a recognized national source are required to be identified on the Form 5500 Series for the plan.

6.3.2 Unrelated business taxable income

Income tax on unrelated business taxable income (UBTI) generated by an asset held by the plan may place a handicap on certain kinds of investments. UBTI results in income taxes to the extent that UBTI exceeds $1,000 annually (IRC Sec. 512(b)(12)). UBTI is, essentially, a tax on an investment that is not related to the exempt nature of a tax-exempt trust. For a qualified plan, UBTI generally falls into the two following categories:

1. *Income from unrelated trades or businesses.* The imposition of income tax on unrelated trade or business income is intended to eliminate a source of unfair competition by taxing otherwise tax-exempt organizations when they operate as a trade or business. Plan investments that may result in the imposition of this tax are certain limited partnership interests that are not passive investments (IRC Sec. 513).
2. *Income from debt-financed property.* The imposition of income tax on debt-financed property is intended to limit the ability of tax-exempt organizations to invest in other than passive investments. The purchase of stock on margin is typical of an investment that would create UBTI income, while borrowing to purchase employer stock by an ESOP is not (IRC Sec. 514(c)(8)). Income from debt-financed real estate, whether from subsequent sale of the real estate or rentals, is taxable income if it is financed by the seller (IRC Sec. 514(c)(9)).

The possible imposition of a tax does not by itself preclude a particular investment from being held by the plan. As is the case with any investment, the fiduciaries must minimize the risk of loss, particularly that associated with plan indebtedness.

6.3.3 Plan investments—overview

The tax-exempt character of the plan itself affects certain investment decisions. For example, plan trustees do not normally purchase tax-exempt lower yielding municipal bonds, as the tax-exempt receipt of the interest is of little value to a qualified plan. The purchase of developed real estate is uncommon not so much for the resulting inability of the plan to use depreciation deductions, but for the loss of potential capital gains on sale if held outside a plan. Further, real estate always has the potential for unforeseen liability that may be, in turn, attached to other plan assets. Participating in equity mortgages, however, is a common plan investment.

On the other hand, a number of investments are structured specifically for tax-exempt trusts. The insurance industry has provided a steady stream of investments in the form of guaranteed investment contracts (GICs). However, trustees must assess the liquidity of these investments against the liquidity needs of future benefit payments and not cause the plan to incur a loss for sale in an off-market.

Profit-sharing, stock bonus, ESOPs, and certain other individual account plans are permitted to invest more than 10 percent of their portfolios in employer securities. Restrictions abound, and such ownership is permitted only if the plan document explicitly so provides (ERISA Secs. 407 and 408(e)).

However, heavy investment in the employer's securities:

- May be inconsistent with prudent, diversified investment management.
- May prove to be a nonliquid investment because of the trustee's reluctance to unload the shares.

7. PLAN ADOPTION AND REPORTING

For a plan to be tax qualified and for the employer to make tax-deductible contributions for the plan year, the plan must be adopted before the close of the employer's tax year. A plan document must comply with the Code regarding form. It must include specific provisions required under IRC Secs. 401(a) and 501. The document must provide for administration and operation in compliance with ERISA.

ERISA established annual filing requirements and identified certain participant notification procedures. The Code also imposes reporting requirements and certain participant notices. These are part of the annual administration requirements of a plan. These responsibilities are placed with the plan administrator that is the named fiduciary in the plan document. Many plans name the employer (for example, Corporation) as the plan administrator.

7.1 Adoption of Plan—Overview of Approval

The first step in assuring that a plan is qualified is having the plan document approved by the IRS. This approval may be obtained by adopting a document that is preapproved (for example, a prototype document) or by having an individually drafted plan submitted to the IRS. Although it is not necessary to have an individually designed plan submitted to the IRS for approval, few, if any, employers adopting such a plan avoid this procedure. The procedure for adopting a preapproved plan has been simplified. The IRS currently permits a plan sponsor to adopt a preapproved standardized or nonstandardized prototype plan or a preapproved volume submitter plan. For most employers, the adoption of a standardized plan is not recommended because of limited options; standardized prototype plans may not be suitable for many employers. Typically, the steps required for the adoption of a qualified plan and trust include the following:

— Adopt resolutions that approve the adoption of the plan and trust, establish the IRC Sec. 415 limitation year, and appoint plan fiduciaries

— Adopt a plan and trust document, which in some cases may be combined into one document

— Apply for employer identification numbers for the trust and for the plan administrator

— Distribute summary plan description to the participants (a simplified explanation of the plan and the claims procedure for requesting benefits)

All tax benefits, for both the employer and the employee, depend upon the plan's qualification in form as well as in operation. That is, the document is required to contain certain wording relating to coverage, minimum benefits, vesting, nondiscrimination, and the availability of benefits that are specified in the Code and regulations. These provisions are continually being updated by legislation and interpreted in regulations. As a result, almost all employers other than the very smallest employer submit their plan document to the IRS for approval of new and amended documents, requesting a determination that the plan has met the requirements of IRC Sec. 401(a).

The request for a favorable letter of determination is filed on the following forms.

— Form 5300 Series—Form 5300 for individually designed defined-benefit plans, and defined-contribution plans

— IRS Form 5307—A short form request of a preapproved prototype or a volume submitter plan

— Notice to Interested Parties

These Forms 5300 and 5307 may require inclusion of the plan document and certain other attachments illustrating benefits and coverage in the plan. A filing fee is required, based on the kind of plan and whether the IRS is asked to review the nondiscrimination, coverage, or other specific provisions of the plan. Under EGTRRA, an eligible small employer is not required to pay a user fee for any determination letter request if the request is made before the later of (1) the last day of the fifth year the plan is in existence or (2) the end of any remedial amendment period beginning within the first five years of the plan. A small employer is one that had no more than 100 employees who received at least $5,000 in compensation in the preceding year. Additionally, the employer must have at least one non-highly compensated employee (NHCE) who is participating in the plan.

Planning Tip:
With the virtual elimination of user fees for small employers regarding determination letter requests for new plans, employers should consider obtaining determination letters in most instances for their qualified retirement plans, other than when prototype plans are being used, as described in Section 7.1. The favorable determination letter demonstrates that the IRS has approved of the plan's language as meeting the requirements for tax qualification. As long as the plan has been operated according to the plan provisions specified by the Code, the tax qualification of the plan should not be in jeopardy.

Note that the DOL no longer requires the plan administrator to mail a copy of the summary plan description to the DOL unless requested by the DOL.

7.1.1 Advantages of master, prototype, or volume submitter plans

Plans are either individually drafted or are selected from preapproved documents (prototype and volume submitter plans). Although the individually drafted plan provides maximum flexibility regarding coverage and benefits, it requires tailoring and can be more costly to adopt. As an alternative to these attorney-crafted plans, an employer can adopt a prototype plan or a volume submitter plan. Prototype and volume submitter plans can be implemented by simply completing the blanks of an adoption agreement, notifying the participants, and signing the form.

Beginning with the so-called GUST restatement period, the IRS has implemented procedures for adopting a prototype or volume submitter document that is granted approval as a qualified plan without the need to prepare any of the submissions previously discussed. Some of these plans are fully approved by the IRS (that is, standardized plans) and do not require any of the submissions discussed above. The word-for-word adopters of a preapproved prototype or volume submitter are treated as having received IRS approval on the plan. However, this approval is contingent on properly completing the adoption agreement and not modifying the document in any significant way. As a result, most employers adopting other than the simplest document will opt to file the Form 5307 to obtain a separate approval.

Note that there are two kinds of prototype plans: standardized and nonstandardized. Both have been preapproved by the IRS to some degree, and either may be adopted by any employer. However, a standardized plan is designed by default to comply with every provision of the Code, and should only be adopted by the smallest of employers.

For example, participants in a standardized plan receive a contribution if they work over 500 hours, even if they terminate before year end. All members of the affiliated service group (IRC Sec. 414(m)) or controlled group (IRC Sec. 414(b)) are eligible to receive a contribution in the employer's plan.

A service organization, financial institution, or trade association may sponsor a prototype plan if it can show that it has at least client adopters. Instructions may be found in Revenue Procs. 2006-4, 2005-16 and 2005-66. The IRS will not approve prototype plans for the following:

— Government or church plans
— Stock bonus plans
— Collectively bargained plans
— ESOPs
— IRC Sec. 403(b) annuities
— Cross-tested plans or cash balance plans

7.1.2 Determination letters

Individual letters of determination are issued by the IRS to adopting employers confirming that the plan document that was adopted qualifies in form, under IRC Sec. 401(a), and that the trust is exempt from taxation under IRC Sec. 501. It is not necessary to secure a determination in advance of operation to secure a tax deduction, but it is prudent to do so.

As noted in Section 7.1.1, letters of determination issued to a sponsor of a prototype plan (referred to as an opinion letter) cover the adopting employer and therefore do not require a separate submission. As is the case with any determination, any misstatement of facts or change in the document will likely invalidate any IRS approval, unless a determination letter is requested. Although the determination letter covers the plan regarding form, the employer must operate the plan in conformity with the plan document and the law to maintain the favorable approval.

Note that adopters of volume submitter plans may want the IRS to express an opinion on the plan's nondiscrimination testing.

7.1.2.1 Terminating plans

Determination letters about the plan's qualification on the date of termination are also suggested for terminating plans. A determination letter upon termination is generally requested for both form (for example, Is the document fully updated?) and operation (for example, Have benefits been discriminatory?). Thus, this filing requires not only information on the current participants, but also information on participation and benefits over the last five years.

The IRS and DOL have joint jurisdiction over qualified plans. The IRS monitors the tax aspects of the plan, while the DOL is charged with protecting the participants. Employers wishing to terminate a defined-benefit pension plan must request permission from the PBGC, a division of DOL. Only small professional employers and family-only businesses are exempt from this requirement. These plans and all other employer types of plans may be submitted to the IRS for its approval at termination.

Distributions from a qualified plan receive favorable tax treatment and, in most cases, are permitted to be rolled over to an IRA. Invalid rollovers carry penalties and adverse tax consequences. As a result, most employers request a favorable letter of determination from the IRS as of the date of termination to assure that the plan is qualified and that all rollovers to IRAs or other plans will be valid. Such a filing is made with Form 5310. The termination filing is optional; however, the final Form 5500 for the plan reflects whether the Form 5310 has been requested. Presumably, the IRS will consider plans for audit that do not request the determination letter.

7.1.3 GUST amendments

Rev. Proc. 2005-16 sets forth a new prototype program (and volume submitter) for approving the amendments required under several laws now collectively referred to as the GUST amendments. This new Procedure replaces Rev. Procs. 89-9 and 89-13 governing both master and prototype plans (M&P) and regional prototype plans. Rev. Proc. 2005-16 was modified by Rev. Proc. 2005-66.

Rev. Proc. 2005-16 describes the procedures for document approvals under a new consolidated program. However, the underlying structure of the prior prototype program is retained. Prototype plans may be (1) standardized, (2) nonstandardized, or (3) nonstandardized safe harbor.

The M&P and Regional Prototype Programs have been combined into one program that will be administered through the IRS National Office in Washington. Any type of entity (for example, bank, insurance company, law firm, accounting firm, third-party administrator [TPA], and so on) can now sponsor a prototype plan. Word-for-word adopters of mass submitter documents will not have to meet a minimum threshold for adopting employers.

All prototype sponsors are now required to maintain a list of adopting employers that could be sent to the IRS upon request. The procedures require that M&P sponsors monitor certain plan activities that become known to the sponsor. Where a prototype sponsor reasonably concludes that an employer's M&P plan may no longer be a qualified plan and the sponsor does not or cannot submit a request to correct the qualification failure under Employee Plans Compliance Resolution System (EPCRS), the prototype sponsor is required to notify the employer that the plan may no longer be qualified. The prototype sponsor must also advise the employer that adverse tax consequences may result from loss of the plan's qualified status and that the qualification failure may be addressed under EPCRS.

7.2 Reporting

Many documents and forms are utilized in the administration of a qualified plan; a number are required, others are optional. The following section includes a brief description of the forms that are typical of the small employer plan.

7.2.1 Participant notification

— *Participant statement*—This statement reflects the vesting and account balance for defined-contribution plans and projected, accrued, and vested benefits for defined-benefit plans. It is required that one be given within 30 days of any participant's request, unless one has been received within the last year. For that reason, most employers provide the statement at least annually. Failure to deliver a participant with the requested statement within 30 days subjects the sponsor to a $110 per day penalty payable to the participant.

- *Summary plan description (SPD)*—Participants must be given this document and any material modifications within 90 days of entering the plan or within 120 days of the effective date of the plan (ERISA Sec. 104(b)). This document must provide the participant with a plain-English explanation of the benefits under the plan. It must also describe the claims procedure available to a participant.
- *Designation of beneficiary*—This applies to plans that provide a death benefit. Generally, the spouse of the participant is the required beneficiary; however, with the consent of the spouse, that designation may be changed.
- *Summary annual report (SAR)*—The format for this report is determined by the DOL. The form includes the latest financial information on the plan (ending assets, income, and expenses) and identifies how the employee can obtain more information on the plan. Beginning for plan years starting after April 17, 2001, certain small plans holding "nonqualifying assets" (for example, real estate or mortgages) are required to provide additional information in the SAR on these assets to participants and beneficiaries.

7.2.2 Annual filing forms

A plan administrator must file an annual report within seven months after the end of the plan year (or for a final form, seven months after all assets have been distributed). This report is filed on the Form 5500, depending on the number of participants covered.

The following documents are part of the annual report:

1. *Annual report, Form 5500*—All plans file Form 5500 (except for plans covering only the owners of the sponsor and spouses, which file Form 5500 EZ). The Form 5500 has 13 schedules (A, B, C, D, E, F, G, H, I, P, R, SSA, T) that are included with Form 5500, based on the type of plan and number of participants. Plans with more than 100 participants file Schedule H, whereas small employers file Schedule I with certain financial information.

   Large employers, those with 100 or more participants at the start of the plan year, must file a certified audit with the Form 5500. Small employers, those with fewer than 100 participants at the start of plan year, do not. A special rule permits plans with between 80 and 120 participants at the start of the year to follow the audit requirements based on their filing category for the year.

   A 5500 EZ is used for plans covering only the business owners and their spouses. Plans covering only a business owner and spouse and having assets less than $100,000 at the end of the plan year are relieved from any reporting, except for the final filing, which requires a Form 5500 and any applicable schedules.

2. *Annual Return of Fiduciary of Employee Benefit Trust, Schedule P*—This is an optional schedule and starts the statute of limitations with respect to income taxation of the trust. It is strongly recommended to be filed. If the plan has taxable income, this form is replaced with the required Form 990-T.
3. *Insurance Information, Schedule A*—This form must be attached if the plan holds insurance as an investment; it is optional for the Form 5500 EZ.
4. *Actuarial Information, Schedule B*—Defined-benefit plans must attach this schedule, which certifies the funding of the plan.
5. *Schedule C, Service Provider Information*—A large plan files Schedule H, attaches this schedule, and includes information on the top 40 service providers receiving payments of $5,000 or more in the plan year, and when they terminate the account preparing the Form 5500 or the plan's enrolled actuary.
6. *Schedule D* (*DFE/Participating Plan Information*)—This schedule is attached to the Form 5500 for certain plans participating in common accounts, insurance pooled accounts, or master trusts, and is prepared by a provider.
7. *Schedule E* (*ESOP Information*).
8. *Schedule F*—This is no longer required for any past or future filing.
9. *Schedule G* (*Financial Schedules*)—This is required for large pension plans, to report loans or fixed obligations in default. Also included are loans in default or classified as uncollectible and nonexempt prohibited transitions.
10. *Schedule H* (*Large Plan and DFE Financial Information*)—This schedule includes financial schedules, as well as questions on the plan's financial activities and the CPA audit report.
11. *Schedule I* (*Small Plan Financial Information*)—This schedule includes financial schedules and questions on the plan's financial activities.
12. *Schedule R* (*Retirement Plan Information*)—This is required for all pension plans and includes information on plan distributions and funding and any amendments that increased the plan's liabilities.
13. *Schedule T* (*Qualified Pension Plan Information*)—This form is used to demonstrate a company's compliance with the Code's coverage and participation requirement.
14. *Schedule SSA, Annual Registration Statement Identifying Separated Participants With Deferred Vested Benefits*—This schedule must be filed for terminated participants that have not received a distribution of their account balance and have been terminated for over one plan year. Although not required, the form should also be used to report when a participant who was previously reported is paid all benefits.

Miscellaneous documentations required periodically are the following:

— *Resolutions for the plan*—Resolutions authorizing a change in the document are required; however, a resolution authorizing the amount of plan contributions to a profit-sharing plan is no longer required. The IRS will treat the amount reported on Form 5500 as the authorized amount.

— *Summary of material modifications to summary plan description*—A significant modification of the terms of the plan document must be communicated to the participants within 210 days after the end of the plan year, by either distributing an updated summary plan description or this summary of material modifications to the SPD.

— *Updated summary plan descriptions*—If the plan has not been materially modified, the SPD is updated and provided to the plan participants every five years, or if no changes have been made, every 10 years.

Documents required in the event of distribution are the following.

— *Withholding Certificate for Pensions Annuity Payments, Form W-4P*—This form is used to identify the withholding for periodic payments. It is optional.

— *Statement for Recipients of Distributions From Profit-Sharing, Retirement Plans, and Individual Retirement Arrangements, Form 1099-R*—This form is used to report all distributions from a plan or IRA.

Documents that are typically filed for terminating defined-benefit pension plans include the following.

— *IRS Form 5310*—An optional filing that requests IRS approval on the tax qualification status of a terminating plan.

— *IRS Form 5310A—Notice of Plan Merger or Consolidation, Spinoff or Transfer of Plan Assets or Liabilities.* Notice of Qualified Separate Lines of Business must be filed to notify the IRS of any qualified consolidation, spinoff, merger, or transfer of plan assets three days before the event.

— *Notice of Intent to Terminate a Defined Benefit Plan*—This filing must be filed with the PBGC before the termination of a defined benefit pension plan insured by PBGC.

— *IRS Form 6088, Distributable Benefits From Employee Pension Benefit Plans*—This is a form that is filed with Form 5310 or 5300 when a plan upon termination asks for a qualification letter.

The penalties for failure to file IRS forms in a timely manner include the following.

— IRS penalty of $15 for each day up to $15,000 if the Form 5500 is late

— DOL penalty of $1,100 for failure to file Form 5500, including omission of the Schedule B

— $1 for each participant (up to $5,000), for each day, for failure to file Form 5500, Schedule SSA

7.3 Audit Guidelines

The IRS has issued guidelines for examiners of employee plans in IRS Announcement 95-99. These guidelines focus the examiner's attention on the following:

— The IRC Sec. 415(b) benefit limitations for defined-benefit plans (but not including the changes made to IRC Sec. 415(b) by the Retirement Protection Act of Title VII of the Uruguay Round Agreements Act (sometimes referred to as GATT, P.L. 103-465);

— Required minimum distributions under IRC Sec. 401(a)(9) (including before-death and after-death distributions);

— The timing of distributions under IRC Sec. 401(a)(14); and

— Notification and other requirements under the IRC Sec. 401(a)(31) rules on optional direct transfers of eligible rollover distributions.

8. SIMPLIFIED EMPLOYEE PENSION PLANS AND SIMPLE PLANS

Small employers have several options when adopting a qualified plan that may appear to be too complex. One of the options is a simplified employee pension (SEP). A SEP is essentially a program of separate IRAs to which an employer makes annual contributions for the participants. An employer may contribute to an IRA established by an employee or establish one for the employee. SEPs are attractive due to their simplified administration. Form 5500 is not required. However, all contributions are fully vested and all employees meeting a basic length of service and age requirement must be covered. One of the unique features of a SEP is that it does not have to be adopted before the end of the employer's tax year. Employers must, however, execute the SEP document before the due date of the employer's tax return, including extensions.

Unlike a qualified plan, employer contributions are subject to a 25 percent-of-pay limitation for each participant. This is both a per-participant and an employer tax deduction limit.

SEPs may be adopted through a model agreement (Form 5305-SEP) available from the IRS, or through a plan sponsored by a financial institution. Generally, a non-5305-SEP is more attractive to an employer. SEPs provided by financial institutions may have less restrictive requirements. Employers precluded from adopting a SEP under form 5305-SEP include the following:

— Employers that have ever maintained a defined-benefit plan

— Employers that use the services of leased employees

— Employers that are members of a controlled group or an affiliated service group, or members of a group of trades or businesses under common control, unless all members of such groups participate under the SEP

— Employers that sponsor another plan at the same time

In addition, a Salary Reduction SEP (SARSEP) adopted through the 5305A-SEP is deemed to be top heavy and requires a 3 percent-of-pay contribution for all eligible participants, while SEP documents offered through a financial institution require the top heavy contribution only when the plan is in fact top heavy.

Procedures are also provided for an employer to adopt individually designed SEPs. SEPs are subject to the top heavy, nondiscrimination, and minimum coverage rules.

Before 1997, employers wishing to permit deductible employee contributions could adopt a SARSEP using Form 5305A-SEP or a financial institution's SARSEP document. These plans may not be implemented after December 31, 1996, but existing plans may be maintained and new participants enrolled. These plans are limited to employers with fewer than 26 employees who are eligible to participate and at least 50 percent of the eligible employees do not participate. Special ADP rules apply to SARSEPs.

Although a SEP is not required to file a Form 5500, there are other notification requirements. The trustee or custodian (who cannot be the employer or an individual) is required to provide each participant with a statement of the amount of employer contributions made to the employee's account by the later of January 31 of the subsequent year or 30 days after the contribution has been deposited. This requirement is satisfied if the information is on the employee's W-2 for the calendar year for which the contribution is made (Prop. Regs. 1.408-9). The employer must provide participants with notification of the adoption of a SEP. The trustee or custodian sponsoring the IRAs that are part of the SEP must report the deposit to the IRS on Form 5498 and provide the same information to the participants.

8.1 SEP Qualification Requirements

SEPs must have eligibility provisions that are less restrictive than those of qualified plans. In general, an employer cannot omit contributions from employees who work part-time or terminate before the end of the year if they otherwise meet the eligibility requirements. Contributions are required for each employee who:

— Has reached age 21. (A younger age may be established.)

— Has performed any services for the employer during at least three of the immediately preceding five calendar years (an employer may elect to reduce the length of this requirement). There can be no minimum hours of service before being credited with a year of service.

— Has received an amount at least equal to the year's SEP compensation limit ($500 in 2007) (see Appendix 2).

To avoid disqualification, all eligible employees must be included. That is, a SEP cannot restrict contributions to those who have a minimum number of hours or who are employed on the last day of the year (Prop. Regs. 1.408-7(d)(3)). Contributions are generally made at the same percentage for everyone; however, allocations may be allocated to eligible employees using permitted disparity if the document so permits (IRC Secs. 401(l)(2) and 408(k)(3)).

Contributions to a SEP must be fully vested when made. If the SEP is top heavy, the minimum contribution requirements must be met (see section 3.8 of this chapter).

8.2 Deduction Limits

Employer contributions are deductible under rules similar to but slightly less attractive than those of profit-sharing plans. For 2007, the maximum deductible contribution is the lesser of $45,000 or 25 percent of each employee's taxable compensation (see Appendix 2 for COLAs). For 2007, compensation is limited to $225,000. The penalties and excise taxes associated with excess IRA contributions to an individual IRA apply to SEPs (IRC Sec. 4973). Certain SEPs may be integrated with Social Security (that is, permitted disparity); however, no individual can receive an allocation in excess of 25 percent of gross compensation. The rules that apply to permitted disparity are similar to the rules for defined-contribution plans (IRC Secs. 401(l)(2) and 408(k)(3)). Individuals may also contribute to their own IRA, subject to current IRA contribution limits. The employer's SEP is considered an employer plan in determining the deductibility of individual IRA contributions (IRC Secs. 219(g)(5)(A)(v) and 408(j)).

8.3 Taxation of Distributions

All distributions from a SEP are taxed as ordinary income unless they are rolled over to an IRA or qualified plan within 60 days of receipt of the distribution (IRC Sec. 408(d)(3)(A)). An additional 10 percent excise tax is imposed on premature withdrawals made before age 59½ (IRC Sec. 72(t)) (see section 5.4 of this chapter for exceptions). An employee must not be prohibited from immediately withdrawing employer contributions to a SEP.

Distributions from a SEP are not eligible for any lump-sum distributions treatment (see section 5.1 of this chapter).

8.4 Elective Contributions to an SEP (Plans Adopted Before January 1, 1997)

An employer can allow employees a choice of receiving cash or a contribution to an SEP. Employee-elective deferrals to an employer-sponsored SARSEP are subject to the IRC Sec. 402(g) limit of $15,500 for 2007. This limit is the 401(k) salary reduction limit (see Appendix 2 for COLAs). Catch-up contributions are also permitted if the SARSEP document permits such contribution. Note that a special ADP test is required for SEPs that differs from the ADP test for IRC Sec. 401(k) plans: (1) no averaging of the elective deferrals under the test for the HCEs is permitted and (2) the percentage deferral for any HCE cannot exceed 1.25 times the average for the nonhighly-compensated. Note the alternative "2 plus" and "2 times" testing threshold that is available for 401(k) plans does not apply to testing the ADP of a SARSEP.

8.5 SIMPLE Plans

Another option for a small employer is a SIMPLE plan. Beginning in 1997, an eligible employer can establish a SIMPLE retirement plan to receive some of the tax-favored benefits of qualified plans without having to meet many of the qualification requirements (IRC Sec. 408(p)). There are two types of SIMPLE plans: SIMPLE IRA and SIMPLE 401(k). The SIMPLE 401(k) tends to be less attractive because the plan must meet the coverage and reporting requirements of a traditional 401(k) plan (although testing is avoided under the ADP and ACP tests) and the maximum salary deferrals and employer contributions are greatly reduced. When an employer adopts a SIMPLE plan, there can be no other qualified plan for the employer.

8.5.1 SIMPLE plan contributions

Under a SIMPLE IRA, the amount of the employer's elective contributions withheld from the employee's pay and the required employer contribution are made to an IRA on behalf of the employee. The employer must make one of the two types of employer contributions:

— A 100 percent matching contribution on elective salary deferrals of an employee up to 3 percent of the employee's compensation, or

— A nonelective contribution of 2 percent of each eligible employee's compensation. (This contribution is not made for only those who salary defer.)

Note: An exception applies where the match is being made: An employer may elect to match at a percentage of compensation less than 3 percent, but not less than 1 percent, for two years during any five-year period (IRC Sec. 408(p)(2)(C)).

For 2007 an eligible employee may make elective deferrals up to $10,500 per year. It is subject to COLAs (IRC Secs. 408(p)(2)(A)(ii) and 408(p)(2)(E)). This contribution limitation and employer contribution limit applies to both SIMPLE IRAs and SIMPLE 401(k) plans.

EGTRRA created a provision allowing for annual catch-up contributions to be made by individuals who are at least age 50 before the end of any plan year after December 31, 2001, and who participate in a 401(k), SARSEP, or SIMPLE plan. The allowable catch-up amount, in excess of the normal SIMPLE elective deferral limit, is $2,500 for 2007.

Planning Tip:

As SIMPLE contribution amounts increase, some small employers who can fund no more than the SIMPLE limits may consider implementing a SIMPLE rather than a 401(k) plan. By implementing a SIMPLE rather than a 401(k) plan, employers avoid the compliance requirements of maintaining a 401(k) while still allowing for salary deferral for employees. Note however that employer contributions are mandatory and fully vested. If an employer is not interested in providing for an employer contribution over and above the required matching or discretionary amounts, a SIMPLE plan may meet the employer's needs and is less costly to adopt and administer than a 401(k) plan.

8.5.2 Compensation for SIMPLE purposes

Compensation for purposes of SIMPLE plan purposes is Form W-2 compensation plus elective deferrals. For self-employed individuals, compensation is net earnings from self-employment, without regard to elective deferrals or other SIMPLE contributions.

For 2007, the IRC Sec. 401(a)(17) compensation limit of $225,000 applies only in determining the 2 percent nonelective contribution (but not in determining the 3 percent matching contribution for SIMPLE IRAs).

8.5.3 Other SIMPLE requirements

An employer may make no other contribution to any plan beyond either the required SIMPLE match or nonelective contributions. An employer must deposit a participant's elective deferrals to a SIMPLE IRA no later than the 30th day following the last day of the month in which the deferrals were made. The employer must make the matching or nonelective contributions no later than the due date of the employer's tax return (including extensions) for the employer's year in which the SIMPLE's calendar year ends (IRC Sec. 408(p)(5)(A)). The 25 percent-of-compensation limitation that applies to a SEP does not apply to a SIMPLE IRA. Thus, an employee with at least $10,500 of compensation in 2007 can salary-defer the full $10,500.

Plan participation in the SIMPLE IRA must be provided for any employees who received at least $5,000 in compensation from the employer during any two preceding years and whom the employer reasonably expects to receive at least $5,000 in compensation during the year. SIMPLE 401(k) plans are subject to the minimum coverage requirements of traditional 401(k) plans. During the 60-day period before the beginning of any year, any eligible employee may elect to participate in the SIMPLE plan or may modify an election.

An eligible employer is an employer who:

— Employed not more than 100 employees who earned $5,000 or more during the preceding calendar year.

— Does not maintain any other qualified plan.

The related employer rules of IRC Sec. 414(b) apply in determining whether an employer is an eligible employer.

8.5.4 Credit for elective deferrals to a SIMPLE plan

To encourage low- and middle-income taxpayers to establish or maintain private savings accounts, EGTRRA established a nonrefundable credit for elective contributions to SIMPLE and other qualified retirement savings plans (IRC Sec. 25B). The amount of the credit for a tax year is equal to the applicable percentage times the amount of savings contributions (not to exceed $2,000) made by an eligible individual. The applicable percentage is determined by the taxpayer's filing status and adjusted gross income. The contribution amount must be reduced by any distributions received from the plan during the year. The credit may be used against both regular and alternative minimum tax liability. (See section 3.9.2 for a complete discussion of the credit for elective deferrals.)

9. OTHER KINDS OF PLANS

Although defined-benefit pension, money-purchase pension, stock bonus, and profit-sharing plans represent the four broad categories of qualified retirement plans, variations on the basic themes are common. A few of the variations are described in the following section.

9.1 Thrift or Savings Plans

Thrift plans, once common, have lost favor since the general acceptance of 401(k) plans. Thrift plans permit after-tax employee contributions. The Tax Reform Act of 1986 introduced a new nondiscrimination test under Section 401(m) that applies to after-tax employee contributions. These rules generally require that the percentage of after-tax contributions for the HCE be aggregated with any employer contributions and that these meet the same percentage limitations of 401(k) elective deferrals. Traditionally, after-tax contributions have only been made by the higher paid employees, and thus the average contribution rate for the NHCEs tends to be close to zero. Although an advantage remains to having employee contributions grow tax-deferred, the restrictions on withdrawals and administration generally offset any advantage.

Characteristics of thrift plans are the following.

- — Payroll deductions grow on a tax-deferred basis.
- — Company contributions are conditioned upon both profits and employee contributions.

After-tax employee contributions to profit-sharing plans are usually made voluntarily. Some larger defined-benefit and defined-contribution plans require mandatory after-tax contributions by employees to pension plans as a condition of employment. These plans are subject to nondiscrimination rules that apply to the employer provided benefits (IRC Sec. 401(a)(4)). Such plans are permitted as long as they are not so burdensome that lesser paid workers fail to participate, thus making the plans discriminatory. For the most part, these features are only seen in municipal or governmental plans (Regs. 1.401-3 and 4).

9.2 Stock Bonus Plans

A stock bonus plan is a defined-contribution plan established and maintained by an employer to provide benefits similar to those of a profit-sharing plan. Contributions made by the employer may either be in cash or in company stock. Benefits are ordinarily distributable in the stock of the employer company; however, an employer can be forced to purchase that stock (a put option). Rules on allocating stock to participants' accounts and contribution limits are similar to rules covering defined-contribution plans (IRC Sec. 401(a)(23) and Reg. 1.401-1(a)(2)(iii)).

If the employer's stock is not publicly traded and more than 10 percent of the plan's total assets are securities of the employer, certain voting rights of the employer's stock are, in effect, passed through to the participants.

Unless elected otherwise by the participant, distributions from a stock bonus plan must begin not later than one year after the plan year in which the participant separates from service due to the attainment of normal retirement age or due to disability or death, or after five years if separation is for other reasons (IRC Sec. 409(o)(1)(A)). Unless the participant elects otherwise, distributions must proceed in substantially equal payments over a period not longer than the greater of one of the following:

1. Five years
2. Five years plus one additional year (but not more than five additional years) for each $180,000 (for 2007) by which the participant's account balance exceeds $915,000 (IRC Sec. 409(o)(1)(C))

Participants entitled to a distribution from the plan have a right to demand that benefits be distributed in the form of employer securities (IRC Sec. 409(h)(1)). If the securities are not readily tradable, the employer must repurchase them or provide a 60-day put option (IRC Secs. 409(h)(1)(B) and 409(h)(4)). In certain cases, cash may be an acceptable medium for distribution (IRC Sec. 409(h)(2)). A type of stock bonus plan is an ESOP. It generally differs in that it is designed to hold 100 percent of the plan's assets in employer securities and it will frequently borrow to purchase a large block of employer stock. (See section 3.10 of this chapter.)

9.3 Money-Purchase Pension Plans

Money-purchase pension plans are defined-contribution pension plans that have fixed employer contributions and have the following characteristics.

— Employer contributions are mandatory.
— Employer contributions typically are either a specified amount or a percentage of an employee's compensation.
— Contributions must be definitely determinable and, thus, can neither be based on profits nor otherwise be allocated under the employer's discretion (Rev. Rul. 72-302).
— Employer contributions cannot be based on an employee's discretionary contributions (that is, salary deferrals).
— The normal form of benefit must be an annuity; however, lump sums are generally provided as an option if elected and all waivers and conditions met.
— Under certain conditions, age and service contribution formulas are permitted. The formulas must not result in prohibited discrimination (Reg. 1.401(a)(4)-2(a)) (for example, certain age-weighted allocations) (Reg. 1.401(a)(4)-8(b)). See the discussion of target benefit plans in the following section.

Forfeitures may be (but need not be) reallocated to the current plan participants, or may be used to reduce the employer's required contributions (IRC Sec. 401(a)(8)).

With the increase of the deduction limits for profit-sharing plans from 15 percent of total eligible compensation to 25 percent of total eligible compensation (see section 4.2) and equal to money-purchase pension plans, the use of money-purchase pension plans has essentially become obsolete. See section 4.2 for a Planning Tip related to money-purchase pension plans.

9.4 Target Benefit Plans (Hybrid Plans)

A target benefit plan is a type of money-purchase pension plan. The annual contributions are subject to the lesser of 10 percent of pay or $45,000 (see Appendix 2 for current amount). These contributions are determined under a formula in the plan that is based upon actuarial concepts. In some ways, these plans resemble defined-benefit plans but do not require any actuarial certification.

— Employer contributions are mandatory.
— The annual contributions are based on approved actuarial methods that provide level funding to a targeted benefit for each participant.
— Forfeitures may not be reallocated to other participants.
— Contributions may not be conditioned on profitability.
— Actuarial certifications are not required for the year-end Form 5500.

— Individual accounts for participants must be maintained.
— Benefits are based on the amounts that can be purchased from a participant's individual account.
— Insurance by the PBGC is not available.

Although these plans are discussed often, they currently make up less than 1 percent of employer plans. The Section 1.410(a)(4) regulations describe the rules for designing and funding these plans. Those regulations also permit a similar plan, the age-weighted plan (Reg. 1.401(a)(4)-8(b)).

10. ACCOUNTING FOR PENSION PLANS

Generally accepted accounting principles (GAAP) must be used by employers as a guide for the financial statements that are part of the Form 5500 filing. The accounting requirements that apply to defined-benefit and defined-contribution plans were completely changed by Financial Accounting Standards Board (FASB) Statements of Financial Accounting Standards Nos. 87 and 88. Implementation of these standards was not required until 1987 (1989 for some small companies) for calendar-year reporting. Recognition of minimum liability (discussed in Section 10.2) was not required until 1989. These pronouncements settle the following three major accounting issues.

1. How much pension expense should be charged annually?
2. What assets and liabilities should appear on the company's balance sheet?
3. What disclosures are necessary?

10.1 Calculation of Pension Expense—Defined-Benefit Pension Plans

Annual pension expense is determined as a function of the following five factors.

1. Service cost, also called normal cost, determined actuarially as the present value of benefits attributed to employee service during the period. If future compensation levels are incorporated in the benefit formula, then the benefits/years-of-service approach, which uses future pay, must be the basis for this period's cost. (Pension liability calculated under the benefits/years-of-service approach—called the projected benefit obligation rather than the accumulated benefit

obligation—is based on current pay levels and used for calculating minimum liability.)

2. Interest accrued on the present value of the projected benefit obligation outstanding during the period.
3. The actual return on plan assets, determined based on the fair value of plan assets at the beginning and the end of the period and adjusted for benefit payments and contributions.
4. Prior service cost (resulting from plan amendments or unfunded liability at adoption, as amortized, whether as a declining charge or a straight-line charge).
5. Gains and losses as a result of differences between expected and actual experience in respect to both assets and liabilities.

Gains and losses measure the effect of the plan's experience on the assumptions used, including return on plan assets, mortality experience, employee turnover, and salary levels. Gains and losses reflecting differences between expected and actual values might be significant in dollar amounts. To prevent wide fluctuations that might be caused by these differences, the corridor approach is used. The corridor approach requires amortization over the remaining service period of active employees of gains and losses in excess of 10 percent of the greater of the projected benefit obligation or the market-related asset value. Certain single-occurrence gains and losses that might arise from closing a plant or providing termination benefits in conjunction with a reduction in workforces or the discontinuance of a business segment are to be recognized as part of the immediate effect of the occurrence.

The extent of gains and losses on plan assets is measured by the market-related approach, which encompasses the use of a moving average of asset values over a period of time. The time horizon and the weighing scheme are both somewhat a matter of the management's choice.

To the extent that pension expense is overfunded or underfunded annually by asset contributions, prepaid pension cost (asset) or accrued pension cost (liability) accounts are created.

10.2 Minimum Liability

A liability must be recognized when the accumulated benefit obligation exceeds the fair value of the plan assets. The account to be debited as this liability is recognized as an intangible asset called, perhaps, deferred pension cost. If an accrued pension cost or liability account already exists, only the additional liability to bring the total up to the minimum needs to be recorded. No asset may be recorded if the fair value of the assets exceeds the accumulated benefit obligation.

10.3 Required Financial Statement Presentation and Disclosures

Excess of pension expense over amounts funded appears as a long-term liability, while an asset is shown when plan contributions exceed expense. After 1988, an additional liability appears if the accumulated benefit obligation exceeds the fair value of the plan assets. The debit is normally to an intangible asset account. If this debit is greater than the unrecognized prior service cost, the excess is reported as a contra account to stockholders' equity. Footnotes must include the following.

— A description of the plan, including groups covered, kind of benefit formula, funding policy, assets held, and the nature and effect of significant matters affecting comparability among the periods presented

— The components making up net pension expense for the period

— A reconciliation of the funded status of the plan with the amounts reported in the balance sheet, showing the amount of the following:

- Plan assets at fair value
- Projected benefit obligation
- Unrecognized prior service cost
- Unrecognized net gain or loss

— Any remaining unrecognized net obligation or net asset existing at the date of initial application of FASB Statement No. 87

— Additional liability recognized

— Prepaid pension cost or accrued pension cost recognized

10.4 Amortization of Transition Amounts and Prior Service Costs

Amortization is required for the transition amount that comes about when companies switch standards (that is, from FASB Statement No. 8 to FASB Statement No. 87). The transition amount is the difference between the projected benefit obligation and the fair value of the plan assets (an unrecognized net asset or net obligation). Straight-line amortization is useful over the greater of the average remaining service life of current participants in the plan or, if the employer so elects, 15 years.

10.5 Accumulated Versus Projected Benefit Obligation

For different purposes, two benefit approaches are used in the FASB pronouncements. The accumulated benefits approach bases pension expense (and liability) on current salary levels. The benefits/years-of-service approach makes its calculations on the estimated future pay of the employees covered by the plan. In most cases, the benefits/years-of-service approach, upon which is based the projected benefit obligation, will be used to determine expense and the accrued pension liability (in the case of underfunding). For purposes of calculating the possible minimum liability, the accumulated benefit obligation is used.

10.6 Regulatory Developments

These developments could affect the auditor's responsibilities during an audit.

10.6.1 Pension and Welfare Benefits Administration review of plan audits

The Pension and Welfare Benefits Administration (PWBA) has an ongoing quality review program to assess the quality of audit work performed by independent auditors in audits of plan financial statements required by ERISA. Practitioners deemed by the PWBA to have performed significantly substandard audit work are referred to either state licensing boards or the AICPA Professional Ethics Division for further investigation. Because ERISA holds plan administrators responsible for ensuring that plan financial statements are audited in accordance with generally accepted auditing standards (GAAS), deficient audit work can also expose administrators to significant penalties under ERISA Section 502(c)(2).

The PWBA continues its aggressive reporting compliance program to ensure that plan administrators comply with ERISA reporting and disclosure requirements. The PWBA plans to conduct a nationwide study to once again assess the quality of employee benefit plan audits.

10.6.2 Small pension plan security regulation

On October 19, 2000, the PWBA published a final rule to improve the security of the more than $300 billion in assets held in private-sector pension plans maintained by small businesses. In recent years, considerable public attention has focused on the potential vulnerability of small plans to fraud and abuse. Although such circumstances are rare, the

DOL decided it was appropriate to strengthen the security of pension assets and the accountability of persons handling those assets.

Historically, pension plans with fewer than 100 participants have been exempt from the requirements to have an independent audit of the plan's financial statements. This regulation is designed to safeguard small pension plan assets by adding to the audit waiver requirements new conditions that focus on persons who hold plan assets, enhance disclosure to participants and beneficiaries, and improve bonding requirements. The audit requirement for health and welfare plans is not affected by this regulation.

Under the regulation, the administrator of an employee pension benefit plan that is required to complete Schedule I of the Form 5500 is not required to engage an independent auditor, provided certain required disclosures are made in the plan's summary annual report (SAR) and:

- — At least 95 percent of the assets of the plan constitute "qualifying plan assets" or
- — Any person who "handles" assets of the plan that do not constitute qualifying plan assets is bonded in accordance with ERISA Section 412 and DOL Regulation 29 CFR 2580.412-6

According to the PWBA, the vast majority of assets of small plans are "qualifying plan assets." The PWBA believes that the plans that do not meet the 95 percent threshold will opt for the less expensive bonding alternative to avoid an independent audit of the plan's financial statements.

11. NONQUALIFIED PLANS

ERISA formulated the rules under which employers are permitted to maintain qualified plans. These rules require that retirement benefits be funded, be placed in a trust, not be discriminatory in favor of highly compensated employees (HCEs) and provide certain minimum coverage. Qualified plans must be established under IRC Sec. 401(a) and be funded into a tax-exempt trust described in IRC Sec. 501 or into insurance or annuity contracts. If this occurs, participants are permitted favorable tax benefits (for example, employer contributions are fully deductible, employers are not taxed until benefits are distributed, and trust earnings grow tax deferred).

There are, however, situations in which the employer does not want either to fund benefits or to provide minimum vesting, or wants to discriminate in favor of the HCEs. This generally results where an employer wants to provide additional retirement benefits to a select group of executives. Such plans can be structured as nonqualified deferred compensation plans or supplemental executive retirement plans (SERPs). Unlike qualified plans, these plans are permitted wide latitude in structure and operation as long as they meet certain ERISA exemptions. Bottom line, they must be structured to avoid application of ERISA.

The following advantages are available to nonqualified plans:

— They are generally more rigorous in benefits but may use longer vesting, making them easier and less costly to set up and maintain.

— Officers and other highly compensated or shareholder-employees or select groups of management can be the only targeted group for coverage (for example, the "top hat" groups).

— Participants generally can avoid current taxation on their benefit accruals because benefits are subject to restrictions (for example, they are forfeited if the employer becomes bankrupt).

However, employers cannot take a deduction for their contributions to a SERP until the time employees are taxed on the benefits, typically when benefits are paid. Generally, these plans must not be "funded" and should not be set up without professional advice. Despite an employer's intentional avoidance of ERISA rules, a nonqualified plan that is either "funded" or covers the wrong individual may trigger statutory requirements for minimum participation, vesting, disclosure, and Form 5500 reporting.

11.1 Deferral of Compensation Before January 1, 2005

Under specified conditions, nonqualified arrangements can assist selected employees by deferring taxability of part of their income. To achieve this deferral, the arrangement must be structured so that the employee is not in actual constructive receipt of the benefits. It is also essential that the employee not enjoy any of the economic benefits of the arrangement until the year when the amounts are to be taxed. The general rules on constructive receipt follow. Reg. 1.83-1 and Rev. Rul. 60-31 relate to the timing of the participant's taxation. The last three of the following items provide a simplified overview.

Income, although not actually reduced to the taxpayer's possession, is constructively received by him or her in the taxable year during which it is credited to his or her account, set apart for him or her, or otherwise made available so that he or she could have drawn upon it during the taxable year, if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions (Reg. 1.451-2(a)).

An employee will be considered to have the economic benefit of property that has not actually or constructively been received if interest in the property can be assigned by the employee to another person.

Similarly, the employee has the economic benefit if the property is placed in a trust or escrow account on his or her behalf and is not subject to a substantial risk of forfeiture (for example, a secular trust).

A risk of forfeiture exists if the legal obligation to pay the employee is subject to a substantial contingency such as, for example, the future performance of substantial services by the employee (IRC Secs. 83(a) and (b)).

Nonqualified arrangements must be unfunded (though an exception exists for "excess only" SERPs) and generally represent an unsecured promise to pay the compensation in a later year. An arrangement of this kind is referred to as a pay-as-you-go plan or as terminal funding. For the employee to achieve tax deferral, the agreement to defer payment to the later year must be made before the payment is earned (Rev. Rul. 60-31). An arrangement will be considered to be funded and the value of funds taxed to the individual if funds are placed in a separate trust, custodial, or escrow account (that is, beyond the control of the employer) or are used to make payments toward an annuity contract, and the employee has a right to receive the payment directly from the trust, account, or annuity (or to transfer rights to another) even if the right will come about only at a future date.

If the funds are segregated but remain part of the general assets of the company subject to claims of creditors (such as in a rabbi trust), they will not be treated as funded, even if they are vested. Under such an arrangement, the employee is only a general and unsecured creditor of the company in an amount equal to the accrued benefits.

The employer's obligation will be considered to be unfunded if the company is designated as the sole beneficiary of a grantor trust or annuity from which benefits are to be paid. Alternatively, even though payment may be secured by funds set aside in a trust, account, or annuity, the company's payment obligation could be made contingent on the employee's continued performance of services with the company during the period designated for tax deferral. Either technique can fulfill the objective of tax deferral.

Under IRC Sec. 3121(v)(2), an amount deferred under a nonqualified deferred compensation plan needs to be taken into account for purposes of FICA and FUTA taxes at the earlier of when the amounts are not subject to substantial restrictions (that is, vested) or when the services are performed. In other words, if amounts were accrued and vested under a deferred compensation agreement, the value of the benefit would be subject to Social Security and Medicare taxes for which no maximum exists. If benefits under a nonqualified deferred compensation plan are reported for FICA and FUTA purposes when required, the benefits (including all increases in value) are not subject to FICA and FUTA taxes when paid.

11.2 Department of Labor Considerations

It is crucial to be aware that nonqualified deferred compensation plans (even those that an employer may intend to be unfunded) are likely to fall under ERISA's requirements for participation, vesting, and funding, unless the plan is both (1) unfunded and (2) maintained by the employer "primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees." Therein lies the particular attraction to start-up companies of nonqualified and unfunded plans. If they are unfunded and also carefully targeted to the select group of management or highly compensated employees (exactly the group likely to be seen as most critical to motivate and reward), a number of the complexities of ERISA can be avoided.

Unfunded plans maintained primarily to provide deferred compensation for a select group of management or highly compensated employees are exempt from the participation, vesting, funding, and fiduciary responsibility provisions of ERISA. Little guidance is provided from the DOL in determining who will constitute this select group.

An employer is required to file a Form 5500 for a nonqualified deferred compensation plan, unless using the alternate reporting requirement under DOL Regulation 2520.104-23. The reporting and disclosure provisions can be satisfied by filing a statement with the Secretary of Labor no later than 120 days after first covering any employee. This statement must include the following:

- The name and address of the employer
- The employer's identification number
- A declaration that the employer maintains a plan or plans primarily for the purpose of providing deferred compensation to a select group of management or highly compensated employees
- A statement of the number of such plans and the number of employees in each plan
- Plan documents, if any, upon request by the Secretary

If the alternative method is not used, other reporting requirements apply, including the requirements to file certain annual reports and to provide a summary plan description. If it is not, the employer must file Form 5500 each year.

11.3 Securing Deferred Compensation Before January 1, 2005

To provide assurance to participants that there will be funds to pay their deferred compensation, an employer may set aside funds to meet the promise of future payments. This security arrangement must be carefully designed to avoid taxation under the doctrine of constructive receipt. Often, these instruments are structured as rabbi trusts, which are grantor trusts with the employer as grantor. The IRS has established procedures to submit a nonqualified plan and a rabbi trust for confirmation such that constructive receipt does not exist (Rev. Procs. 92-64 and 92-65). Rabbi trusts so structured are not deemed by the IRS to be funded. Additionally, the working premise of the DOL seems to be that trusts of this nature will be treated as unfunded plans.

11.4 Taxation of Nonqualified Arrangements Before January 1, 2005

Regardless of the employer's status as an accrual- or cash-basis taxpayer, the employer's contributions to a trust created under a nonqualified plan cannot be deducted until the time when the amounts are taxable to the participant (IRC Sec. 404(a)(5) and Reg. 1.404 (b)-1). Recipients include the payments as gross income in the year in which the benefits become either vested or transferable or are no longer subject to a substantial risk of forfeiture (see section 11.1 of this chapter).

IRS Announcement 2000-1 outlines reporting requirements for government deferred compensation plans (IRC 457 nonqualified deferred compensation plans).

11.5 New Requirements for Nonqualified Deferred Compensation Plans

The American Jobs Creation Act of 2004 (AJCA), enacted on October 22, 2004, added Section 409A to the Internal Revenue Code effective for nonqualified deferred compensation amounts deferred after December 31, 2004. IRC Sec. 409A significantly affects the design and operation of nonqualified deferred compensation plans and affects all employers, whether public, private, or tax exempt.

IRC Sec. 409A provides that all amounts deferred under a nonqualified deferred compensation plan for taxable years after 2004 are currently included in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income, unless specified requirements are met.

The downside of violating these rules is considerable: affected participants in plans not in compliance with the AJCA are immediately taxed on deferred compensation and are subject to a 20 percent penalty (of the compensation required to be included in income) plus underpayment interest on the tax due (charged at the IRS underpayment rate plus 1 percent). The three requirements that must continuously be met to avoid early taxation plus penalty and interest are:

1. The distribution rule (section 11.5.2).
2. The election rule (section 11.5.3).
3. The acceleration of benefits rule (section 11.5.4).

11.5.1 Definition of nonqualified deferred compensation

IRC Sec. 409A applies to any "plan," "agreement," or "arrangement" that provides for deferral of compensation other than tax-qualified plans, qualified annuity plans, tax-deferred annuities, and plans providing for vacation, sick leave, stock option agreements, both statutory and nonstatutory, and death benefits.

The total amount of the employee's deferral for the year must be reported as nonqualified deferred compensation on Form W-2 for the year of the deferral. The amount is reported in box 12 using code Y (deferral under a Section 409A nonqualified deferred compensation plan). However, these reporting requirements were suspended for calendar year 2005 by Notice 2005-94 and for calendar year 2006 by Notice 2006-100.

11.5.2 Plan distributions

The post-2004 deferrals under a nonqualified deferred compensation plan must not permit distributions earlier than:

1. Separation from service (as determined by Treasury),
2. Date the participant becomes disabled,
3. Death,
4. A specified time or pursuant to a fixed schedule specified under the plan at the date of deferral of the compensation,
5. A change in the ownership or control of the employer (to the extent provided by Treasury), or
6. An occurrence of an unforseeable financial emergency.

11.5.3 Election

The timing of all deferral elections must continue to satisfy the rules of constructive receipt. The initial election to defer compensation must be made not later than the close of the preceding year, or at such time as the IRS may provide in regulations. However, in the first year in which the participant becomes eligible to participate in a nonqualified deferred compensation plan, the election may be made with respect to services to be performed subsequent to the election within 30 days after the date the participant is eligible to participate in the plan.

Any performance-based compensation that is based on performance over a period of at least 12 months may be deferred via an election no later than six months before the end of the service period.

11.5.4 Acceleration of benefits

A plan may not permit the acceleration of the time or schedule of any payments except as provided in Treasury regulations. The Conference Committee report indicates that the regulations should provide limited exceptions to the prohibition on accelerated distributions, such as when the accelerated distribution is required for reasons beyond the participant's control.

11.5.5 Comprehensive guidance on the new rules

The IRS has issued guidance with respect to the application of the nonqualified deferred compensation rules.

In Notice 2005-1, IRB No. 2005-2, the IRS addresses the following:

1. Arrangements that are considered nonqualified deferred compensation subject to the new rules.
2. Plan amendment of certain nonqualified deferred compensation arrangements.
3. The definition of change of ownership or control.
4. Application of information reporting and wage withholding requirements.
5. Reliance of transition guidance; good faith, reasonable interpretation.
6. Payment elections.

In late September, 2005, the IRS issued significant proposed regulations (Prop. Regs. 1.409A-1 through 1.409A-6) dealing with the rules of Section 409A. The rules also extended the deadline for documentary compliance with Section 409A to December 31, 2006. The deadline was initially December 31, 2005.

The IRS again extended the deadline for documentary compliance with Section 409A to December 31, 2007 in Notice 2006-79. Final regulations under Section 409A issued during 2007 are not effective until January 1, 2008 and the good faith compliance period and deadline for amending plan documents was also extended until January 1, 2008 by Notice 2006-79.

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APPENDIX 1: Selected ERISA Pension Plan Reporting and Disclosure Requirements

Document	*Type of Information*	*To Whom*	*When*
Summary Plan Description (SPD)	A booklet or similar document written in easily understandable language that tells how the plan operates; when employees are eligible to receive their pensions; how to calculate the amount of their benefits; and how to file claims.	All plan participants, free of charge	Within 90 days after an employee becomes a participant in a plan.
		U.S. Department of Labor (DOL)	Within 120 days after the plan is adopted.
Summary of Material Modification (SMM)	Summary description of any change or modification made to SPD information.	All plan participants and DOL	Within 210 days after end of plan year in which the change was adopted.
Updated SPD	Updates booklet or document to include all changes, modifications.	All plan participants and DOL	Within 210 days after end of plan year in which 5-year period ends if plan was amended; 10 years if not.
Summary Annual Report	Data on plan's financial activities. (Full Annual Report must be provided if requested in writing.)	All plan participants	Within 9 months after the end of the plan year.
Survivor Coverage Data	Information on plan's survivor coverage and how it affects participants and spouses.	All plan participants	Reasonable period after employee becomes a participant.
Benefit Statement	Total benefits a participant has accrued and vested benefits, if any, that have accrued, or date they become vested.	Plan participants or beneficiaries	Within 60 days when requested in writing but not more than once a year; and upon termination of employment or upon break in service.
Form 5500 Series (5500, 5500-C, 5500-R)	Identification, operations, tax qualification, minimum funding, fiduciary, and financial data.	Internal Revenue Service (IRS); participants, if written request	By the last day of 7th month after end of the plan year.

(continued)

Document	*Type of Information*	*To Whom*	*When*
Schedule A	Data on insurance premiums and disbursements to pay premiums, number of persons covered under insurance contract, etc.	IRS	By last day of 7th month after end of the plan year (as attachment to Form 5500 Series).
Schedule B	Actuarial data that must be filed by defined-benefit plans and certain other plans subject to ERISA's minimum funding requirements.	IRS	By last day of 7th month after end of the plan year (as attachment to Form 5500 Series).
Schedule C	A listing of most persons who provide services to a pension plan and the amount of compensation paid them. Also, a listing of all plan trustees and most service-providers terminated during the year, with the reason for the termination.	IRS	By last day of 7th month after end of the plan year (as attachment to Form 5500 Series).
Schedule SSA	Lists terminated employees and the amount of their vested benefits.	IRS (which forwards data to Social Security Administration)	By last day of 7th month after end of plan year for any year in which vested employee terminates (as attachments to Form 5500 Series).
Form 5310 (Parts I and II)	Provides notice of merger, consolidation, or transfer of pension plan assets or liabilities, or plan termination.	IRS	At least 30 days before the plan merger, consolidation, or transfer.
Form 5558	Requesting an extension of time of up to 2½ months which may be granted any filer for filing the Form 5500 Series.	IRS	By last day of 7th month after end of plan year. Form must be filed on time.

APPENDIX 2: Limitations Affected by Cost-of-Living Adjustments

	2002	*2003*	*2004*	*2005*	*2006*	*2007*
Annual Limitations						
Benefit and Compensation Limitations*						
Maximum Benefit (DBP), IRC Sec. 415(b)(1)(A)	$160,000	$160,000	$165,000	$170,000	$175,000	$180,000
Maximum Contribution, IRC Sec. 415(c)(1)(A)	40,000	40,000	41,000	42,000	44,000	45,000
Maximum Compensation, IRC Sec. 401(a)(17)/404(l)	200,000	200,000	205,000	210,000	220,000	225,000
401(k) and SEP Salary Reduction	11,000	12,000	13,000	14,000	15,000	15,500
Highly Compensated Employee Definition, IRC 414(q)(1)(B)*						
An Employee	90,000	90,000	90,000	95,000	100,000	100,000
SEP Compensation Limit 408(k)(2)(C)	450	450	450	450	450	500
Social Security Information						
OASDI Tax Rate	6.2%	6.2%	6.2%	6.2%	6.2%	6.2%
HI Tax Rate	1.45%	1.45%	1.45%	1.45%	1.45%	1.45%
OASDI Wage Base	84,900	87,000	87,900	90,000	94,200	97,500

*These limits are applied on a plan-year basis for plan years beginning on the calendar year. See http://www.irs.gov/newsroom/article/0,,id=163616,00.html and http://www.ssa.gov/pressoffice/factsheets/colafacts2007.htm for more information.

Employment Regulations

EMPLOYMENT REGULATIONS

See also CD Toolkit for updates, links and additional resources.

1. INTRODUCTION

Employment is regulated by the federal government, by state and local governments, by collective bargaining agreements, and by written or oral employment contracts. This chapter covers wages and hours, labor relations, discrimination issues, and certain post-employment issues. Occupational health and safety is covered in the chapter on workers' compensation, and employee benefits and U.S. immigration laws are also covered in other chapters of the manual.

These employment regulations exist to protect employees with regard to such items as wages and hours, unlawful discrimination, and hiring policies.

2. SOURCES

Employment regulation stems from several sources. Federal statutes, state statutes, local ordinances, collective bargaining agreements, common law, and private employment contracts all interact to govern the employer/employee relationship.

Even though federal statutes may not exist in a given area, state and local statutes, along with collective bargaining agreements, should be closely reviewed for possible applicability.

2.1 Federal Statutes and Regulations

The federal government draws its authority to regulate employment from such laws as the Fair Labor Standards Act (FLSA), the Civil Rights Act of 1964 (specifically Title VII), the Age Discrimination in Employment Act of 1967, the 1974 Employee Retirement Income Security Act (ERISA), the 1986 Comprehensive Budget Reconciliation Act (COBRA), the Immigration and Naturalization Act of 1986, the National Labor Relations Act, the Americans with Disabilities Act, Executive Order 11246, as amended in 11375, the Equal Pay Act, and the Family Leave Act.

The agencies authorized by Congress to regulate in this area are

— The Department of Labor (DOL).
— The Equal Employment Opportunity Commission (EEOC).
— The National Labor Relations Board (NLRB).

2.2 State and Local Statutes and Regulations

States and local governments may regulate in areas that have not been preempted by Congress. This means states and local governments may and do regulate in areas not regulated by Congress or where Congress does not expressly or by implication prevent it.

Sources of state regulation can be found in state statutes and administrative rules and regulations. This chapter summarizes *sources* of information on each state and describes general circumstances in states because it would not be practical to cover each state in detail. A listing of the state labor agencies is found at the end of this chapter; to obtain more specific statutory and regulatory information, apply to these sources.

2.3 Common Law

Because many areas of employment law have been heavily contested, both federal and state statutory laws have been interpreted and modified by the courts. Also, labor and payroll management guides such as those published by Commerce Clearing House and Prentice-Hall provide detailed state-by-state information as well (see references to the chapter). Under our common-law system, court-made law is another source of regulation.

2.4 Collective Bargaining Agreements

Collective bargaining agreements, when negotiated, provide a source of regulation for the specific employment relationship mandated by the agreement. Such agreements are valid and enforceable, assuming their provisions are legal and reasonable.

2.5 Written Employment Agreements

Where written employment agreements exist, they are a source of regulation for the specific employment relationships covered by the agreements. As long as the agreements are not illegal or unconscionable, they are valid and enforceable.

3. DEFINITIONS

The following definitions apply throughout this chapter. Different statutes tend to define the terms differently, so the terms must be considered in relation to specific statutes.

Employee. Any individual who performs services at the direction and control of an employer, both as to what shall be done and how it shall be done. An employer has the right to hire and fire an employee and also furnishes the tools and a place to work.

Independent contractor. Persons in business for themselves who are not under the direct supervision of another employee.

Workweek. A fixed and regular recurring period of 168 hours—seven consecutive 24-hour periods—that may start on any day of the week. Some collective bargaining agreements define a workweek to be less than seven days.

Holiday. A day customarily observed in the community in celebration of some historical or religious occasion.

Pay period. Period of service for which a payment of wages is ordinarily made to an employee. Each state governs the length of pay periods.

Vacation. A period of rest from work normally for a specific time frame, normally enjoyed with recreational activities.

Leave. A period for which permission to be absent from work has been granted.

3.1 Independent Contractor or Employee

An employer who erroneously categorizes an employee as an independent contractor may be liable for failure to pay unemployment insurance contributions, minimum wages, overtime, or Social Security, and for failure to withhold income tax. Additionally, employees who have been erroneously classified as independent contractors are covered by the National Labor Relations Act, and, if they are wrongfully discharged, the employer may be held liable for reinstatement of the discharged employee with back pay and restoration of lost benefits.

Statutes, such as the National Labor Relations Act and the Fair Labor Standards Act, do not provide a uniform definition of *independent contractor.* Various administrative agencies and the courts have not formulated one uniform definition, but instead look at the specific facts of each case and the purpose of each law in determining whether a worker is an independent contractor. Because of this, an individual who is considered an independent contractor, for purposes of unemployment insurance, may be determined to be an employee under the Fair Labor Standards Act (FLSA).

Under common law, an employer-employee relationship generally is determined to exist when an employer has the right to control and direct the worker, not only in terms of what needs to be accomplished but also with respect to details and the means by which the result is accomplished. Stated differently, an employee is subject to the will and control of the employer not only in regard to what shall be done, but also *how* it shall be done. As long as the employer has the right to direct and control the manner in which the services are performed, an employer-employee relationship is deemed to exist.

Historically, the courts have also looked at other factors beyond the single determinative issue of control. The courts have found that other major factors that characterize an employer-employee relationship include the fact that the individual has the same wages, hours, or working conditions as other employees, and that the individual is subject to the same personnel policies as other employees, or that the employer furnishes the employee with tools or a place to work as he or she similarly furnishes to other employees.

Conversely, if a person exercises control or direction merely with respect to what is to be accomplished and not to the means and methods for accomplishing the result, an individual working with that person is normally deemed to be an independent contractor. Examples include construction contractors, lawyers and accountants engaged in the pursuit of an independent trade or business, and other similar professional trades or businesses.

An individual's status is determined on a case-by-case basis, and requires an examination of all the factors surrounding a particular working relationship. For the most part, the courts have looked at the "right to control," both in terms of the result to be accomplished and the manner and means by which the result is achieved.

In case of doubt over a worker's status, IRS Form SS-8, "Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding," can be completed and submitted to the IRS by either the firm or the worker. If submitted by the worker, the worker must consent to disclosure of his or her name and of the contents of Form SS-8 to the firm.

The following is a list of factors described in Revenue Ruling 87-41 bearing on the "right to control" that should be considered when determining the employment status of an individual:

- Instructions: Generally, an individual is an employee if required to follow instructions, oral or written, regarding where, when and how the work is to be completed.
- Training: If an individual is trained by an employee, that individual is ordinarily also considered an employee.
- Integration: If an individual's services to a business have a direct bearing on the success or continuation of that business, that individual normally is subject to a certain amount of control, indicating that the individual is an employee.
- Services Rendered Personally: If an employer is concerned with not only how well a job is completed but who completes the job, the

services are considered personal, which thereby indicates that the individual performing the services is an employee.

— Hiring, Supervising & Paying Assistants: If an employer makes payments to, supervises and hires individuals, it is generally considered that the individuals are employees. However, if one individual pays, hires, and supervises other individuals under a contract to provide labor and materials, the supervisor normally would be considered an independent contractor, not an employee.

— Continuing Relationship: An employer-employee relationship exists if a continuing relationship is established between the employer and the individual performing the services.

— Set Hours of Work: If an employer sets hours of work, an employer-employee relationship normally exists.

— Full-Time Work Required: If an individual does not engage in other work, but devotes full time to the business, that individual would normally be considered an employee.

— Place of Work: If an individual performs work on the employer's premises that could be performed elsewhere, the individual is normally considered an employee. The fact that the individual is on the employer's premises implies that the employer controls the direction and supervision of the work.

— Sequence of Work: If an individual's work must be completed in a certain sequence, the employer is establishing control and therefore the individual is considered an employee.

— Reports: If an individual is required to submit reports to the employer, the individual is normally considered an employee.

— Method of Payment: Independent contractors are normally paid by the job, whereas employees are normally paid by the hour, week or month.

— Payment of Business Expenses: An independent contractor normally is not reimbursed for business and traveling expenses, whereas an employee is normally reimbursed by the employer for such expenses.

— Furnishing of Tools & Materials: Employees normally are furnished tools and materials by the employer, whereas an independent contractor normally must furnish these items himself or herself.

— Investment: An individual who must provide facilities for the performance of work is normally considered an independent contractor. For example, independent contractors often must provide their own premises for work, clothing, and other instruments.

— Risk of Loss: An employee normally is not in a position to realize a loss, whereas an independent contractor may realize a profit or loss as a result of work.

— Working for More than One Firm at a Time: An individual who performs services for more than one firm at a time is generally considered an independent contractor.

— Availability of Services to General Public: An individual who holds out services to the general public is generally considered an independent contractor.

— Right to Discharge: If an employer has the right to discharge an individual, that individual is normally considered an employee. An independent contractor normally cannot be discharged as long as the contract is fulfilled.

— Right to Quit: If an individual has the right to terminate work efforts, that individual normally is considered an employee. An independent contractor must complete the contract before terminating the relationship.

In 1996, the IRS released an internal IRS Training Guide entitled "Independent Contractor or Employee?" (Training 3320-102, Rev. 10/96). The guide may not be cited as authority by employers in classifying workers. The training guide moves the focus away from compiling numbers of factors and toward gathering evidence illustrating how the parties view their relationship and the extent of an employer's behavioral and financial control over a worker.

Additionally, the IRS described procedures in Rev. Proc. 99-28 (IRB No. 1999-29), allowing taxpayers to request early referrals of employment tax issues, including worker classification issues, to the Appellate Office of the IRS.

Under a new worker classification settlement program, businesses that filed Form 1099 information returns and failed to meet the requirements for Section 530 (1978 Revenue Act) relief would be allowed to reclassify workers prospectively and pay only a specified tax assessment, not to exceed a one-year tax liability. In IRS Notice 98-21, the IRS extended the classification settlement program until further notice.

4. FEDERAL WAGE AND HOUR REQUIREMENTS

4.1 Covered Enterprises

All employees of certain enterprises having workers engaged in interstate commerce, producing goods for interstate commerce, or handling, selling, or otherwise working on goods or materials that have been moved in or produced for such commerce by any person, are covered by the Fair Labor Standards Act.

A covered enterprise is the related activities performed through unified operation or common control by any person or persons for a common business purpose and

— Whose annual gross volume of sales made or business done is not less than $500,000 (exclusive of excise taxes at the retail level that are separately stated); or

— Is engaged in the operation of a hospital, an institution primarily engaged in the care of those who are physically or mentally ill or disabled or aged, and who reside on the premises, a school for children who are mentally or physically disabled or gifted, a preschool, an elementary or secondary school, or an institution of higher education (whether operated for profit or not for profit); or

— Is an activity of a public agency.

Some employees are specifically exempted from the requirements of the Fair Labor Standards Act. As a basic rule, bona fide executive, administrative, and professional employees (including academic administrative personnel and teachers) and outside salespeople are exempt from the minimum wage and overtime requirements if they meet the tests set forth for each category.

Whether employees are exempt depends on

— Their duties and responsibilities.

— The salary paid (except in the case of doctors, lawyers, teachers, and outside salespeople).

The following partial lists represent employees who are fully or partially exempt from minimum wage, equal pay, and overtime pay requirements of the FLSA. A complete listing can be found in payroll management guides such as those published by Commerce Clearing House (CCH) and Prentice Hall (see references to the chapter).

— Fully exempt from minimum wage, equal pay, and overtime pay:

Executive, administrative, or professional employees, including teachers, who meet minimum salary levels

Outside salespersons

Employees of amusement or recreational establishments that have seasonal peaks

Agricultural employees with very specific limitations (see a payroll guide for details)

— Fully exempt from only the overtime requirements:

Employees of motor carriers subject to regulation by the secretary of transportation
Seamen
Agricultural employees
Taxicab drivers
Household domestic employees

— Partially exempt from overtime pay requirements:

Commissioned employees of retail or service establishments
Private hospital employees
Employees of hotels, motels, or restaurants

4.2 Covered and Exempt Employees

The Department of Labor issued regulations effective August 23, 2004, that significantly changed the rules for overtime pay. Employees generally cannot be exempted unless they are guaranteed a minimum weekly salary in addition to performing certain job-related duties. Exemptions do not apply to manual laborers or other "blue collar" workers who perform work involving repetitive operations with their hands, physical skill, and energy. Thus, for example, nonmanagement production-line employees and nonmanagement employees in maintenance, construction, and similar occupations, such as carpenters, electricians, mechanics, plumbers, iron workers, craftsmen, operating engineers, longshoremen, construction workers and laborers have always been, and will continue to be, entitled to overtime pay.

Exemptions do not apply to "first responders," such as police officers, firefighters, paramedics, emergency medical technicians, and similar public safety employees who perform work such as preventing, controlling, or extinguishing fires of any type; rescuing fire, crime, or accident victims; preventing or detecting crimes; conducting investigations or inspections for violations of law; performing surveillance; interviewing witnesses; interrogating and fingerprinting suspects; preparing investigative reports; and similar work.

4.2.1 Minimum salary test

The minimum salary level required for exemption is $455 per week. Highly compensated employees may be exempt from overtime pay. The "highly compensated" test in the final regulation applies only to employees who earn at least $100,000 per year. The "highly compensated" test applies only to employees who receive at least $455 per week on a salary basis. The regulation also requires that exempt highly compensated employees must "customarily and regularly" perform exempt duties. The minimum salary test applies to all employee groups except outside salespersons.

4.2.2 Executive exemption

Employees who own at least a bona fide 20 percent equity interest in an enterprise are exempt only if they are "actively engaged in its management." The final regulations delete the special rules for exemption applicable to "sole charge" executives. Executives must regularly and customarily direct the work of two or more full-time employees. An exempt executive must have authority to "hire or fire" other employees or must make recommendations on the "hiring, firing, advancement, promotion or any other change of status."

4.2.3 Administrative exemption

Administrative employees perform office work in the business operation or management of the employer or employer's clients, such as accounting, finance, quality control, purchasing, advertising, or human resources. Exempt administrative employees must exercise discretion and independent judgment.

4.2.4 Professional exemption

A professional employee is exempt when the duties require advanced knowledge in a field of science or learning normally acquired by a prolonged course of specialized study. The rules define "work requiring advanced knowledge" as work that is predominantly intellectual in character and includes work requiring the consistent exercise of discretion and judgment. The distinctions between exempt and nonexempt may be subtle, such that licensed practical nurses and other similar health care employees do not qualify as exempt professionals, whereas registered nurses may be exempt if they are salaried, rather than compensated hourly.

Creative professionals have specific criteria to be classified as exempt, including performing work requiring invention, imagination, originality, or talent in a recognized field of artistic or creative endeavor.

Similarly, computer professionals involved in programming, systems analyses, and software engineering are exempt from overtime when their primary duties include system or program design, development, documentation, analysis, creation, testing, or modification.

4.2.5 Outside sales exemption

Outside sales employees are exempt from overtime rules when their primary duties include making sales or obtaining orders or service contracts at the customer's place of business or home. Outside sales generally do not include Internet sales, or those made by mail or telephone. The minimum salary test does not apply to outside sales employees.

4.3 Overtime Pay

Generally, overtime pay must be paid on hours over forty worked in a workweek. The overtime pay must be one and one-half times the employee's regular hourly rate. The *regular hourly rate* is normally defined to be the average rate paid for hours worked during the week. It is the employee's total weekly compensation, less exclusions provided for in the FLSA, divided by total weekly hours worked. Calculations and requirements on overtime pay are these:

— The overtime pay is figured on a workweek basis whether the employee is paid on a daily, weekly, biweekly, monthly, or piecework basis.

— The FLSA prevails over less beneficial state laws where both cover the same employees. Where requirements fixed by state law are higher than those under the FLSA, state law prevails.

— Each workweek stands alone. Overtime worked in one week may not be offset against nonovertime hours worked in another week.

— The FLSA contains no provision that requires the employer to pay an employee overtime for hours worked in excess of eight hours per day or for work on holidays, Saturdays, or Sundays, although some state and local statutes contain such provisions.

— An employer's order prohibiting overtime does not relieve the employer of the responsibility to pay overtime, if the employee is permitted to work.

— Overtime does not need to be paid weekly. It can be paid on the normal payday.

4.3.1 Overtime computations

Following are examples of computing overtime.

Hourly rate (regular pay rate for an employee paid by the hour). If more than forty hours are worked, at least one and one-half times the regular rate for each hour over forty is due, where regular rate is defined per paragraph one of section 4.3, above.

Example. An employee paid $5.15 an hour works 44 hours in a workweek. The employee is entitled to at least one and one-half times $5.15, or $7.73, for each hour over forty. Pay for the week would be $206 for the first forty hours, plus $30.92 for the four hours of overtime—a total of $236.92.

Piece rate. The regular rate of pay for an employee paid on a piecework basis is obtained by dividing the total weekly earnings by the total number of hours worked in the same week. The employee is entitled to an additional one-half times this regular rate for each hour over forty besides the full piecework earnings.

Example. An employee paid on a piecework basis works forty-five hours in a week and earns $236.25. The regular pay rate for this week is $236.25 divided by forty-five, or $5.25 an hour. In addition to the straight-time pay, the employee is entitled to $2.63 (one-half the regular rate) for each hour over forty.

Time and a half. Another way to compensate a pieceworker for overtime, if agreed to before the work is performed, is to pay one and one-half times the piece rate for each piece produced during overtime hours. The piece rate must then be the one actually paid during non-overtime hours and must be enough to yield at least the minimum wage per hour.

4.4 Minimum Wage Requirements

The federal minimum wage is $5.15 per hour, effective September 1, 1997. However, Congress was considering legislation at the time of publication that would increase the minimum wage to $7.25 over two years. The FLSA prevails over less beneficial state laws where both cover the same employees. Where requirements fixed by state law are higher, state law prevails.

Employees can be paid on an hourly, salary, monthly, piecework, or any other basis as long as the minimum hourly requirement is met. Calculations and requirements of the minimum hourly rate are as follows:

- A week in which the minimum rate is underpaid cannot be averaged with a week in which it is overpaid to satisfy the minimum requirement.
- Employees hired solely on the hourly rate *must* be paid at least the minimum rate.
- A fixed weekly salary divided by the number of hours worked must equal or exceed the minimum rate.

— Wages paid on a piece-rate basis meet the minimum requirements if the average hourly earnings for the workweek equal or exceed the minimum rate.

4.5 Amounts Treated as Wages for Agricultural Employees

Although most agricultural labor is considered covered employment under the Federal Insurance Contribution Act (FICA), only cash payments constitute wages for purposes of the FICA and only if the cash remuneration paid during the year is $150 or more per employee or the employer's total payroll is $2,500 or more (including noncash wages) for the year (IRC Sec. 3121(a)(8)(B)). However, wages paid to a farmworker who receives less than $150 in annual cash wages are not subject to FICA even if the employer paid $2,500 or more in that year to all farmworkers, if the farmworker—

- Is employed in agriculture as a hand harvest laborer,
- Is paid piece rates in an operation that is usually paid on a piece-rate basis in the region of employment,
- Commutes daily from his or her home to the farm, and
- Had been employed in agriculture less than thirteen weeks in the preceding calendar year.

The amounts paid to these seasonal farmworkers count toward the $2,500 or more test for determining FICA coverage of other farm workers.

Cash includes checks and other monetary forms of exchange, but not noncash items such as lodging, food, clothing, or payment of other goods or commodities (IRC Sec. 3121(a)(8)(A)). Noncash payments for agricultural employees are not subject to FICA, federal, or state tax withholding or unemployment taxes.

Special rules under the FLSA and state law apply to minimum wage and overtime pay for agricultural employees. Payroll management guides such as those published by Commerce Clearing House (CCH) and Prentice Hall, along with applicable state law, should be reviewed.

4.6 Tipped Employees

Wages paid to a tipped employee are deemed to be increased by up to 50 percent of the applicable statutory minimum wage rate but not more than the actual tips received by the employee. In paying the wages of a tipped employee, the employer is allowed to credit up to 50 percent of the employee's statutory minimum wage as coming from tips. Each state sets its own maximum tip credit.

> *Example.* Assume the statutory minimum wage is $5.15. The employer is allowed to pay a tipped employee $2.58 per hour (5.15 − (5.15 × .50)) provided that the employee actually received tips equal to or in excess of the tip credit.

To qualify as a tipped employee, the employee must be engaged in an occupation in which it is customary to receive more than $30 per month in tips.

4.7 Paid Time Off

Employers are not required by the FLSA to pay employees who do not work holidays or to pay at a premium rate for those who do work on holidays. Employers should also review state law holiday pay requirements.

Employers are not required by the FLSA to give employees vacations, paid or otherwise, or to pay sick pay. Employers should also review state law sick pay requirements.

4.8 Rest Periods and Coffee Breaks

The FLSA does not require that employees be given rest or meal periods or coffee breaks. However, if rest periods and coffee breaks are given, governmental enforcement agents require them to be counted as hours worked if they last twenty minutes or less.

4.9 Child Labor Laws

The FLSA child labor provisions protect children who are employed. The provisions protect the educational opportunities of minors and prohibit their employment in jobs under conditions detrimental to their health or well-being. The Secretary of Labor provides lists of hazardous occupations for both farm and nonfarm jobs, in which minors below specified ages may not be employed.

Regulations governing youth employment in farm versus nonfarm jobs differ somewhat. A complete list of ages and acceptable work may be obtained by contacting the state labor agency as listed in Appendix 1 or the local office of the

U.S. Department of Labor
Employment Standards Administration
Wage and Hour Division

Minors of any age may be employed by their parents at any time in any occupation on a farm owned and operated by their parents, although many state statutes exist to provide more restrictive regulations. Such state statutes should be referred to for specifics.

4.10 Employer's Records

Every employer subject to the provisions of the FLSA must maintain records on its employees and their wages, hours, and pay. This is true even with respect to exempt employees in determining whether the conditions for exemption are satisfied.

4.10.1 Employee information

The records for each covered employee must include the following:

— Full name

— Home address

— Date of birth if employee is younger than nineteen

— Sex and occupation

— Time and day on which the employee's workweek begins

— Regular hourly pay rate, the basis on which wages are paid, and regular rate exclusions

— Hours worked each workday and each workweek

— Total daily or weekly straight-time wages

— Total overtime excess compensation for the workweek

— Total additions to or deductions from wages paid each pay period

— Total wages paid each pay period

— Date of payment and the pay period covered

— Retroactive wage payment under government supervision

— The basis for payment of any wages differential to employees of the opposite sex in the same establishment

4.10.2 Form W-4

Employers are required to retain on file for each employee Form W-4, Employee's Withholding Allowance Certificate. The information on this form is used to determine the amount of income tax withholding per payroll for the employee. If an employee claims more than ten exemptions or exemption from income tax withholding if wages are expected

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to exceed $200 per week, the employer is required to send a copy of the form to the Internal Revenue Service along with the next Form 941, Employers Quarterly Federal Tax Return, filed.

4.10.3 Form I-9

Employers are required to retain on file a completed Form I-9, Employment Eligibility Verification, for all employees hired after November 7, 1986. Form I-9 was developed for verifying that persons are eligible to work in the United States. Form I-9 does not need to be filed with any authorities.

4.10.4 Statement of deductions

Some states require that employees be given a statement of deductions for each wage payment. Other states require that such information be given employees at stipulated intervals. A complete list of requirements by state can be found in a payroll management guide such as those published by Commerce Clearing House (CCH) or Prentice-Hall (see references to this chapter).

4.10.5 Form of records and their retention

There are no specific guidelines as to the particular form that the employer's records must follow. However, the records will be considered inadequate if the specified information must be computed from scattered, unrelated, or illegible sources.

Most of the employer's records on an employee's wages and hours must be retained for three years, although it is recommended that retention be for a longer period, normally five years. There is significant disagreement about the length of time to retain records beyond that required by law.

4.10.6 Timing of wage payments

Each state governs the required frequency with which wage payments must be made. A payroll management guide such as those published by Commerce Clearing House or Prentice-Hall contains details (see references to this chapter).

4.11 Penalties

Any person found to willfully violate the Fair Labor Standards Act may be subject to a fine up to $10,000 or imprisonment up to six months.

Employers may be subject to civil liability to employees of unpaid minimum wages or overtime pay plus an equal amount as liquidated damages as well as attorneys' fees and costs, if a willful violation occurs.

If an employer is found to have discriminated against an employee for filing a complaint under this statute, the employer may also be subject to additional liability to that employee as a court may deem appropriate.

4.12 Payroll Deductions

Payroll deductions fall into seven categories:

1. Deductions to cover the cost of furnishing board, lodging, and other facilities to employees.
2. Deductions for other items such as tools and uniforms that are not regarded as facilities.
3. Social Security tax and other deductions required by law.
4. Reductions in a fixed salary paid for a fixed workweek in weeks when the employee fails to work the full schedule.
5. Deductions for disciplinary reasons.
6. Garnishment. If an employer is required under court order to make payment to an employee's creditor, the payments are equivalent to payment to the employee. The amount withheld from a wage payment may not exceed restrictions imposed by the federal garnishment law. The wage garnishment law also prohibits the firing of an employee whose pay is garnished for the payment of a single debt.
7. Other deductions authorized by the employee in writing and permitted by law, such as union dues.

4.13 Handicapped Workers

Special reduced minimum wage rates are allowed under the FLSA for people whose earning capability is impaired due to age, physical or mental deficiency, or injury. A certificate authorizing employment at a lower rate must be obtained from the authorized regional representative of the Wage and Hour Administrator. The following rules apply to these certificates:

— Applications must be made on an official form signed by the handicapped worker and the employer.

— Certificates remain in effect no longer than twelve months.

— Applications for renewal will be reviewed by the administrator's representative.

— Descriptions of alleged handicaps must be detailed.
— A medical certificate is required when the handicap is not clearly obvious.
— The disability must be a specific handicap to the proposed employment.

4.14 Termination

4.14.1 Termination pay

Dismissal payments and severance pay are any payments made by an employer on account of the involuntary separation of an employee from the service of the employer. These payments are subject to FICA, income tax withholding, and unemployment tax.

4.14.2 Final wage payment

Each state governs the time within which a final wage payment must be made to a terminated employee.

4.14.3 Form W-2

Upon termination, employees may request that their Form W-2 be issued to them. The employer is required to furnish the form within thirty days of the request or final payment of wages, whichever is later.

4.15 Leaves of Absence

4.15.1 Time off to vote

Many states have laws that allow employees to take time off to vote. Although state laws vary, a general pattern exists. Ordinarily, an employee who is entitled to vote may leave work for a specified time without penalty or deduction from wages. The employer designates the length of the absence, although minimum time periods may be imposed by state law.

4.15.2 Military leave

The FLSA does not provide specific guidelines with regard to payment of wages during military leave. If an employee is on temporary leave from the job to serve in a state National Guard unit and the employer pays the employee the difference between the regular salary and the amount received from the state, the difference is considered wages and is subject to withholding.

4.15.3 Disability leave

The FLSA does not specify guidelines regarding disability leave. Company policy governs the length of any disability leave and other specifications. Many companies address disability leaves through funding provided by short-term and long-term disability insurance programs.

Federal statute specifies that sex discrimination includes discrimination on the basis of pregnancy, and that pregnant workers must be treated similarly to employees affected by other medical conditions. Pregnant workers have a qualified right to reinstatement of employment, and equal employment opportunity assures that pregnant workers will not lose their jobs on account of pregnancy. Many states guarantee pregnant women a certain number of pregnancy disability leaves in a manner similar to other disability leaves.

4.15.4 Jury leave

Under the Jury System Improvement Act of 1978, employers are prohibited from discharging, threatening to discharge, intimidating, or coercing any permanent employee as a result of that employee's jury duty service.

Employers who violate this act

— Are liable for lost wages due to the employee.

— May be forced to provide other appropriate relief such as reinstatement of an employee discharged because of the employee's jury leave.

— Are subject to a civil penalty of up to $1,000 for each violation to each employee.

4.15.5 Family and medical leave

The Family and Medical Leave Act of 1993 entitles eligible employees to job-protected, unpaid leave of up to twelve workweeks for either of the following:

— Upon the birth or adoption of a child of the employee or the placement of a child with the employee for foster care

— When the employee, employee's spouse, child, or parent has a serious health condition which requires care from the employee

Employers must continue to pay their share of health insurance premiums throughout the leave. The employee is guaranteed job reinstatement, or its equivalent, at the end of the leave.

Employer.
Organizations engaged in commerce or in any industry or activity affecting commerce who employ fifty or more employees for each working day during each of twenty or more calendar workweeks in the current or preceding calendar year are subject to the requirements of this act.

Eligible employee.
An eligible employee is an employee who

— Works for a business which employs fifty or more workers within 75 miles of the employee's work site.

— Has been working for that employer for at least twelve months prior to the requested leave.

— Has worked at least 1,250 hours during the time of his employment.

Effective date.
The leave requirements were generally effective August 5, 1993, six months after the enactment date. Employers should review the Family and Medical Leave Act of 1993 thoroughly to be certain they are in compliance with its provisions.

4.16 Family Employment

The employment of family members is subject to special rules.

Income tax withholding. No statutory exclusion is granted from the withholding of income tax from wages paid between family members. All agricultural wages subject to Social Security withholding are subject to federal income tax withholding whether paid to family or nonfamily members.

FICA tax. Work performed by a child under eighteen years of age employed by a parent is exempt from FICA tax (IRC Sec. 3121(b)(3)(A)). This exemption ceases on the child's eighteenth birthday. (See also the Social Security chapter herein.)

The family service exception does not apply to work performed for a corporation where services are being performed by a child. The same is generally true for partnerships.

Federal unemployment tax. Services performed by an individual for a child or spouse and services performed by a child under the age of twenty-one in the employ of a parent are not subject to federal unemployment tax (IRC Sec. 3306(c)(5)). (See section 3.8, on "Exemptions," of the Unemployment Insurance chapter.)

5. DISCRIMINATION

5.1 Definition

Employment discrimination is the failure to apply similar terms and conditions of employment to all persons equally where no reasonable distinction can be found between those favored and those not favored.

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5.2 Federal Legislation

Federal statutes prohibit discrimination in employment against those individuals who belong to a protected class: race, color, religion, sex, national origin, or age. For government contractors, discrimination is also prohibited for physical and mental handicap and against veterans.

5.2.1 Prohibited actions

These statutes specifically prohibit discrimination against any member of a protected class in any aspect of employment, including hiring, promotion, compensation, employee benefits, and termination. They also cover limiting, segregating, or classifying employees or applicants for employment in any manner that would deprive or tend to deprive any member of a protected class of employment opportunities or otherwise adversely affect that individual's employment status.

Employees who feel they have been discriminated against can obtain relief under provisions of the federal Equal Employment Opportunity Act and various state and local statutes.

5.2.2 Sexual harassment

Title VII of the Civil Rights Act of 1964, as well as state and local antidiscrimination laws, prohibit sexual harassment on the job. Sexual advances, verbal and physical, are considered sexual harassment when

— Submission to the advance is made either explicitly or implicitly a term of employment.

— Submission to or rejection of the advance is used as a basis for employment decisions.

— The advances substantially interfere with the individual's work performance or make the working environment intimidating, hostile, or offensive.

Penalties include injunctive relief, reinstatement or rehiring (with or without back pay), or any other equitable relief a court deems appropriate (including attorneys' fees).

5.2.3 Employer's obligations

An employer should have a policy stating clearly and concisely that discrimination and sexual harassment in the workplace are prohibited. See the *Accountant's Business Manual Toolkit CD-ROM,* appendix 4, "Sample Productive Work Environment Policy." In conjunction with these policies, there should also be a mechanism in place that will promptly and effectively permit an employee to raise a complaint with responsible management and require management to investigate and respond to complaints about discrimination and sexual harassment.

In November, 1993, the U.S. Supreme Court ruled that individuals who sue their employers for sexual harassment do not need to prove severe psychological harm. Rather, the court held that it is sufficient if a reasonable person would find the atmosphere hostile or abusive.

Two primary reasons employers should have both a policy and a procedure are that

— Complaints may be resolved before expensive governmental investigation and litigation.

— Employers may not be subject to liability if an employee does establish discrimination in the workplace, but failed to report it.

5.3 Age Discrimination in Employment Act (ADEA)

Employers are prohibited from discriminating against any individual because of that individual's age. Since the coverage of this law is under the Commerce Clause of the U.S. Constitution, only employers who are engaged in an industry in interstate commerce are affected. The purpose of the age discrimination law is to encourage the hiring of individuals based on ability rather than age. Many states also have statutes prohibiting discrimination based on age.

Employer coverage. Employers covered by ADEA must

— Be engaged in industry affecting commerce.

— Employ twenty or more workers for each working day in each of twenty or more weeks in the current or preceding calendar year.

Employee coverage. Generally, the age discrimination law covers employees over forty years of age.

Enforcement. The Age Discrimination Employment Act is enforced under the Fair Labor Standards Act by the Equal Employment Opportunity Commission (EEOC). Enforcement is obtained through individual employee suits and collective actions by employees.

5.4 Americans With Disabilities Act of 1990 (ADA)

On July 26, 1990, the Americans With Disabilities Act of 1990 (ADA) was signed into law. The employment provisions of the act were effective July 26, 1992, for employers with twenty-five or more employees. Employers with fifteen to twenty-four employees had until July 26, 1994, to comply with the ADA, whereas employers with fewer than fifteen employees are exempt from the provisions of this act.

The ADA is designed to give comprehensive civil rights protection to disabled individuals in the following areas:

- — Employment
- — Transportation
- — Public accommodations
- — Telecommunications
- — State and local services

One provision of the ADA is that businesses must make reasonable accommodations in the work environment to provide disabled individuals with equal employment opportunities. Changes to make reasonable accommodations are not required if they impose "undue hardship" on the operations of the employer's business.

Employers should review the ADA thoroughly to be certain they are in compliance with its provisions. See the *Accountant's Business Manual Toolkit CD-ROM,* appendix 5, "Types of Reasonable Accommodations Related to Job Performance."

5.5 State Antidiscrimination Laws

Appendixes at the end of this chapter summarize the respective state agencies in the area of civil rights and equal employment opportunity.

5.6 Comparable Worth

The Equal Pay Act of 1963 requires that workers receive equal pay for similar jobs, regardless of the sex of the individual employed. The objective is to prevent wage discrimination in the workplace based on gender.

Comparable worth addresses the difference in compensation that cannot be accounted for except by the individual's sex. Wages should be based on the worth of the work, not on the sex of the person doing the work. To conform to comparable-worth guidelines, major studies are frequently required to determine the worth of work.

5.7 Affirmative Action

Affirmative action is the attempt to systematically dismantle discrimination against protected classes. Its proponents believe that affirmative action is one of the few effective methods to resolve discrimination.

Although a statement of affirmative action is not mandated by law for all employers, many companies establish a plan. Under provisions of the Equal Employment Opportunity Act, government contractors and others must issue and follow affirmative action programs. Employers should also review federal and state law to determine their responsibilities in this area.

6. NATIONAL LABOR RELATIONS BOARD

6.1 General Provisions

The purpose of the National Labor Relations Act (NLRA) is to ensure that labor strife does not impede interstate commerce in a major way and to encourage the collective bargaining process as a means to accomplish this purpose. It attempts to protect against abuses of the collective bargaining process on the part of employers, employees, and unions by prohibiting certain unfair labor practices.

This act gives employees the right to form, join, or assist labor organizations and to bargain collectively through representatives of their own choosing as well as engage in other concerted activities for the purpose of collective bargaining or other mutual aid or protection. This act also gives employees the right to refrain from these activities unless an agreement requiring membership in a labor organization exists. The act is administered by the National Labor Relations Board through regional offices.

6.2 Prohibited Practices

6.2.1 Employers

The following acts are considered unfair labor practices on the part of employers:

— To interfere with employees in the exercise of their rights to organize.

— To dominate or interfere with the formation or administration of any labor organization, including financial or other support.

— To discriminate against any employee with respect to hiring, discharge, or conditions of employment in order to discourage or encourage union membership or because the employee has filed charges or given testimony under this act.

— To refuse to bargain collectively with the representatives of their employees.

6.2.2 Labor organizations

Labor organizations and their agents (including employees) may not

— Restrain or coerce
  Employees with respect to their rights under this act.
  Employers in their selection of their representatives for collective bargaining or grievance adjustment purposes.

— Cause or attempt to cause an employer to discriminate against an employee when such discrimination would be an unfair labor practice.

— Refuse to bargain collectively with an employer.

— Engage in or induce or coerce others to engage in unlawful strikes.

— Require excessive membership fees from employees.

— Require payment from an employer for services that have not been or will not be rendered.

— Picket unlawfully.

— Enter into an agreement with an employer in which the employer agrees to cease doing business with any other employer. (There is an exception for the construction industry.)

6.3 Penalties

The National Labor Relations Board (NLRB) has the power to prevent unfair labor practices. If the NLRB finds that any person has engaged or is engaging in any unfair labor practices, it has the power to issue a cease-and-desist order and to take any affirmative action, including reinstatement of employees with or without back pay, consistent with the policies of the NLRA. If the order is not complied with, the NLRB has the right to seek enforcement in any of the Courts of Appeals of the United States.

Employers. Employers may be forced to cease or desist from engaging in unfair labor practices, reinstate employees with or without back pay, and perform other acts consistent with the policies of the NLRA.

Labor organizations, agents. Labor organizations may be ordered to cease and desist from engaging in unfair labor practices along with any other acts, consistent with the purposes of the NLRA.

Employees. Employees who participate in unlawful strikes may be terminated from employment.

Others. Any person who willfully interferes with the NLRB or any member or agent is subject to a fine of not more than $5,000 or imprisonment for up to one year.

7. PAYROLL REQUIREMENTS

Employers are required to withhold payroll taxes (FICA and federal and state income tax) from covered employees' wages and remit the withholding to the proper federal and state offices. Employers also must pay payroll taxes for their share of Social Security (FICA tax) and federal and state unemployment taxes. For a complete listing of types of employment and requirements for withholding employment taxes, see IRS Circular E: *Employer's Tax Guide,* which is available at any IRS office or by mail from the Internal Revenue Service.

7.1 Federal Insurance Contribution Act (FICA)

The FICA tax rate is 7.65 percent for both employees and employers. Consult the chapter on Social Security for the currrent maximum Old Age, Survivors, and Disability Insurance (OASDI) wage base. The 1.45 percent Medicare Hospital Insurance (HI) portion of the total 7.65 percent rate has no maximum wage base and applies to all earned income.

7.1.1 Agricultural employment

Because of the part-time, irregular nature of farm work, farmers hiring seasonal help are subject to special rules governing how farm workers' wages are reported for Social Security purposes. Any time the wages of a farm worker exceed $150 in cash during a calendar year, Social Security tax must be paid on the wages. Similarly, wages may count if they are paid on a time basis, such as by the hour, day, week, or month, for any part of twenty or more days during a calendar year. Also, if the total payroll of the agricultural employer is $2,500 or more for the year, any cash wages paid are subject to Social Security tax (IRC Sec. 3121(a)(8)(B)).

7.1.2 Household employment

In 2006 and 2007, household employee cash wages of $1,500 or more are subject to FICA. The $1,500 test applies separately to each household employee. The value of food, lodging and other noncash items is not subject to FICA. Taxes on wages are paid and reported on Schedule H of Form 1040. See IRS Publication 926 for a further discussion on household employees.

6.2.2 Labor organizations

Labor organizations and their agents (including employees) may not

— Restrain or coerce
  Employees with respect to their rights under this act.
  Employers in their selection of their representatives for collective bargaining or grievance adjustment purposes.

— Cause or attempt to cause an employer to discriminate against an employee when such discrimination would be an unfair labor practice.

— Refuse to bargain collectively with an employer.

— Engage in or induce or coerce others to engage in unlawful strikes.

— Require excessive membership fees from employees.

— Require payment from an employer for services that have not been or will not be rendered.

— Picket unlawfully.

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Employers. Employers may be forced to cease or desist from engaging in unfair labor practices, reinstate employees with or without back pay, and perform other acts consistent with the policies of the NLRA.

Labor organizations, agents. Labor organizations may be ordered to cease and desist from engaging in unfair labor practices along with any other acts, consistent with the purposes of the NLRA.

Employees. Employees who participate in unlawful strikes may be terminated from employment.

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7.1.1 Agricultural employment

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7.1.2 Household employment

In 2005, household employee cash wages of $1,400 or more are subject to FICA. The $1,400 test applies separately to each household employee. The value of food, lodging and other noncash items is not subject to FICA. Taxes on wages are paid and reported on Schedule H of Form 1040. See IRS Publication 926 for a further discussion on household employees.

7.2 Federal and State Income Tax

Tables for withholding income tax from employees' wages can be found in IRS Circular E: *Employer's Tax Guide* and state withholding booklets.

7.3 Unemployment Tax

A separate chapter in this manual is devoted to Unemployment Insurance. The Federal Unemployment Tax Act and state unemployment insurance requirements are discussed in sections 3 through 6 of that chapter.

7.4 Deposit of Payroll Taxes

7.4.1 FICA and federal income tax

Employers must make deposits of the FICA and federal income tax withheld from employees' wages plus the employer's share of FICA when the liability reaches certain limits. The following calculation should be used to determine the federal payroll liability.

Total Social Security wages	XXX	
× combined employee/employer Social Security rate	× .124	
Social Security tax		XXX
Total Medicare wages	XXX	
× combined employee/employer Medicare rate	× .029	
Medicare tax		XXX
Total FICA tax		XXX
FWHT (federal income tax withheld)		+XXX
Liability		XXX

7.4.2 Rules for depositing federal liability

Treasury Regs. 31.6302-0 through 31.6302-4 describe the payroll tax deposit requirements.

"Lookback" rule. The payroll tax deposit rules enable employers to determine a standard deposit cycle for an entire year by looking back to prior payroll tax liabilities. Using the "lookback" rule, an employer can determine whether the depositor is monthly or semiweekly by examining the employment tax liability during the "lookback" period.

"Lookback" period. The "lookback" period used for determining whether an employer will be a monthly or a semiweekly depositor is the twelve-month period that ended with the preceding June 30. For example, the "lookback" period for calendar year 2005 is the period July 1, 2003, to June 30, 2004. The IRS notifies businesses at the beginning of each year regarding which deposit category applies.

Monthly depositor. If the aggregate amount of employment taxes reported for the "lookback" period is $50,000 or less, the employer is a monthly depositor. If an employer is a monthly depositor, each month's payroll taxes are due on the fifteenth day of the following month, or on the next banking day, should the fifteenth not be a banking day.

Semiweekly depositor. If the aggregate amount of employment taxes reported for the "lookback" period is over $50,000, the employer is a semiweekly depositor. For wages paid on Wednesday, Thursday, and Friday, employment taxes must be deposited on the following Wednesday. For wages paid on Saturday, Sunday, Monday, and Tuesday, employment taxes must be deposited by the following Friday.

One-day rule. Accumulated employment taxes of $100,000 or more are due the next banking day, regardless of the employer's deposit status. If a monthly depositor incurs a $100,000 liability, that employer automatically becomes a semiweekly depositor the day after the $100,000 liability is incurred. The employer is then considered a semiweekly depositor for the remainder of the calendar year and for the following calendar year.

The Treasury has developed the Electronic Federal Tax Payment System (EFTPS), an electronic fund transfer system to remit payroll taxes and convey deposit information directly to the Treasury. All employers who deposited more than $200,000 of taxes during a calendar year beginning after 1997 must use EFTPS beginning with the second succeeding calendar year, and continuing through all succeeding years. Many businesses have voluntarily switched to EFTPS due to the convenience factor of electronic transmission. EFTPS is accessed over the phone or Internet at least one calendar day before the tax due date. EFTPS payments can also be made through a financial institution by instructing them to electronically move funds from the taxpayer's account to the Treasury's account.

7.4.3 State income tax

All state income tax withheld from employees' wages must be deposited with the proper state agency. Deposit rules vary by state.

7.5 Electronic Filing Forms W-2

Employers who file 250 or more Forms W-2 are required to transmit electronically under Reg. 301.6011-2. The due date for electronically filed W-2s is March 31 versus February 28 for all other filing methods.

Electronic filing is done through a secure Internet connection at no cost. It does, however, provide an electronic receipt for proof of filing. Filing using physical magnetic media, such as diskettes and tapes, was only available through 2005.

Employers required to file electronically, but who fail to do so, are deemed under the regulation to have failed to file the necessary returns, and will be subject to applicable penalties. IRS Reg. 301.6011-2 provides for a waiver for employers who can show that they will be subject to hardship if required to file a return electronically. A request for waiver (Form 8508) must be submitted at least forty-five days before the filing of the first return for which the waiver is sought. The waiver is in effect for one year at a time.

8. POSTEMPLOYMENT ISSUES

8.1 Covenants Not to Compete

A covenant not to compete is a clause in an employment agreement under which an employee agrees not to compete with his or her employer while employed and after terminating employment. To be enforceable, these covenants must be reasonably necessary to protect the employer and they cannot be so restrictive as to prevent the former employee from self-support. Generally, they cannot exceed a geographic area larger than that covered by the employment agreement and are rarely valid if they exceed one year. Unreasonable covenants are not enforceable. Some states allow their courts to edit these covenants to make them reasonable; others simply refuse to enforce them.

8.2 Wrongful Discharge

Wrongful discharge is an action based on the claim that an employee was unlawfully discharged from employment. This claim can be based on some form of discrimination, retaliation for the attempt to exercise a right, or violation of an employment agreement. The employee may be seeking reinstatement, back wages, and/or punitive damages.

An employer's best defense to any legal action is one supported by contemporaneous records. In particular, employee discipline, including warnings, should be documented in writing. Employees should be asked to sign the document.

8.2.1 Constructive discharge

Constructive discharge is similar to wrongful discharge. The difference is that, under constructive discharge, the employee was not discharged but rather the employer made working conditions so unreasonable that the employee was forced to quit.

8.3 Insurance Continuation

The federal Consolidated Omnibus Budget Reconciliation Act of 1986 (COBRA) supersedes most state law relating to insurance coverage continuation following employment termination. State law will override federal law to the extent that the state law provides greater benefits to the employee.

8.3.1 Employers covered by COBRA

All employers of twenty or more employees, with health insurance plans (self-insured or through an insurance carrier), must offer continuation of insurance coverage on termination of employment or death.

8.3.2 Right to continue insurance coverage

Persons other than employees have the right to continue insurance coverage. Continued coverage must be offered to

- Voluntarily and involuntarily terminated employees, except employees discharged for gross misconduct.
- Employees who may lose coverage because of change in employment status from full-time to part-time.
- Employees' spouses and spouses who are divorced, widowed, or separated, and their dependents.
- Dependent children who might become ineligible because of divorce, marriage, or age.

(Text continued on page 31)

8.3.3 Period of coverage

Insurance coverage may continue for a maximum of eighteen months. Spouses and dependents are eligible for thirty-six months of continuation. Coverage may be terminated if a qualified person fails to pay a premium or if he or she becomes covered by another group plan.

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APPENDIX 1: State Labor Agencies

ALABAMA
State of Alabama Dept. of Labor
100 N Union St., Ste 620
P O Box 303500
Montgomery, AL 36130-3500
(334) 242-3460
FAX (334) 240-3417
www.alalabor.state.al us

ALASKA
Alaska Dept. of Labor
1111 W Eighth St., Rm. 304
P O Box 21149
Juneau, AK 99801-1149
(907) 465-4842
FAX (907) 465-3584
www labor state ak us

ARIZONA
Arizona Labor Dept.
P O Box 19070
Phoenix, AZ 85005-9070
(602) 542-4515
FAX (602) 542-8097
www ica.state az us

ARKANSAS
Arkansas Dept of Labor
10421 W Markham
Little Rock, AR 72205
(501) 682-4500; (501) 682-4541 Directors Office
FAX (501) 682-4535
www.arkansas.gov/labor

CALIFORNIA
Dept. of Industrial Relations
Division of Labor Standards Enforcement
2031 Howe Avenue, Ste 100
Sacramento, CA 95825
(916) 263-1811
www.dir.ca.gov

COLORADO
Colorado Dept. of Labor & Employment
633 17th St.
Suite 201
Denver, CO 80202-3660
(303) 318-8000
FAX (303) 318-8048
www.coworkforce.com

CONNECTICUT
Connecticut Dept. of Labor
Carl R. Olandt
UC Director of Accounts
200 Folly Brook Blvd.
Wethersfield, CT 06109-1114
(860) 263-6450
FAX (860) 263-6567
www.ctdol.state.ct.us

State Board of Labor Relations
38 Wolcott Hill Road
Wethersfield, CT 06109-1114
(860) 263-6860; (860) 263-6879
FAX (860) 263-6875
www.ct gov/dol

DELAWARE
Delaware Dept. of Labor
Division of Industrial Affairs
4425 N. Market Street—3rd Fl.
Wilmington, DE 19802
(302) 761-8200
FAX (302) 761-6601
www.delawareworks.com

FLORIDA
Workforce Services
Agency for Workforce Innovation
107 E. Madison Street
The Caldwell Bldg.
Tallahassee, FL 32399-4120
(850) 245-7105
FAX (850) 921-3223
www.floridajobs.org

GEORGIA
Georgia Dept. of Labor
148 International Blvd. NE
Sussex Place, Rm. 392
Atlanta, GA 30303-1751
(404) 232-3605
FAX (404) 232-3603
www.dol.state.ga.us

HAWAII
Dept. of Labor & Industrial Relations
Information Office
830 Punchbowl St., Rm. 321
Honolulu, HI 96813
(808) 586-8842
FAX (808) 586-9099
www.hawaii.gov/labor

IDAHO
Idaho Commerce & Labor
Employer Accounts Bureau
317 W Main Street
Boise, ID 83735-0760
(208) 332-3570
FAX (208) 334-6301
www.cl idaho.gov

ILLINOIS
Illinois Dept. of Labor
160 N LaSalle St., C-1300
Chicago, IL 60601
(313) 793-2800
FAX (312) 793-5257
www.state il.us/agency/idol

INDIANA
Indiana Dept. of Labor
402 W Washington St., Rm. W195
Indianapolis, IN 46204-2751
(317) 232-2655
FAX (317) 233-3790
www in gov/labor

IOWA
Division of Labor Services
1000 East Grand Avenue
Des Moines, IA 50319-0209
(515) 242-5870
FAX (515) 281-7995
www.state.ia.us

KANSAS
Kansas Dept. of Labor
Office of Employment Standards
401 SW Topeka Blvd.
Topeka, KS 66603-3182
(785) 269-4062
FAX (785) 368-6462
www.dol.ks.gov

KENTUCKY
Kentucky Labor Department
1047 U.S. Hwy 127 S, Ste. 4
Frankfort, KY 40601-4381
(502) 564-3070
FAX (502) 654-5387
www.labor.ky.gov

LOUISIANA
Dept. of Labor/Labor Program Section
P.O. Box 94094
Baton Rouge, LA 70804-9094
(225) 342-7690
FAX (225) 342-2717
www.laworks.net

MAINE
Labor Relations Board
90 State House Station
Augusta, ME 04333-0090
(207) 287-2015
FAX (207) 287-4416
www.maine.gov/mlrb

MARYLAND
Division of Labor & Industry
1100 N Eutaw St., Rm. 606
Baltimore, MD 21201
(410) 767-2241
FAX (410) 767-2996
www.dllr.state.md.us

MASSACHUSETTS
Commonwealth of Massachusetts
Labor Relations Commission
399 Washington Street
Boston, MA 02108
(617) 727-3505
www.state.ma.us/lrc

MICHIGAN
Dept. of Consumer & Industry Services
525 W. Ottawa
Williams Bldg 4th Floor
P.O. Box 30004
Lansing, MI 48909
(517) 373-1820
FAX (517) 373-2129
www.michigan.gov/cis

MINNESOTA
Dept. of Labor & Industry
443 Lafayette Road N
St. Paul, MN 55155
(651) 284-5005; 800-DIAL-DLI
FAX (651) 284-5729
www.doli.state.mn.us

MISSISSIPPI
Mississippi Dept of Employment Security
Attn: Tax Dept.
P.O. Box 22781
Jackson, MS 39225-2781
(601) 321-6228
FAX (601) 321-6173
www.mdes.ms.gov

MISSOURI
Dept. of Labor & Industrial Relations
421 E. Dunklin St.
P.O. Box 504
Jefferson City, MO 65102-0504
(573) 751-4091
FAX (573) 751-4135
www.dolir.mo.gov

MONTANA
Dept. of Labor & Industry
Wage & Hour Unit
Labor Standards Bureau
Employment Relations Division
P.O. Box 6518
Helena, MT 59604-6518
(406) 444-5600
FAX (406) 444-7071
www.mtwagehourbopa.com

NEBRASKA
Nebraska Workforce Development
Dept. of Labor
550 South Sixteenth
P.O. Box 94600
Lincoln, NE 68509-4600
(402) 471-9000
FAX (402) 471-2318
www.uiconnect.state.ne.us
www.dol.state.ne.us

NEVADA
Nevada State Labor Commission
555 E. Washington Ave., Ste. 4100
Las Vegas, NV 89101-1083
(702) 486-2650
FAX (702) 486-2660
www.laborcommissioner.com
mail@laborcommissioner.com

NEW HAMPSHIRE
Dept. of Labor
95 Pleasant Street
Concord, NH 03301
(603) 271-3176; (603) 271-2668
FAX (603) 271-6149
www.labor.state.nh.us

NEW JERSEY
New Jersey Dept. of Labor & Workforce Development
P.O. Box 388
Trenton, NJ 08625-0388
(609) 984-2595
FAX (609) 984-6833
www.nj.gov/labor

NEW MEXICO
Dept. of Labor/Labor & Industrial Division
Wage & Hour Bureau
501 Mountain Road NE, Rm. 106
Albuquerque, NM 87102
(505) 222-4667
FAX (505) 222-4666
www.dol.state.nm.us

NEW YORK
State Labor Relations Act
NY State Employment Relations Board
345 Hudson Street
Suite 8201
P.O. Box 706
New York, NY 10014
(212) 352-6671
FAX (212) 352-6824
www.labor.state.ny.us.erb

NORTH CAROLINA
NC Dept. of Labor/Labor Standards Bureau
Wage & Hour Office
1101 Mail Service Center
Raleigh, NC 27699-1101
(919) 807-2796; (800) 625-2267—NC Labor
FAX (919) 807-2786
www.nclabor.com

NORTH DAKOTA
North Dakota Dept. of Labor
600 E. Boulevard Ave., Dept. 406
State Capitol, 13th Fl.
Bismarck, ND 58505-0340
(701) 328-2660; (800) 582-8032 (toll-free within ND only)
FAX (701) 328-2031
www.disovernd.com/labor or www.disovernd.com/humanrights

OHIO
Ohio Dept. of Commerce
Division of Labor & Worker Safety
Wage & Hour Division
77 S. High Street, 22nd Floor
Columbus, OH 43215
(614) 644-2239
FAX (614) 728-8639
www.com.state.oh.us

OKLAHOMA
State Dept. of Labor
4001 N. Lincoln Blvd.
Oklahoma, OK 73105
(405) 528-1500
FAX (405) 528-5751
www.state.ok.us/~okdol/

OREGON
Employment Relations Board
528 Cottage St., NE, Ste. 400
Salem, OR 97301-3807
(503) 378-3807
FAX (503) 373-0021
www.oregon.gov/erb
emprel.board@state.or.us

OREGON
All Other Labor Laws
Bureau of Labor & Industries
State Office Bldg.
800 NE. Oregon St., #32
Portland, OR 97232-2109
(971) 673-0761
FAX (971) 673-0762
www.oregon.gov/boli

PENNSYLVANIA
Labor Relations Acts
Pennsylvania Labor Relations Board
418 Labor & Industry Bldg.
7th & Forster Streets
Harrisburg, PA 17120
(717) 787-1091
FAX (717) 783-2974
www.dli.state.pa.us keywords "labor relations board"

Bureau of Labor Law Compliance
1301 Labor & Industry Bldg.
7th & Forster Streets
Harrisburg, PA 17120
(717) 787-4763; (800) 932-0665
FAX (717) 787-0517
www.dli.state.pa.us keywords

RHODE ISLAND
RI Dept. of Labor & Training
Division of Labor Standards
1511 Pontiac Ave.
P.O. Box 20390 Bldg. 70
Cranston, RI 02920
(401) 462-8850
FAX (401) 462-8530
www.dlt.state.ri.us

SOUTH CAROLINA
South Carolina Board of Accountancy
110 Centerview Drive
P.O. Box 11329
Columbia, SC 29211-1329
(803) 896-4770
FAX (803) 896-4554
TTD (803) 896-4553
www.llr.state.sc.us/pol/accountancy

SOUTH DAKOTA
Dept. of Labor
Division of Labor & Management
Kneip Bldg.
700 Governor's Drive
Pierre, SD 57501-2277
(605) 773-3681
FAX (605) 773-4211
www.sdjobs.org
james.marsh@state.sd.us

TENNESSEE
Dept. of Labor & Workforce Development
Andrew Johnson Tower, 8th Fl.
710 James Robertson Parkway
Nashville, TN 37243-0655
(615) 741-6642
FAX (615) 741-5078
www.state.tn.us/labor-wfd

TEXAS
Texas Workforce Commission
Labor Law Section
101 E. 15th St., Ste. 110
Austin, TX 78778-0001
(512) 837-9559; (800) 832-9243 (within TX only)
FAX (512) 834-3526
www.twc.state.tx.us/tui/lablaw/lablaw.html

UTAH
Utah Labor Commission
Antidiscrimination & Labor Division
160 E. 300 South, 3rd Fl.
P.O. Box 146630
Salt Lake City, UT 84114-6630
(801) 530-6801; (800) 222-1238
FAX (801) 530-7609
TTD (801) 530-7685 (In state only)
www.labor.state.ut.us or www.laborcommission.utah.gov

VERMONT
Dept. of Labor
National Life Drive Drawer 20
Montpelier, VT 05620-3401
(802) 828-2288
FAX (802) 828-2195
www.state.vt.us/labind or www.labor.vermont.gov

VIRGINIA
Dept. of Labor & Industry
13 S. Thirteenth Street
Richmond, VA 23219
(804) 786-2372
FAX (804) 786-9877
www.doli.virginia.gov

WASHINGTON
Dept. of Labor & Industries
P.O. Box 44832
Olympia, WA 98504-4832
(360) 902-6967
FAX (360) 902-6990
www.wa.gov

WEST VIRGINIA
Division of Labor
Capitol Complex
Bldg. 6, Rm 749-B
Charleston, WV 25305
(304) 558-7890
FAX (304) 558-2273
www.state.wv.us/labor

WISCONSIN
Dept. of Workforce Development
P.O. Box 7946
Madison, WI 53707
(608) 266-8250
FAX (608) 267-1020
www.dwd.state.wi.us

WYOMING
No Department

DISTRICT OF COLUMBIA
Dept. of Employment Services
Labor Standards Bureau
Office of the Assistant Director
64 New York Avenue NE
Washington, DC 20002
(202) 724-7000; (877) 319-7346
FAX (202) 673-6412
www.does.dc.gov

GUAM
Dept. of Labor
504 E. Sunset Blvd. Tijan
P.O. Box 9970
Tamuning, GU 96931
(671) 649-6400
FAX (671) 477-2988
www.gov.gu/government.htm

PUERTO RICO
Dept. of Labor & Human Resources
505 Munoz Rivera Avenue
Hato Rey, PR 00918
(787) 754-5262
FAX (787) 754-5269
TTD (787) 753-2097

APPENDIX 2: State Civil Rights Agencies

These agencies have overall responsibility for preventing and redressing discrimination due to race, color, sex, age, national origin, religion, or handicap in employment, education, housing, public accommodations, and credit.

ALABAMA
Equal Employment Opportunity
Dept. of Industrial Relations
649 Monroe Street
Montgomery, AL 36131
(334) 242-8055; (800) 669-4000
FAX (205) 731-2101
www.eeoc.gov

ALASKA
Alaska State Commission for Human Rights
800 A Street, Ste. 204
Anchorage, AK 99501-3669
(907) 274-4692
FAX (907) 278-8588
TTD (907) 276-3177
www.gov.state.ak.us/aschr/aschr.htm

ARIZONA
Civil Rights Division, Compliance Section
Office of Attorney General
1275 W. Washington
Phoenix, AZ 85007-2926
(602) 542-5263; (887) 491-5742
FAX (602) 542-8885
www.azag.gov

CALIFORNIA
Dept. of Fair Employment & Housing
2218 Kausen Drive, Ste. 100
Elk Grove, CA 95758
(916) 478-7251
FAX (916) 478-7329
www.dfeh.ca.gov or www.dfehmp.ca.gov

COLORADO
Division of Civil Rights
1560 Broadway
Suite 1050
Denver, CO 80202
http://www.dora.state.co.us/Civil-Rights/
(303) 894-2997; (800) 262-4845
FAX (303) 894-7830

CONNECTICUT
Commission on Human Rights & Opportunities
21 Grand Street, Third Floor
Hartford, CT 06106-1507
(860) 541-3415
FAX (860) 246-5068
www.state.ct.us/chro/

DELAWARE
Office of Labor Law Enforcement
4425 North Market Street
Wilmington, DE 19802
(302) 761-8085
FAX (302) 761-6601
www.delawareworks.com

FLORIDA
Florida Commission on Human Relations
2009 Apalachee Parkway
Suite 100
Tallahassee, FL 32301
(800) 850-7082
FAX (850) 488-5291
TTD (800) 955-1339
http://fchr.state.fl.us/

GEORGIA
Georgia Commission on Equal Opportunity
Suite 1002—West Tower
2 Martin Luther King Jr. Drive SE
Atlanta, GA 30334
(404) 656-1736; (800) 493-OPEN
FAX (404) 656-4399
www.gceo.state.ga.us

HAWAII
Civil Rights Commission
830 Punchbowl Street, Rm. 411
Honolulu, HI 96813
(808) 586-8636
FAX (808) 586-8655
TTD (808) 586-8692
http://hawaii.gov/labor/hcrc/

IDAHO
Human Rights Commission
1109 Main Street, Ste. 400
Box 83720
Boise, ID 83720-0040
(208) 334-2873; (888) 249-7025
FAX (208) 334-2664
TTD (208) 334-4751
www.state.id.us/ihrc/ihrchome.htm

ILLINOIS
Dept. of Human Rights Commission
James R. Thompson Center
100 W. Randolph, Ste 5-100
Chicago, IL 60601
(312) 814-6269
FAX (312) 814-6517
www.state.il.us/ihrc

INDIANA
Civil Rights Commission
Indiana Government Center North
100 N. Senate Avenue, Rm. N103
Indianapolis, IN 46204
(317) 232-2600; (800) 628-2909
FAX (317) 232-6580
www.in.gov/icrc

IOWA
Civil Rights Commission
Grimes State Office Bldg.
400 E. 14th Street
Des Moines, IA 50319
(515) 281-4121, (800) 457-4416
FAX (515) 242-5840
www.state.ia.us/government/crc

KANSAS
Kansas Human Rights Comm.
900 S.W. Jackson, Ste. 568 S
Topeka, KS. 66612-2818
(785) 296-3206
FAX (785) 296-0589
www.khrc.net
khrc@ink.org

KENTUCKY
KY Commission on Human Rights
The Heyburn Bldg., 7th Floor
332 W. Broadway
Louisville, KY 40202
(502) 595-4024
FAX (502) 595-4081
TTD (502) 595-4084
www.state.ky.us/agencies2/kchr

LOUISIANA
Louisiana Human Right
P.O. Box 94094
Baton Rouge, LA 70804-9094
(225) 342-6969
FAX (225) 342-2063
www.gov.state.la.us

MAINE
ME Human Rights Commission
51 State House Station
Augusta, ME 04333-0051
(207) 624-6050
FAX (207) 624-6063
TTD (207) 624-6064
www.maine.gov/mhrc

MASSACHUSETTS
Comm. Against Discrimination
One Ashburton Place, Rm. 601
Boston, MA 02108
(617) 994-6000
FAX (617) 994-6024
TTD (617) 994-6196
www.mass.gov/mcad

MICHIGAN
Michigan Dept. of Civil Rights
Cadilla Place
3054 W. Grand Blvd, Ste. 3600
Detroit, MI 48202
(313) 456-3700; (800) 482-3604
FAX (313) 456-3791
TTD (877) 878-8464
http://www.mdcr.state.mi.us/mdcr/

MINNESOTA
MN Dept. of Human Rights
Sibley Square at Mears Park
190 E. Fifth Street, Ste. 700
St. Paul, MN 55101
(651) 296-5663
FAX (651) 296-9042
www.humanrights.state.mn.us

MISSOURI
Comm. on Human Rights
Labor & Industrial Relations Dept.
3315 W. Truman Blvd., Rm. 212
P.O Box 1129
Jefferson City, MO 65102-1129
(573) 751-3325; (877) 781-4236 (Complaint Hotline, msg. only)
FAX (573) 751-2905
TTD (573) 526-5091
www.dolir.state.mo.gov

MONTANA
Human Rights Bureau
Dept. of Labor & Industry
P.O. Box 1728
Helena, MT 59624-1728
(406) 444-2884; (800) 542-0807 (Montana only)
FAX (406) 444-2798
http://erd.dli.state.mt.us/HumanRights/HRhome.asp

NEBRASKA
Equal Opportunity Commission
301 Centennial Mall S., 5th Floor
P O Box 94934
Lincoln, NE 68509-4934
(402) 471-2024; (800) 642-6112
FAX (402) 471-4059
www.neoc.ne.gov

NEVADA
Equal Rights Commission
1515 E. Tropicana Avenue, Ste. 590
Las Vegas, NV 89119-7161
(702) 486-7161
FAX (702) 486-7054
www nvdetr org

NEW HAMPSHIRE
Commission for Human Rights
2 Chenell Drive
Concord, NH 03301-8501
(603) 271-2767
FAX (603) 271-6339
www.state.nh.us/hrc/index.html

NEW MEXICO
Dept. of Labor
Human Rights Division
Aspen Plaza
1596 Pacheco Street
Santa Fe, NM 87505-3979
(505) 827-6838; (800) 566-9471
FAX (505) 827-6878
www.dol.state.nm.us

NEW YORK
Division of Human Rights
Executive Dept.
1 Fordham Plaza, Fourth Floor
Bronx, NY 10458
(718) 741-8400
FAX (718) 741-3214
www.dhr.state.ny.us

NORTH CAROLINA
NC Human Relations Commission
Dept. of Administration
1318 Mail Service Center
Raleigh, NC 27699-1318
(919) 733-7996; (866) 324-7474 (Fair Housing)
FAX (919) 733-7940
www.doa.state.nc.us/doa/hrc/hrc.htm

NORTH DAKOTA
North Dakota Dept. of Labor
State Capitol, 13th Floor
600 E. Boulevard Avenue, Dept. 406
Bismarck, ND 58505-0340
(701) 328-2660; (800) 582-8032 (ND only)
FAX (701) 328-2031
www.nd.gov/labor OR www.nd.gov/humanrights

OHIO
Ohio Civil Rights Comm.
1111 E. Broad Street, Ste. 301
Columbus, OH 43205-1379
(614) 466-2785
FAX (614) 644-8776; (614) 466-7742
TTD: (614) 466-9353
http://crc/ohio.gov

OKLAHOMA
Human Rights Commission
Jim Thorpe Bldg., Rm. 480
2101 N. Lincoln Blvd.
Oklahoma City, OK 73105
(405) 521-2360
FAX (405) 522-3635
www.hrc.state.ok.us

OREGON
Civil Rights Division
Bureau of Labor & Industries
800 NE. Oregon Street, #32, Ste. 1070
Portland, OR 97232
(503) 731-4874
FAX (503) 731-4069
www boli.state.or us/

PENNSYLVANIA
PA Human Relations Comm.
Pennsylvania Place
301 Chestnut Street, Ste. 300
Harrisburg, PA 17101-2702
(717) 787-4410
FAX (717) 787-0420
TTD (717) 787-4087
http://www.phrc.state.pa.us

RHODE ISLAND
RI Commission of Human Rights
180 West Minster Street, Third Floor
Providence, RI 02903
(401) 222-2661
FAX (401) 222-2616
www.richr.state.ri.us

SOUTH CAROLINA
SC Human Affairs Commission
2611 Forest Drive, Ste. 200
Columbia, SC 29204
(803) 737-7800; (800) 521-0725
FAX (803) 253-4191
www.state.sc.us/schac/

SOUTH DAKOTA
Division of Human Rights
700 Governor's Drive
Pierre, SD 57501-2291
(605) 773-4493
FAX (605) 773-4211
www.state.sd.us/dol/boards/hr/HR_Hom.htm
james.marsh@state.sd.us

TENNESSEE
Human Rights Commission
530 Church Street, Ste. 305
Cornerstone Square Bldg.
Nashville, TN. 37243-0745
(615) 741-5825
FAX (615) 532-2197
www.state.tn.us/humanrights

TEXAS
Texas Workforce Commission
Civil Rights Division
1117 Trinity Street, Rm. 144T
Austin, TX 78778
(512) 463-2642; (888) 452-4778 (Texas only)
FAX (512) 463-2643
www.twc.state tx.us

UTAH
Utah Labor Commission
Utah Antidiscrimination & Labor Division
160 East 300 South, Third Floor
P.O. Box 14630
Salt Lake City, UT 84114-6630
(801) 530-6801; (800) 222-1238 (Utah only)
FAX (801) 530-7609
www.laborcommission.utah.gov

VIRGINIA
Virginia Council of Human Rights
Pocahontas Bldg., Fourth Floor
900 E. Main Street
Richmond, VA 23219
(804) 225-2292
FAX (804) 225-3294
www.chr.virginia.gov

VERMONT
Civil Rights Unit
Public Protection Division
Office of Attorney General
109 State Street
Montpelier, VT 05609-1001
(802) 828-5511; (888) 745-9195
FAX (802) 828-2154
www.atg.state.vt.us

WASHINGTON
Human Rights Commission
711 S. Capitol Way, Ste. 402
P.O. Box 42490
Olympia, WA 98504-2490
(360) 753-6770; (800) 233-3247
FAX (360) 586-2282
TTD (800) 300-7525
www.hum.wa.gov

WEST VIRGINIA
West Virginia Human Rights Commission
1321 Plaza E, Rm. 108A
Charleston, WV 25301-1400
(304) 558-2616
FAX (304) 558-0085
TTD (304) 558-2976
www wvf.state.wv us/wvhrc

WYOMING
Dept. of Administration & Information
Emerson Bldg., Rm. 104
Cheyenne, WY 82002
(307) 777-7201
FAX (307) 777-3633
http://ai.state.wy.us

DISTRICT OF COLUMBIA
Office of Human Rights
441 Fourth Street NW, Ste 570 N
Washington, DC 20001
(202) 727-4559
FAX (202) 727-9589
www.ohr.dc.gov

PUERTO RICO
Civil Rights Commission
P.O. Box 192338
Hato Rey, PR 00919-2338
(787) 764-8686; (800) 981-4144
FAX (787) 250-1756
www.derechoscivilespr.org

VIRGIN ISLANDS
Civil Rights Commission
P.O. Box 6645
St. Thomas, Virgin Islands 00804
(340) 774-5666 ext 175/177
FAX (340) 776-3494

APPENDIX 3: State Equal Employment Opportunity Agencies

These agencies enforce laws promoting equal employment opportunity.

ALABAMA
Equal Opportunity Employment Office
Dept. of Industrial Relations
649 Monroe Street
Montgomery, AL 36131
(334) 242-8495
FAX (334) 242-2048
http://es.dir.alabama.gov/

ALASKA
Office of the Governor
Equal Employment Opportunity
619 E. Ship Creek, Suite 301
Anchorage, AK 99501
(907) 279-0299; (907) 279-0290
FAX (907) 279-0250
www.eeo.state.ak.us

ARIZONA
Governor's Office of Equal Opportunity
1700 W. Washington, Ste. 156
Phoenix, AZ 85007
(602) 542-3711
FAX (602) 542-3712
www.governor.state.az.us/eop

ARKANSAS
Dept of Human Services
Donaghey Plaza North, Slot N203
P.O. Box 1437
Little Rock, AR 72203-1437
(501) 682-8675
FAX (501) 682-8637
www.arkansas.gov

CALIFORNIA
Dept of Fair Employment & Housing
2218 Kausen Dr., Ste. 100
Elk Grove, CA 95758
(916) 478-7251
FAX (916) 478-7329
www.dfeh.ca.gov or www.dfehmp.ca.gov

COLORADO
Civil Rights Division
Dept of Regulatory Agencies
1560 Broadway, Ste. 1050
Denver, CO 80202-4941
(303) 894-2997; (800) 262-4845
FAX (303) 894-7830
www.dora.state.co.us/civil-rights/

CONNECTICUT
State of Connecticut
Commission on Human Rights & Opportunities
21 Grand Street
Hartford, CT 06106-1507
(800) 541-3400
FAX (860) 246-5068—Business Office
(860) 541-3451—Exec. Director's Office
www.state.ct.us/chro/

DELAWARE
Office of Labor Law Enforcement
DE Dept of Labor
4425 N. Market Street
Wilmington, DE 19802
(302) 761-8200
FAX (302) 761-6601
www.delawareworks.com

FLORIDA
Florida Commission of Human Relations
2009 Apalachee Parkway, Ste. 100
Tallahassee, FL 32301
(850) 488-7082
FAX (850) 488-5291; (850) 487-9397
http://fchr.state.fl.us

GEORGIA
Georgia Commission on Equal Opportunity
Suite 1002—West Tower
2 Martin Luther King Jr. Drive, SE
Atlanta, GA 30334
(404) 656-1736; (800) 493-OPEN
FAX (404) 656-4399
www.gceo.state.ga.us

HAWAII
Hawaii Civil Rights Commission
830 Punchbowl Street, Rm. 411
Honolulu, HI 96813
(808) 586-8636
FAX (808) 586-8655
TTD (808) 586-8692
http://hawaii.gov/labor/hcrc

IDAHO
Human Rights Commission
1109 Main Street, Ste. 400
P.O. Box 83720
Boise, ID 83720-0040
(208) 334-2873; (888) 249-7025
FAX (208) 334-2664
TTD: (208) 334-4751
www2.idaho.gov/ihrc

ILLINOIS
Dept. of Human Rights
100 W. Randolph
James R. Thompson Center, Ste. 10-100
Chicago, IL 60601
(312) 814-6200
FAX (312) 814-6251

INDIANA
Civil Rights Commission
Indiana Government Center North
100 N. Senate Avenue, Rm. N103
Indianapolis, IN 46204
(317) 232-2600; (800) 628-2909
FAX (317) 232-6580
www.in.gov/icrc

IOWA
Iowa Civil Rights Commission
Grimes State Office Building
400 E. 14th Street
Des Moines, IA 50319
(515) 281-4121; (800) 457-4416
FAX (515) 242-5840
www.state.ia.us/government/crc

KANSAS
Kansas Human Rights Commission
Landon State Office Bldg.
900 S.W. Jackson, Ste. 568 S.
Topeka, KS. 66612-2818
(785) 296-3206
FAX (785) 296-0589
www.khrc.net

KENTUCKY
Comm on Human Rights
The Heyburn Bldg., 7th Floor
332 W. Broadway
Louisville, KY 40202
(502) 595-4024
FAX (502) 595-0820
www.state.ky.us/agencies2/kchr/index.htm

LOUISIANA
Dept. of Labor
Equal Opportunity & Compliance Division
1001 N. 23rd St., Rm. 262
P.O. Box 94094
Baton Rouge, LA 70804-9094
(225) 342-3075
FAX (225) 342-7961

MAINE
Maine Human Rights Commission
51 State House Station
Augusta, ME 04333-0051
(207) 624-6050
FAX (207) 624-6063
TTD (888) 577-6690
www.maine.gov/mhrc

MARYLAND
Commission on Human Rights
6 St. Paul Street, 9th Floor
Baltimore, MD 21202-1631
(410) 767-8600; (800) 637-6247
FAX (410) 333-1841
www.mchr.state.md.us

MASSACHUSETTS
Office of Diversity & Equal Opportunity
One Ashburton Place, Rm. 213
Boston, MA 02108
(617) 727-7441
FAX (617) 727-0568
TTD (617) 727-6015 (TTY)
www.mass.gov/hrd

MICHIGAN
Dept. of Civil Rights
1200 Sixth Avenue
Detroit, MI 48226
(313) 256-2663
FAX (313) 256-2167
www.mder.com
mdcrservicecenter@state.mi.us

MINNESOTA
Dept. of Economic Security
Tax Accounting
390 N. Robert Street, 4th Floor
St. Paul, MN 55101
(651) 296-3624
FAX (651) 297-5283
www.mnworkforcecenter.org/tax

MISSOURI
Comm. on Human Rights
Labor & Industrial Relations Dept.
3315 W. Truman Blvd
P.O. Box 1129
Jefferson City, MO 65102-1129
(573) 751-3325
FAX (573) 751-2905
TTD (573) 526-5091
www.dolir.state.mo.us

MISSISSIPPI
Mississippi Dept. of Employment Security
P.O. Box 1699
1235 Echelon Parkway
Jackson, MS 39215-1699
(601) 321-6021
FAX (601) 321-6037
www.mdes.ms.gov

MONTANA
Human Rights Bureau
Dept of Labor & Industry
1625 11th Avenue
P.O. Box 1728
Helena, MT 59624-1728
(406) 444-2884; (800) 542-0807 (in state only)
FAX (406) 444-2798
www.montanadiscrimination.org

NEBRASKA
Nebraska Equal Opportunity Comm.
301 Centennial Mall South, 5th Floor
P.O. Box 94934
Lincoln, NE 68509-4934
(402) 471-2024
FAX (402) 471-4059
www.neoc.ne.gov

NEVADA
Equal Rights Commission
1515 E. Tropicana Avenue, Ste. 590
Las Vegas, NV 89119-7161
(702) 486-7161
FAX (702) 486-7054
www.nvdetr.org

NEW JERSEY
Division of Civil Rights
140 E. Front Street
P.O. Box 089
Trenton, NJ 08625-0089
(609) 292-4605
FAX (609) 777-0466
www.njcivilrights.org

NEW MEXICO
Dept. of Labor
Human Rights Division
Aspen Plaza
1596 Pacheco Street
Santa Fe, NM 87505
(505) 827-6838; (800) 566-9471
FAX (505) 827-6878
www.state.nm.us/dol

NEW YORK
Dept. of Civil Service
W. Averell Harriman State Office Building
Campus Bldg. 1
Albany, NY 12239
(518) 457-9375
FAX (518) 457-6654
www.cs.state.ny.us

NORTH CAROLINA
Office of State Personnel
Equal Opportunity Services
1331 Mail Service Center
Raleigh, NC 27699-1331
(919) 807-4800
FAX (919) 733-0653
www.osp.state.nc.us

NORTH DAKOTA
North Dakota Dept. of Labor
600 E. Boulevard Avenue, Dept. 406
State Capitol, 13th Floor
Bismark, ND 58505-0340
(701) 328-2660; (800) 582-8032 (in state only)
FAX (701) 328-2031
www.discovernd.com/labor or www.discovernd.com/humanrights

OHIO
Civil Rights Commission
1111 E. Broad Street, Ste. 301
Columbus, OH 43205-1379
(614) 466-2785
FAX (614) 644-8776
www.crc.ohio.gov

OKLAHOMA
Oklahoma Employment Security Commission
2401 North Lincoln Boulevard
Oklahoma City, OK 73105
(405) 557-7100; (888) 980-9675
www.oesc.state.ok.us

OREGON
Employment Department
875 Union Street NE
Salem, OR 97311-0030
(503) 947-1488
FAX (503) 947-1487
www.emp.state.or.us

PENNSYLVANIA
PA Human Relations Comm.
Pennsylvania Place, Ste. 300
301 Chestnut Street
Harrisburg, PA 17101-2702
(717) 787-4410
FAX (717) 787-0420
www.phrc.state.pa.us

RHODE ISLAND
Dept. of Admin., Div. of Human Services
Equal Opportunity Office
1 Capitol Hill
Providence, RI 02908-5865
(401) 222-3090
FAX (401) 222-6391
www.doa.state.ri.us

SOUTH CAROLINA
Human Affairs Commission
2611 Forest Dr., Ste. 200
P.O. Box 4490
Columbia, SC 29240
(803) 737-7800; (800) 521-0725 (In state only)
FAX (803) 253-4191
www.state.sc.us/schac/

SOUTH DAKOTA
Bureau of Personnel
500 East Capital
Pierre, SD 57501-5070
(605) 773-3148
FAX (605) 773-4344
www.state.sd.us/bop/

TENNESSEE
Equal Employment Opportunity Commission
Dept. of Employment Security
500 James Robertson Pkwy
Nashville, TN 37245-0001
(615) 741-8805
FAX (651) 741-5078
http://www.tennessee.gov/labor-wfd/

TEXAS
Office of the Governor
Human Resources Division
Capitol Station
P.O. Box 12428
Austin, TX 78711
(512) 463-2000
FAX (512) 463-1849
www.governor.state.tx.us

UTAH
Labor Commission
Antidiscrimination & Labor Division
160 East 300 South, Third Floor
Salt Lake City, UT 84114
(801) 530-6801; (800) 222-1238
FAX (801) 530-7609
TTD (801) 530-7685
www.laborcommission.utah.gov

VERMONT
Office of the Attorney General
Civil Rights Unit
Pavilion Office Bldg.
109 State Street
Montpelier, VT 05609-1001
(802) 828-5511
FAX (802) 828-2154
www.atg.state.vt.us

VIRGINIA
Office of Equal Employment Services
Dept. of Human Resource Management
101 N. 14th Street
Richmond, VA 23219
(804) 225-2136
FAX (804) 371-7401
www.dhrm.virginia.gov

WASHINGTON
Workforce Diversity Program
Dept of Personnel
521 S. Capitol
P.O. Box 47500
Olympia, WA 98504-7500
(360) 664-6228
FAX (360) 586-4694
http://www.dop.wa.gov/hrprofessionals/diversity

WEST VIRGINIA
Personnel Division
Bldg. 6, Rm. B-416
1900 Kanawha Blvd E.
Charleston, WV 25305
(304) 558-3950
FAX (304) 558-1399
www.state.wv.us/admin/personnel

WISCONSIN
Dept of Workforce Development
Equal Rights Division
P.O. Box 8928
Madison, WI 53708
(608) 266-6860
FAX (608) 267-4592
www.dwd.state.wi.us/er/

WYOMING
Dept. of Employment
Labor Standards/Fair Employment
1510 E. Pershing Blvd.
West Wing, Rm. 150
Cheyenne, WY 82002
(307) 777-7261
FAX (307) 777-5633
http://doe.state.wy.us

AMERICAN SAMOA
Dept. of Human Resources
American Samoa Government
Pago Pago, AS. 96799
(684) 633-4485
FAX (684) 633-1139

Dept. of Labor
Second Floor Afetna Square Building
Caller Box 10007
Saipan, MP 96950
(670) 236-0900/0901
FAX (670) 236-0992/0991

DISTRICT OF COLUMBIA
Office of Human Rights & Local Business Development
441 Fourth St., NW, Suite 970
Washington, DC 20001
(202) 724-1385
FAX (202) 724-3786
www.ohr.dc.gov

GUAM
Dept. of Labor
P.O. Box 9970
Tamuning, GU 96931-9970
(671) 475-7046/7000
FAX (671) 475/7045
www.guamdol.net

PUERTO RICO
Fair Employment
Labor & Human Resources Dept
505 Munoz Rivera Avenue
Hato Rey, PR 00918
(787) 754-2119
FAX (787) 753-9550

VIRGIN ISLANDS
Dept. of Labor
Labor Relations Division
P.O. Box 302608
St. Thomas, VI 00803-3359
(340) 776-3700
FAX (340) 774-5908
www.vidol.gov

WORKERS' COMPENSATION

See also CD Toolkit for updates, links and additional resources.

1. INTRODUCTION

1.1 Background

Before workers' compensation benefits became statutory, injured employees who sought compensation for a loss were obliged to sue their employers under the civil negligence laws. Such action normally was very lengthy and costly, and often the employee did not receive any compensation at all. As the inequity of this system became widely realized, states developed plans whereby employees gave up their right to sue the employer for negligence. In return, the employer was required to guarantee certain benefits. A system of insurance was designed to implement this plan, and workers' compensation was formed. In the course of time, workers' compensation has shifted the burden of industrial injury to the cost of production and established a system compensating employees for injuries, under state law.

1.2 Purpose

The purpose of workers' compensation laws is to provide a uniform and fair system of compensating employees for work-related injuries, diseases, and deaths.

Workers' compensation laws make the employer strictly liable to an employee for injuries sustained by the employee that arise out of and in the course of employment. This liability is paid for by workers' compensation insurance policies, self-insured employer plans, or state funds. In awarding compensation for injuries, negligence on the part of the employer or employee is disregarded, with compensation uniformly held to be a no-fault exclusive remedy. All states have workers' compensation laws that provide medical, compensation, and other benefits for injuries. Although these laws vary from state to state, they are broadly similar in their provisions.

2. DEFINITIONS

Employer. An entity engaged in a business effecting commerce that has employees (29 U.S.C. Section 652(5)).

Employee. One employed in a business of an employer that effects commerce (29 U.S.C. Section 652(6)).

Commerce. "Trade, traffic commerce, transportation, or communication among the several states, or between a state and any place outside thereof, or within the District of Columbia, or a possession of the United States . . . , or between points in the same state but through a point outside thereof" (29 U.S.C Section 652 (3)).

3. FEDERAL REGULATIONS

3.1 Coverage

A determination of the exact jurisdiction and benefits applicable to a particular workers' compensation claim depends on the jurisdiction and benefit provisions of each state's workers' compensation statute. Each state has its own law establishing benefits and jurisdictional considerations. In addition to state laws, there are several federal workers' compensation statutes that provide workers' compensation coverage for certain specified groups of employees.

Exemptions from workers' compensation coverage are discussed in section 3.3 of this chapter.

3.2 Compulsory Coverage

Workers' compensation laws are classified as either compulsory or elective. Under a compulsory law, every employer must accept the act and must provide the specified compensation benefits. Under an elective act, employers have the option of either accepting or rejecting the benefits under the act. However, if the act is rejected, the employer loses the customary common law defenses, such as assumption of the risk by an employee, negligence of fellow employees, and contributory negligence of an employee.

Today, most states have compulsory workers' compensation laws. Accordingly, some form of insurance is mandatory for covered employers. Specific requirements for coverage, as well as penalties for failure to insure, vary considerably from state to state and can be learned only by examining the appropriate state regulations. Section 5 of this chapter discusses specific state requirements for coverage. New employers should contact their state workers' compensation authority to determine the exact requirements for workers' compensation insurance.

3.3 Employees

Compensation for work-related injuries will only be paid to employees, a definition that generally includes both part-time and temporary employees. Professional and managerial employees are also considered employees. Certain types of employees may nevertheless be excluded from coverage under workers' compensation laws (for example, partners, some corporate officers, family members, volunteers, farm and domestic labor, and students). State regulations must be examined to determine exemption.

Sole proprietors are not considered "employers" or "employees" and are generally not covered under workers' compensation laws. Again, it is necessary to examine state laws to make a final determination.

The employer is responsible for compensating the injured employee. In general, workers are compensated for their loss of wages while out of work because of an injury, for their permanent disabilities and loss of wage-earning capacity, and for their medical needs. The amount of compensation varies from state to state, and benefits are paid directly by an employer's workers' compensation insurer or from a self-insured fund. Specific categories of benefits are discussed in section 3.13 of this chapter.

3.4 Employers

All employers covered under workers' compensation regulations are classified into specific groups by the nature of their business and activities, classifications based on the degree of risk of injury and accidents involved in the business.

All employers must be aware of their primary legal responsibilities and duties to injured employees. Under workers' compensation laws, the exact definition of *employer* varies from state to state. For example, some states base their definition on the number of employees a particular person employs. Again, individual state statutes must be reviewed. Whenever an employer is required to provide workers' compensation coverage, most laws require that he or she file certain reports and keep certain records.

3.5 Financing and Recordkeeping

Covered employers are liable for the cost of workers' compensation insurance, and the cost may not be passed along to employees.

Accurate wage records must be kept for all covered workers and be available for review, inspection, or audit at all times. Failure to comply may result in penalties and fines.

Management is responsible for understanding and meeting the requirements of the various workers' compensation statutes in states where its employees are situated. Management must establish a system to ensure that covered employees and their salary bases are properly accounted for and reported. Employees should be properly classified and these classifications periodically reviewed in connection with rate changes. The claims-handling process should also be re-evaluated periodically.

3.6 Rates

Accident experience throughout American business is compiled by the National Council on Compensation Insurance. The council is recognized by all insurance carriers and state fund administrators. Rates are determined in accord with a standard nationwide rate-making procedure approved by the National Association of Insurance Commissioners. The National Council on Compensation Insurance has issued an experience-rating-plan manual that is standard with all insurance companies.

Workers' compensation rates are assigned to employers based on the employer's classification. The rate is usually expressed as a percentage of payroll paid by an employer and is adjusted according to the employer's accident record. Employers in the same classification may have different rates based on the number of accidents their workers experience. In this way, the cost of workers' compensation is spread out more justly.

3.7 Wage Base

The rate assigned an employer is applied to the employer's wage base to determine the employer's workers' compensation liability. The wage base is the estimated wages an employer will pay in a year and should be adjusted periodically according to state regulations.

Wage-base audits are periodically completed to determine whether an employer has overpaid or underpaid. A wage-base audit compares the estimated wage base to the actual wages paid for a specified period.

3.8 Accidental Injury

Most state and federal workers' compensation laws require that an inquiry be "accidental" in nature. The majority of states accept an injury as accidental if its cause was a chance nature or if its effect was the unexpected result of the routine performance of an employee's normal job duties. A few states require proof that an employee's injury was in some way unusual and not merely the result of performing normal job duties.

3.9 Arising Out of Employment

All state and federal workers' compensation laws require that an injury "arise out of" employment in order to be compensable. An injury generally is said to arise out of employment when conditions of employment cause the injury.

3.10 In the Course of Employment

All state and federal workers' compensation laws also require that an injury occur "in the course of" employment. The time, place, and activity of the employee are demonstrative of whether the injury occurred in the course of employment. For example, in most states, many injuries that occur while employees are on their way to and from work are generally held not to occur in the scope of the employment and are not covered under workers' compensation laws.

3.11 Occupational Diseases

In addition to coverage for accidental injuries, most workers' compensation laws provide compensation for employees who sustain occupational diseases that arise out of and in the course of employment. In general, while an accidental injury arises from a specific event, occupational diseases result from repeated exposure over a long period of time to some condition that is characteristic of the employment. The exact definition of an occupational disease and the benefits payable for such a disease vary from state to state. Some states provide workers' compensation coverage not only for physical diseases, but also for mental diseases arising from employment, such as work-related mental and emotional stress and psychiatric disorders.

3.12 Accident Reports

Employees are legally required to report accidents to their employers as soon as possible. In turn, employers are required to submit reports of accidents and injuries to the proper authorities in their state. In many states the report should be made to the state workers' compensation board, but this varies from state to state. Failure by an employer to report an accident may result in penalties and fines. These limitation periods vary from state to state and may require that a claim be filed as soon as one year following an injury, or as long as three years.

3.13 Benefits

An employee can recover the costs of hospitalization, medical care, and other expenses resulting from a work-related injury. In addition, an employee is generally entitled to receive disability benefits as a replacement for temporary wage loss while out of work following an injury or as compensation for a permanent disability.

3.13.1 Categories of benefits

There are four basic categories of workers' compensation benefits:

1. *Temporary Total Benefits.* These benefits are for a disability that is temporary in quality and total in character. They are wage loss benefits and are generally payable to employees out of work following an injury and before maximum medical improvement is reached.
2. *Temporary Partial Benefits.* These benefits are for a disability that is temporary in quality and partial in character. They are wage loss benefits and are payable when an employee returns to work at a lighter-duty and lower-paying job, but before the employee reaches maximum medical improvement.
3. *Permanent Partial Benefits.* These benefits are for a disability that is permanent in quality and partial in character. They are monetary benefits in addition to medical treatment and care for a permanent disability and may be based on a percentage of anatomical disability or on a permanent loss of wage-earning capacity, depending on the provisions of a state's statute. The amount of permanent partial benefits may be based upon the part of the body that is injured, such as the arm, the leg, or the back.
4. *Permanent Total Benefits.* These benefits are for a disability that is permanent in quality and total in character. They are payable when an employee is permanently unable to return to work at his or her regular job or to any form of gainful employment.

3.13.2 Vocational rehabilitation

When an employee is physically unable to return to work at his or her regular job following a work-related injury, but is able to work at alternative jobs, most workers' compensation laws require employers to provide vocational rehabilitation services. Vocational rehabilitation may include vocational guidance, counseling, testing, retraining, and relocation. Job placement, education, and assistance in modification of an employee's home to accommodate a disability may also be included in vocational rehabilitation.

The extent of required vocational rehabilitation varies considerably from state to state. Some states provide for a fund from which an employer may seek payment to cover the cost of rehabilitation. Other states do not provide for such a fund, and the cost of rehabilitation is usually directly paid by the employer's workers' compensation insurer.

3.13.3 Death benefits

When an employee dies as the result of a work-related injury, his or her surviving spouse, children, or other dependents may be entitled to death benefits. The amount of such benefits varies depending on whether a dependent was totally dependent on the deceased employee's income for support, or only partially dependent. Death benefits may also include some reimbursement for funeral expenses and some education costs for minor children through college. The specific requirements and amounts of death benefits vary substantially from state to state.

3.13.4 Benefits for pre-existing disabilities

In some cases, an employee's work-related permanent disability may be superimposed over a pre-existing disability or injury. In such situations, some states have special funds established under the workers' compensation statute that may be responsible for payment of permanent disability benefits to an employee for a pre-existing disability. The policy behind such special funds is to ensure that an employer is responsible for only the disability caused by a work-related injury and to encourage employers to hire employees with pre-existing disabilities or handicaps.

3.14 Tax Consequences

Workers' compensation premiums are deductible as a business expense by employers. Benefits are not taxable to an employee upon receipt under IRC Section 104(a)(1).

4. OCCUPATIONAL SAFETY AND HEALTH

Occupational safety and health standards help create a safe and healthful work environment, which in theory reduces the number of workers' compensation claims filed against employers.

4.1 Background

The Occupational Safety and Health Act (OSHA) was enacted by Congress in 1970 because states were perceived as not providing adequate protection for workers. It is an attempt to provide uniform standards and a method of enforcement.

In general, OSHA covers all employers and employees in all fifty states, the District of Columbia, Puerto Rico, and all other federal territories. The act does not cover self-employed persons, farms where only immediate members of the farmer's family work, and workplaces already protected by other federal laws. Although federal agencies are covered, OSHA does not cover employees of state and local governments. However, many states have laws with requirements similar to those of OSHA.

4.2 Scope and Purpose

The purpose of the act is to "assure so far as possible every working man and woman in the Nation safe and healthful working conditions. . . ." The statute looks to a number of methods to carry out this purpose. These methods include voluntary efforts by employees and employers as well as joint labor/management to reduce hazards, standards promulgated by the federal Secretary of Labor; effective means to enforce the standards, research into causes and prevention of occupational injuries and disease, and encouragement of state efforts.

4.3 Compliance with OSHA

Employers have an obligation to provide places and working conditions free from recognized hazards, and both employers and employees have an obligation to comply with OSHA standards. Employers and employees who do not comply with OSHA standards may be subject to civil fines and/or imprisonment. The nature of the fine and the length of imprisonment depend on the nature of noncompliance.

Enacted safety standards are published in the code of Federal Regulations. Proposed safety standards are published in the Federal Register. Employers may obtain temporary or permanent variances from standards by showing that noncompliance is due to circumstances beyond their control or that existing working conditions are as safe as the proposed OSHA standards. Employees have the right to a hearing on employer's requested variances.

4.4 Relation to State Laws

This act is not meant to affect any workers' compensation act or any existing common law or statutory duties, rights, or liabilities of employers and employees with respect to occupational safety and health. States may regulate any occupational safety or health issue with respect to which there are no standards in effect under OSHA. They may also regulate issues already covered by OSHA standards upon submission to and approval of a plan for development of standards and enforcement that are at least as effective as OSHA standards and enforcement. See the Appendix at the end of this chapter for a complete list of state occupational safety agencies and addresses.

5. STATE INFORMATION AND OFFICES

A compulsory statute applies to all employers who are not specifically excluded, and excluded employers are often covered voluntarily. An elective statute either applies to all employers who elect to be covered by the statute or does not apply to those employers who reject the statute. Employers who opt out of elective statutes may be sued without being able to use common-law defenses that were available before the statutes were enacted.

The penalty for the failure to insure varies widely from state to state. It can include a fine, imprisonment, or an injunction from doing business or engaging in employment activities. Many states also allow injured workers to sue their employers with the common-law defenses either as an alternate remedy to the compensation provided by the statute or in addition to that compensation. If the employer is a corporation, officers are frequently held personally liable for penalties, damages, and compensation.

The following is a brief state-by-state analysis of workers' compensation laws as they relate to private employment.

Alabama The statute is compulsory. Insurance is required of all employers with five or more employees. Failure to insure is subject to a misdemeanor fine from $100 to $1,000. The court may impose civil penalties against an employer in noncompliance in an amount not to exceed $100 per day. An injured employee may sue the employer and receive double compensation under the statute if the employer is uninsured.

Code of Alabama. Sections 25-5-8(E) and 25-5-50.

Workers' Compensation Division
Dept. of Industrial Relations
649 Monroe Street
Montgomery, AL 36131
(334) 242-2868
Fax: (334) 353-8262
www.alabama.gov/wc

Alaska Insurance is required of all employers with few exceptions. Those who do not need to be covered under a workers' compensation policy generally include sole proprietors in a sole proprietorship, general partners in a partnership, executive officers in a nonprofit corporation, members in a member-managed limited liability company, part-time babysitters, cleaning persons (noncommercial), harvest help and similar part-time or transient help, sports officials for amateur events, contract entertainers, commercial fishers, taxicab drivers, participants in the Alaska temporary assistance program, and professional hockey team players and coaches and effective 2006 (Chapter 85 8A 06). Also exempt are licensed realtors performing services under a written contract providing they will not be treated as an employee and whose pay is based on sales or output rather than hours worked. In addition, executive officers in a for-profit corporation may exempt themselves by filing an Executive Officer Waiver with the department. The failure to insure is a class B or C felony subject to a fine of up to $50,000, imprisonment up to 10 years, or both. Section 23.30.075(b) of the Alaska Statutes provides for a fine up to $10,000 or imprisonment up to one year, or both. The employer may be enjoined from doing business if the uninsured employer is sued and negligence is presumed. Corporate officers and managers are personally liable.

Alaska Statutes. Section 23.30.005 et seq.

Dept. of Labor & Workforce Development
Division of Workers' Compensation
P.O. Box 115512
Juneau, AK 99811-5512
(907) 465-2790
Fax: (907) 465-2797
www.labor.state.ak.us/

Arizona Except as statutorily authorized, workers' compensation insurance is required of all employers. An injured employee may elect to receive workers' compensation benefits under the Arizona Workers' Compensation Act or to pursue legal remedies in tort if the employer is not insured. The employer may be enjoined from doing business if the employer fails to insure. A minimum penalty of $1,000 or 10 percent of benefits paid, whichever is greater, will be assessed against an unisured employer if an award is made to an employee for a compensable claim. A civil penalty of $1,000 may be assessed against an uninsured employer if an award is made to an employee for a noncompensable claim. Even in the absence of an injury, a civil penalty of $1,000 may be assessed against an employer who is required to obtain but fails to secure insurance. For workers' compensation purposes, the Industrial Commission of Arizona determines employer/employee versus independent contractor status, independent of Internal Revenue Agency determination.

Arizona Revised Statutes. Section 23-901 et seq.

Industrial Commission of Arizona
800 W. Washington
P.O. Box 19070
Phoenix, AZ 85005-9070
(602) 542-4661
Fax: (602) 542-3373
www.ica.state.az.us

Arkansas The statute is compulsory. Coverage is required for all employers with three or more employees with certain exceptions. Failure to insure is subject to a fine. If the employer has no workers' compensation coverage, an employee may also elect to receive compensation under the statute or to sue the employer.

Arkansas Statutes. Ark. Code Ann. 11-9-101 et seq.

Workers' Compensation Commission
324 Spring Street
P.O. Box 950
Little Rock, AR 72203-0950
(501) 682-3930
Fax: (501) 682-2777
www.awcc.state.ar.us

California Workers' compensation is compulsory. Insurance is required of all employers. If an employer is enjoined from doing business, there is a penalty of $1,000 per employee, with $10,000 for compensable cases. Intentional failure to insure is a felony. Failure to obey a stop order injunction is a misdemeanor, subject to a fine of up to $10,000, imprisonment for up to sixty days, or both. The injured worker may receive workers' compensation and also sue the employer in civil court.

California Labor Code. Section 3201 et seq.

Dept. of Industrial Relations
Division of Workers' Compensation
455 Golden Gate, 9th Floor
San Francisco, CA 94102
(415) 703-4600
Fax: (415) 703-4716
www.dir.ca.gov

Colorado All public and private employers in Colorado, with limited exceptions, must provide workers' compensation coverage for their employees if one or more full or part-time persons are employed. An employer who fails to insure may be enjoined from doing business or fined. If an employer is uninsured at the time of an injury, the injured worker may elect to file a claim for compensation benefits plus a 50 percent penalty under the statute or pursue other legal remedies.

Colorado Revised Statutes. Section 8-40-101, et seq., Colorado Revised Statutes (2004).

Colorado Department of Labor & Employment
633 17th St., Ste. 400
Denver, CO 80202-3610
(303) 318-8700
Fax: (303) 318-8710
www.workerscomp.cdle.state.co.us

Connecticut The statute is compulsory. Insurance is required of all employers. Willful failure to insure is subject to a fine up to $50,000. An additional penalty of $100 per day up to $50,000 may be assessed for noncompliance after a finding of noncompliance.

Connecticut General Statutes. Section 31-275 et seq.

Workers' Compensation Commission
21 Oak Street—Capitol Place
Hartford, CT 06106
(860) 493-1500
Fax: (860) 247-1361
http://wcc.state.ct.us

Delaware The statute is compulsory. Insurance is required of all employers. Failure to insure is subject to a civil penalty of $1 per day for each employee in his or her service when the insurance became due, but not less than $25. The employer may be enjoined from doing business if failure to insure continues for 30 days. Employers who refuse or neglect workers' compensation coverage are subject to penalties. In addition, an injured worker may elect to receive compensation or to sue the employer who fails to insure.

Delaware Code. Section 2374 et seq.

Dept. of Labor
Office of Workers' Compensation
4425 N. Market Street, 3rd Fl.
Wilmington, DE 19802
(302) 761-8200
Fax: (302) 761-6601
www.delawareworks.com

Florida Chapter 440, F. S., Workers' Compensation Law is administered by the Florida Department of Financial Services, Division of Workers' Compensation. Pursuant to Chapter 440, F.S., all employers engaged in the non-construction industry that employ four or more employees, and all employers engaged in work in the construction industry that employ one or more employees must secure and maintain the payment of workers compensation for their employees.

Corporate officers are employees. However, corporate officers may exempt themselves from the workers' compensation law providing they meet specific statutory and regulatory eligibility requirements.

"Securing the payment of workers' compensation" means obtaining coverage that meets the requirements of Chapter 440, F.S. and the Florida Insurance Code. An employer is deemed to have failed to secure the payment of compensation if at any time the employer materially understates or conceals payroll, materially misrepresents or conceals employee duties so as to avoid proper classification for premium calculations or materially misrepresents or conceals information pertinent to the computation and application of an experience rating modification factor.

A homeowner shall not be considered the employer of persons hired by the homeowner to carry out construction on the homeowner's own premises if those premises are not intended for immediate lease, sale, or resale.

Whenever the Department determines that an employer, who is required to secure the payment of compensation to his employees as required by Chapter 440, has failed to do so, such failure justifies the service of a stop-work order by the Department requiring the cessation of all business operations of the employer. A penalty of $1,000 per day will be assessed against an employer who conducts business operations in violation of a stop-work order. In addition, the Department will access a penalty equal to 1.5 times the amount the employer would have paid in workers' compensation premiums during periods for which it failed to secure the payment of workers' compensation.

The Department is also authorized to assess a penalty of $5,000 for each employee who is represented by an employer to the Department or carrier as an independent contractor but is determined by the Department not to be an independent contractor.

A stop-work order served by the Department shall remain in effect until the employer provides satisfactory evidence that the employer has complied with the coverage requirements of Chapter 440, F.S. and has paid all penalties assessed. The Department may issue an order of conditional release from a stop-work order to an employer upon finding that the employer has complied with the coverage requirements of Chapter 440, F.S. and has agreed to remit periodic payments of the penalty pursuant to a payment agreement schedule with the Department.

Florida Statutes. Sections 440.10 and 440.107.

Department of Financial Services
Division of Workers' Compensation, Bureau of Compliance
200 East Gaines Street
Tallahassee, FL 32399
(850) 413-1609
http://www.fldfs.com/WC

Georgia The statute is compulsory for all employers with three or more employees. Employers are required to obtain insurance or be approved as self-insurers.

Official Code of Georgia. Section 34-9-1 et seq.

State Board of Workers' Compensation
270 Peachtree Street NW
Atlanta, GA 30303-1299
(404) 656-2048
Fax: (404) 656-7768
www.state.ga.us/sbwc

Hawaii Insurance is required of all employers. Failure to insure is subject to a penalty of $250, or $10 per day, per employee for every day during which such failure continues, whichever is greater. If the failure lasts for 30 days, the employer may be enjoined from doing business.

Hawaii Revised Statutes. Section 386-123 et seq.

Dept. of Labor & Industrial Relations
830 Punchbowl Street, Rm. 209
Honolulu, HI 96813
(808) 586-9200
Fax: (808) 586-9206
www.hawaii.gov/labor/dcd

Idaho Coverage is mandatory for all employers unless specifically exempted. Failure to insure is a misdemeanor. Employers who fail to maintain workers' compensation insurance are subject to a penalty of $2 per day per employee or $25 per day, whichever amount is greater. An employer who is in default can be enjoined from operating the business. In the case of a corporation, any officer or employee of the corporation who has authority to procure insurance and fails to do so is also guilty of a misdemeanor and personally liable for penalties. Injured workers of a noninsured employer are entitled to all statutory benefits as well as a penalty of 10 percent of the amount of compensation to be paid by the noninsured employer.

Idaho Code. Section 72-101 et seq.

Idaho Industrial Commission
P.O. Box 83720
Boise, ID 83720-0041
(208) 334-6000
Fax: (208) 334-5145
Other: 800-950-2110
www.iic.idaho.gov

Illinois The statute is compulsory. Insurance is required of nearly all. Failure to insure is a civil offense and criminal offense. The civil fine is up to $500 per day with a $10,000 minimum fine. The knowing failure to provide coverage is a Class 4 felony and the negligent failure to provide coverage is a Class A misdemeanor. The Commission may issue a work stop order on employer and employer may be liable in a civil action for employee's injuries. If an employer meets statutory qualifications, self-insurance is permissible pursuant to 820 ILCS 305/4 or become a member of a group workers' compensation pool under Article V3/4 of the Illinois Insurance Code.

Illinois Statutes. Section 820 ILCS 205/1 et seq.

Illinois Workers' Compensation Commission
James R. Thompson Center
100 W. Randolph, Ste. 8-200
Chicago, IL 60601
(312) 814-6500
www.iwcc.il.gov

Indiana The statute is compulsory. Insurance is required of all employers. Failure to insure is a class A infraction with a fine of up to $10,000. The employer may be enjoined from doing business. An injured employee may be awarded an amount up to double the compensation provided by the statute plus medical expenses and attorneys' fees.

Indiana Code. Section 22-3-1 et seq.

Workers' Compensation Board of Indiana
402 W. Washington St., Rm. W196
Indianapolis, IN 46204
(317) 232-3811
Fax: (317) 233-5493
www.in.gov/workcomp

Iowa Workers' compensation is compulsory for most employers with few exceptions. An employer must obtain insurance from a licensed insurance company unless the employer is approved by the Iowa Insurance Commissioner to be self insured. A covered employer who operates illegally without insurance may be sued by an injured employee for personal injury damages and the employer is presumed to have been negligent. An employer who knowingly and willfully fails to insure is guilty of a class D felony and can be enjoined from operating without insurance.

Iowa Code. Chapter 87.

Division of Workers' Compensation
1000 E. Grand Avenue
Des Moines, IA 50319
(515) 281-5387
Fax: (515) 281-6501
Other: 800-562-4692
www.iowaworkforce.org/wc

Kansas The statute is compulsory. Insurance is required of most employers who have or can reasonably anticipate having a gross annual payroll of more than $20,000 in a calendar year. Agricultural pursuits, real estate agents and owner-operator truck drivers are exempted.

Kansas Statutes. Section 44-501 et seq.

Department of Human Resources
Division of Workers' Compensation
800 SW Jackson, 7th Floor
Topeka, KS 66612-1227
(785) 296-2996
Fax: (785) 296-0025
www.dol.ks.gov
workerscomp@dol.ks.gov

Kentucky The statute is compulsory. Insurance is required of all employers with a few exceptions (mainly those engaged solely in agriculture). Workers may voluntarily reject the act but an employer may not compel an employee to reject as a condition of employment. Plus, case law had established that employees must understand what they are rejecting. If every employee rejects, it may prove that the rejections are not voluntary. An employer may be enjoined from doing business and fined if it does not have workers' compensation insurance. The employee of an uninsured employer may still file a claim for benefits, which will be paid by the Uninsured Employers' Fund, which may attempt to recover from the uninsured employer any benefits paid on its behalf.

Kentucky Revised Statues. Section 342.001 et seq.

Office of Workers' Claims
Prevention Park
657 Chamberlin Avenue
Frankfort, KY 40601
(502) 564-5550
Fax: (502) 564-5934
www.labor.ky.gov/workersclaims

Louisiana The statute is compulsory. Insurance is required of all employers. An employer who fails to insure is liable for the compensation and may be subject to penalties of up to $10,000. An employer who fails to pay compensation is subject to penalties of $250 per employee, with a maximum of $10,000.

Louisiana Revised Statutes. Section 23.1021 et seq.

Office of Workers' Compensation
Dept. of Labor
P.O. Box 94040
Baton Rouge, LA 70804-9040
(225) 342-7555
Fax: (225) 342-7578
www.laworks.net

Maine The statute is compulsory. Failure to insure is a class D crime and noncomplying employers may be liable to pay a civil penalty up to $10,000 or 108 percent of the premium that should have been paid. Incorporated employers may also have corporate status revoked. An employer's license, certification, or registration may be revoked or suspended.

Maine Revised Statutes. 39-A Section 101 et seq.

Workers' Compensation Board
27 State House Station
Augusta, ME 04333-0027
(207) 287-3751
Fax: (207) 287-7198
TTD: (207) 287-6119
www.maine.gov/wcb

Maryland The statute is compulsory. Insurance with an authorized insure of self-insurance is required of all employers. Failure to insure is a misdemeanor subject to a fine not to exceed $5,000, imprisonment for up to one (1) year, or both. The employer may be assessed a penalty equal to six months' premiums paid to the State Treasurer, for the benefit and use of the Injured Workers' Insurance Fund if the employer fails to become insured within ten (10) days after being ordered by the workers' compensation commission to do so. An employee may elect compensation under the statute or file suit against the non-insured employer.

Annotated Code of Maryland. Title 9, Labor & Employment Article.

Workers' Compensation Commission
10 E. Baltimore Street
Baltimore, MD 21202
(410) 864-5100
www.wcc.state.md.us

Massachusetts The statute is compulsory. Insurance is required of all employers, as defined by state law. Employers operating without workers' compensation coverage can be issued a Stop Work Order by the DIA Office of Investigations, and shall be assessed a $100 per day fine commencing on the date of the Stop Work Order and accruing until the date insurance coverage becomes effective and the fine is paid, as authorized under M.G.L. Chapter 152, Section 25C. In addition, the employer may be subject to criminal sanctions including, not more than one year imprisonment and/or up to a $1,500 fine, upon conviction. Workers may elect at time of hire or initial coverage to decline coverage and retain common law rights to sue.

Massachusetts General Law c. 152, 452 CMR 1.00 et seq.

Dept. of Industrial Accidents
600 Washington Street, 7th Floor
Boston, MA 02111
(617) 727-4900
Fax: (617) 727-6477
www.mass.gov/dial

Michigan The system is compulsory for all private employers, except agricultural, who regularly employ three or more persons; all private employers, except agricultural, who regularly employ one person for 35 or more hours per week for 13 weeks or longer during a 52-week period; all public employers; and all agricultural employers with three or more employees who were employed for 13 consecutive weeks during the previous 52 weeks. Real estate salesperson, under certain conditions, are not considered employees under the statute. Certain stockholders of closely held corporations, partners in a partnership, or members who are managers of a limited liability company can choose to be excluded from the act if they are the only employees. In addition, if the business is a sole proprietorship, the spouse, child, or parent may be excluded if they are the only employees of the business. Failure to insure is subject to a penalty of $1,000 per day, imprisonment for from 30 days to six months, or both. A civic penalty may be assessed up to $1,000 for every day a business is not in compliance.

Michigan Compiled Laws. Section 418.161 et seq.

Workers' Compensation Agency
Labor & Economic Growth
P.O. Box 30016
Lansing, MI 48909
(517) 322-1195
Fax: (517) 322-1990
www.michigan.gov/wca

Minnesota The statute is compulsory for all employers. Failure to insure is subject to a fine of up to $1,000 per employee per week during which the employer is not in compliance. The employer has 10 working days to contest a penalty assessment.

Minnesota Statutes. Section 176.181 et seq.

Special Compensation Fund
Workers' Compensation Division
Dept. of Labor & Industry
443 Lafayette Road N.
St. Paul, MN 55155-4317
(651) 284-5045
Fax: (651) 284-5733
www.doli.state.mn.us/workcomp.html

Mississippi The statute is compulsory. Insurance is required of all employers with five or more employees. Failure to insure is subject to a fine up to $1,000, imprisonment up to one year, or both, and a civil penalty not to exceed $10,000.

Mississippi Code. Section 71-3-1 et seq.

Workers' Compensation Commission
1428 Lakeland Drive
P.O. Box 5300
Jackson, MS 39296-5300
(601) 987-4284
Fax: (601) 987-4283
www.mwcc.state.ms.us

Missouri In Missouri, workers' compensation coverage is compulsory for all employers that have five or more employees. Construction industry employers who erect, demolish, alter or repair improvements must carry workers' compensation insurance if they have one or more employees.

Under the Missouri workers' compensation law, an injured worker is entitled to three benefits, namely; medical benefits, temporary total disability benefits (TTD), permanent partial disability or permanent total disability benefits, respectively. The TTD benefits generally equal two-thirds of the injured employee's average weekly wage not to exceed a maximum rate set by the legislature. The average weekly wage is determined by examining various pay periods immediately preceding the date of injury. If the injury results in death, that statute provides for payment of reasonable burial expenses not to exceed $5,000 and payment of death benefit to the dependents, if any.

Under the Missouri workers' compensation law, the employer is required to provide medical benefits as may reasonably be required to cure and relieve the employee from the effects of the injury. In addition, the workers' compensation law grants the employer the right to select the treating physician. However, the employee has the right to select the treating physician at the employee's own expense. Section 287.140 (13) RSMo, precludes a hospital, physician, or other health care provider, other than one selected by the employee at the employee's expense, from billing or attempting to collect any amount from the employee for health care services provided in a workers' compensation case. Any continued attempt to collect the bill may result in civil liability being imposed on the health care provider.

A contractor in the construction industry must provide a certificate of workers' compensation insurance coverage or an affidavit attesting that the contractor is exempt, to a city or county, when applying for an occupational or business license. Any employer who fails to insure his workers' compensation liability under Chapter 287, RSMo shall be guilty of a class A misdemeanor and, in addition, shall be liable to pay a penalty in an amount equal to three times the annual premium the employer would have paid if it obtained workers' compensation insurance or $50,000, whichever is greater. Subsequent conviction failing to insure results in a class D felony.

Missouri Statutes. Chapter 287, RSMo.

Dept. of Labor & Industrial Relations
Division of Workers' Compensation
P.O. Box 58
Jefferson City, MO 65102-0058
(573) 751-4231

Fax: (573) 526-4960
www.dolir.mo.gov/wc

Montana Workers' compensation insurance is required of all employers with some exceptions. Failure to insure may be subject to a penalty equal to twice the unpaid premium (not less than $200). The uninsured employer may also be subject to an injunction. The employee may file a claim under the uninsured employers fund (for which the employer is liable), may sue the employer for damages, and has a separate course of action because the employer was uninsured. The Uninsured Fund has the right to set off against any funds recovered from the uninsured employer or any third party.

Montana Code Annotate. Section 39-71-501 et seq.

Dept. of Labor & Industry
Uninsured Employers' Fund
Employment Relations Division
P.O. Box 8011
Helena, MT 59604-8011
(406) 444-9728
Fax: (406) 444-3465
http://uid.dli.mt.gov

Nebraska The statute is compulsory. Insurance is required of all employers. Failure to insure is subject to a fine of up to $1,000, imprisonment for up to one year, or both. Each day of continued failure to secure payment of compensation constitutes a separate violation. The employer may be enjoined from doing business in Nebraska until compliance is secured. The employer/insurance carrier may be sued by any injured worker.

Revised Statutes of Nebraska. Section 48-101 et seq.

Workers' Compensation Court
13th Floor, State Capitol
P.O. Box 98908
Lincoln, NE 68509-8908
(402) 471-6468; (800) 599-5155
Fax: (402) 471-2700 or (402) 471-8231
www.wcc.ne.gov

Nevada Workers' compensation insurance is required of all employers with one or more employees with certain exceptions such as independent contractors and excluded persons as defined in NRS 616A.110. Employers failing to secure or maintain proper coverage are guilty of a gross misdemeanor for the first offense and a felony for the second or subsequent offenses within seven years of the previous offense, punishable by imprisonment of one to five years and/or by a fine of up to $50,000. The employer may be ordered to cease business. An injured employee of an uninsured employer may elect to receive compensation from the Uninsured Employers Claim Account or pursue legal action against the employer.

Nevada Revised Statutes. NRS 616A.110, 616B.650, 616C.220, 616D.200.

Dept. of Business & Industry
Division of Industrial Relations
Workers' Compensation Section
1301 N. Green Valley Pkwy #200
Henderson, NV 89074
(702) 486-9080
Fax: (702) 990-0364
http://dirweb.state.nv.us/wcs/wcs.htm

New Hampshire The statute is compulsory. Insurance is required of all employers. Failure to insure is subject to a penalty of $2,500 plus $100 per day per employee. The employer may be subject to an injunction. The employee may sue the employer in tort if there is no coverage. Employer who fails to secure coverage shall be guilty of a misdemeanor.

New Hampshire Revised Statutes. Section 281-A et seq.

Workers' Compensation Division
Dept. of Labor
95 Pleasant Street
Concord, NH 03301
(603) 271-3176
Fax: (603) 271-6149
www.labor.state.nh.us/workers_compensation.asp

New Jersey Every employer in the state of New Jersey, except the state, counties, and municipalities, is required to maintain workers' compensation insurance or to be approved for self-insurance for workers' compensation risks.

All corporations, regardless of type, operating in New Jersey are required to maintain workers' compensation protection so long as any one or more individuals, including corporate officers, receive compensation from the corporation.

All partnerships and limited liability companies (LLCs) are required to maintain workers' compensation protection so long as any one or more individuals, excluding partners or members of the LLC, receive compensation from the partnership or LLC.

All sole proprietorships are required to maintain workers' compensation protection so long as any one or more individuals, excluding the principal business owner, receives compensation from the business.

There are no exemptions for employees who are family members, minors, or persons working less than full time.

An employer who fails to provide the required workers' compensation protection shall be guilty of a disorderly persons offense; if the failure is willful, the employer shall be guilty of a crime of the fourth degree. Failure to provide the required protection will result in a penalty of up to $1,000 for the first 20 days and up to $1,000 for each subsequent 10 days of such failure. If the entity is a corporation, the officers of such corporation shall be both individually and severally liable for such failure.

New Jersey Statutes. Section 34: 15-1 et seq.

New Jersey Dept. of Labor
Office of Special Compensation Funds
John Fitch Plaza
P.O. Box 399
Trenton, NJ 08625-0399
(609) 292-0165
Fax: (609) 984-2515
www.state.nj.us/labor/wc/default.htm

New Mexico The statute is compulsory with some numerical and occupational exceptions and qualifications. The employer may be enjoined from doing business for failure to secure insurance. The employee may not sue in common law if the employer has secured workers' compensation insurance.

New Mexico Statutes Annotated. Section 52-1-1 et seq.

Workers' Compensation Administration
2410 Centre Ave. SE
P.O. Box 27198
Albuquerque, NM 87125-7198
(505) 841-6000
In-state Toll Free: (800) 255-7965
www.workerscomp.state.nm.us

New York The statute is compulsory. Insurance is required of all employers. The first-time offense for failure to insure is subject to a fine of from $500 to $2,500, imprisonment of up to one year, or both. Repeated offenses can go up to $7,500. There is an additional penalty of $250 for each ten-day period without coverage or 2 percent of the payroll for that period. The employer may be sued by the employee or the employee may apply for workers' compensation benefits. If the employee received benefits, the employer is liable for the benefits and for an assessment of $250 plus 15 percent of the award, such assessment not being less than $1,500 and not exceeding $5,000 on each claim.

In an emergency session of the Workers' Compensation Board's meeting on September 25, 2001, the board suspended the practice of requiring dependents to produce a death certificate to begin benefits. The resolution enables the board to create alternative means to process claims for the families of missing or deceased workers as a result of the September 11, 2001, terrorist attacks. (*Consolidated Laws of New York, Workers' Compensation Law*).

In addition, workers who do not qualify for regular unemployment insurance benefits, including persons who have become the breadwinner or major support for a household because the head of the household died as a direct result of the disaster, may be eligible for Disaster Unemployment Assistance. (*Consolidated Laws of New York, Labor Law*).

All victims of the World Trade Center disaster are eligible to apply to the New York crime victims board for a possible reimbursement of expenses related to the crime. Allowable expenses include but are not limited to medical expenses not covered by insurance or other benefits, burial expenses, loss of earnings or support up to $30,000, and counseling expenses.

Consolidated Laws of New York. Executive Law

On August 14, 2006, Governor Pataki signed Chapter 446 into the law which is effective immediately and is deemed to have been in effect on and after September 11, 2001. Chapter 446 adds a new Article 8-A to the New York State Workers' Compensation Law to provide an alternative time period for the filing of a claim by individuals who, either as employees or volunteers, participated in rescue, recovery and/or clean-up operations at the World Trade Center site, the Fresh Kill's Landfill, the morgue and temporary morgues, or the barges between the west wide of Manhattan and the Fresh Kill's landfill between September 11, 2001, and September 12, 2002. Pursuant to the provisions of Article 8-A, participants suffering from qualifying conditions, which are latent diseases caused by the hazardous exposure from performing the rescue, recovery and/or clean-up operations, have two years from date of disablement or after the individual knew or should have known that the condition was causally related to his or her participation, whichever is later, to give notice to the employer and file a claim. Such claims will be treated as accidental claims with the date of accident being the date of disablement. In addition, any claims that were disallowed using the then existing notice and claim filing time periods in Workers' Compensation Law §§ 18 and 28 must be reopened by the Board upon the filing of a registration statement. In order for the provisions of Article 8-A to apply to any claim, the individual must file a registration form with the Board within one year of the date of the enactment of the Article, which is before August 14, 2007. The registration form prescribed by the Board is Form WTC-12. The employer liable for any qualifying conditions from participation is the one the participant was working for when performing the rescue, recovery, and/or clean-up operations. The liable carrier is the one providing coverage on the date of accident which for purposes of this Article is the last day of participation.

Workers' Compensation Board
20 Park Street, Ste. 401
Albany, NY 12207
(518) 486-7676
Fax: (518) 402-0113
www.wcb.state.ny.us

North Carolina The statute is compulsory. Insurance is generally required of all employers with three or more employees. For sole proprietorships, partnerships, and LLCs, the principals are excluded from determining the requisite number of employees unless they select coverage for themselves. Failure to insure is subject to a penalty of $1.00 per day per employee (from $50 to $100). It is also a misdemeanor for which an employer may be fined or imprisoned, or both, at the discretion of the court. The employer is liable to injured workers either for compensation under the statute or in a civil action suit if the employer has not provided workers' compensation insurance and if the Industrial Commission makes an award of benefits under the Act. Corporate officers who work at the corporation are counted for purposes of determining whether or not there are three employees, but may still be excluded from the NC policy (that is, president, vice president and a secretary work for the corporation). Workers' Compensation must be purchased for the secretary, but the President and Vice President may exclude themselves from the policy.

General Statutes of North Carolina. Section 97-1 et seq.

NC Industrial Commission
Dobbs Bldg.
430 N. Salisbury Street
Raleigh, NC 27611
(919) 807-2500
Fax: (919) 715-0282
www.comp.state.nc.us

North Dakota Workforce Safety & Insurance (WSI) is a monopolistic state fund. With limited exceptions, all employers having significant contacts in North Dakota must secure coverage through WSI. Part-time, seasonal, or occasional workers are not exempt from coverage requirements.

Employers who fail to obtain required coverage face significant penalties plus payment of the noncompliance premium, and are deemed uninsured.

Employers who participate in the WSI qualified risk management programs are eligible for premium discounts of up to 10 percent.

Starting with an account's fifth year of North Dakota operations, accounts are experience rated. Qualification for experience rating requires an account to have an aggregate premium of $25,000 over the five-year period. Accounts not meeting the aggregate level will be awarded a "Loss Free Credit." The credit will be offered to accounts that have not incurred any losses in excess of the $250 medical assessment during the five-year period that serves as the basis for the experience rating calculations.

North Dakota Century Code. Section 65-01 et seq.

Workforce Safety & Insurance
1600 E. Century Avenue, Ste. 1
Bismarck, ND 58506-5585
(701) 328-3800; (800) 777-5033
Fax: (701) 328-3820
www.workforcesafety.com

Ohio The statute is compulsory, and Ohio is an exclusive jurisdiction state. Coverage is required for all employers, although larger employers may be granted the privilege of self-insurance. Failure to obtain coverage or to have coverage in effect on the date of injury makes a "noncomplying" employer directly liable for all compensation and medical expenses paid out in a claim, and a lien may be filed against the employer's property to secure payment. The employer may be enjoined from doing business. The employer may also be sued to recollect amounts paid to a claimant from the State Surplus Fund or to collect past due premium obligations.

Page's Ohio Revised Code Annotated. Section 4123.01 et seq.

Bureau of Workers' Compensation
William Green Bldg.
30 West Spring Street
Columbus, OH 43215-2256
(800) 644-6292
Fax: (614) 644-0581
www.ohiobwc.com

Oklahoma The statute is compulsory. Coverage is required by all employers on all employees, whether full-time or part-time, except for employees enumerated in Sec. 2.1, et seq. and employers in Sec. 2.6. The civil penalty for failure to insure is not to exceed either $250 per employee for a first offense or $1,000 per employee for a second offense, up to a maximum of $10,000. The $250 penalty per employee for a first offense may be reduced to $75 per employee if workers' compensation insurance is obtained within 30 days of receiving notice from the Commissioner of Labor of the violation. A second violation constitutes a prima facie case of willful violation, which could result in the issuance of cease-and-desist orders, fines and/or imprisonment (85 O.S. Sec. 63.3).

Oklahoma Statutes Annotated. Title 85 O.S. Section 63.1 et seq.

Workers' Compensation Court
1915 North Stiles
Oklahoma City, OK 73105-4904
(405) 522-8600 Oklahoma City; (918) 581-2714 Tulsa
Fax: (405) 522-8683
www.owcc.state.ok.us

Oregon The statute is compulsory. Insurance is required of all employers who have one or more subject workers. All workers are subject except those specifically excluded. Insurance may be obtained from authorized Oregon workers' compensation insurers, including SAIF Corp. (State Accident Insurance Fund). The publicly-owned insurance company that sells workers' compensation insurance to Oregon employers essentially operates as other private insurers. Self-insurance is allowed for qualified employers. Failure to insure subjects an employer to a first violation of the greater of $1,000 or twice the premium the employer should have paid during the noncomplying period. If an employer fails to become insured after being found subject and noncomplying, it may be fined $250 per day without limit. The employee may file a claim for all compensation, including medical. Under the statute, if the employer is found to be noncomplying, the worker may also sue the employer in civil court. Claim costs are paid out of the Workers' Benefit Fund and then reimbursed by the employer and/or responsible parties of the employer personally. These costs include compensation, disputed-claim settlements, claim disposition agreements, reasonable administrative and claims processing costs, attorney fees related to compensability issues, and any attorney fees awarded to the claimant. Administrative costs for processing claims are paid to an assigned claims agent at a rate negotiated periodically between the assigned claims agent and the Workers' Compensation

Division. With cooperation and compliance of the employer, civil penalties may be reduced, but claim costs are paid by the employer dollar for dollar.

Oregon Revised Statutes. Section 656.001 et seq.

Dept. of Consumer & Business Services
Workers' Compensation Division
Compliance Section
350 Winter Street NE, Rm. 27
P.O. Box 14480
Salem, OR 97309-0405
(503) 947-7815
Fax: (503) 947-7718
www.oregonwcd.org

Pennsylvania The statute is compulsory. Coverage is required for all emplyers unless exempt. It is a third-degree misdemeanor offense for an employer not to carry workers' compensation insurance. Fines of up to $2,500 and/or one year in prision for each day of noncoverage can be imposed for noncompliance with the law. If the failure to insure is intentional, the offense then becomes a felony. Any party may file a criminal complaint against an uninusred party with the county district attorney's office. Uninsured employers are liable for benefits and do not have the protection from civil or criminal actions provided to insured employers. Where the employer does have workers' compensation insurance coverage or has been approved as a self-insured employer by the Bureau of Workers' Compensation, the employee's exclusive remedy is under the statute. If the employer was not insured and not otherwise exempted as a self-insurer as of the date of injury, the employee may file judgment pursuant to the Workers' Compensation Act or file a claim in civil court.

Purdon's Pennsylvania Statutes Annotated. Title 77.

Bureau of Workers' Compensation
Dept. of Labor & Industry
7th & Forster Streets
Harrisburg, PA 17120
(717) 772-4447
www.dli.state.pa.us

Rhode Island The statute is compulsory. Insurance is required of all employers with one or more employees. Failure to insure is subject to a fine of not less than $500 or more than $1,000 for each day of noncompliance. An administrative penalty may be imposed and/or civil and criminal action may be filed. The director may suspend the operation of the business. Corporate officers are personally liable for compensation while the corporation is uninsured. The employer may be sued. Corporate officers, managers and managing members of a limited liability company, partners of a partnership or registered limited liability partnership, general partners of a limited partnership or a registered limited liability limited partnership are subject to $1,000 fine and jail term.

General Laws of Rhode Island. Section 28-29-6 et seq. Per 28-36-15 Amendment 2005.

Dept. of Labor & Training
Workers' Compensation Unit
P.O. Box 20190
Cranston, RI 02920-0942
(401) 462-8100
Fax: (401) 462-8105 or (401) 462-8095
www.dlt.ri.gov.wc

South Carolina Any employer who regularly employs four or more workers full-time or part-time is required to have workers' compensation insurance. There are some exceptions, including agricultural employees, casual employees as defined by the Workers' Compensation Act, and employers who had a total annual payroll during the previous calendar year of less than $3,000, regardless of the number of workers employed during that period. Although most employers must purchase workers' compensation insurance, any employer may purchase coverage. Sole proprietors and partners may specifically elect to be covered; corporate officers are considered to be employees, but may be exempted from workers' compensation insurance. Failure to insure is subject to a fine of $.10 per day per employee (minimum $1, maximum $50 per day). The willful failure to insure is a misdemeanor subject to a fine of up to $1,000, imprisonment of from thirty days to six months, or both.

Code of South Carolina. Title 42.

Workers' Compensation Commission
P.O. Box 1715
Columbia, SC 29202-1715
(803) 737-5700
Fax: (803) 737-5768
www.wcc.state.sc.us

South Dakota The statute appears to be elective. Any employer who fails to insure is deemed to have elected not to operate under the statute. The employer may be sued. There is no civil fine or criminal penalty for the failure to insure, but there can be a greater civil liability.

South Dakota Codified Laws. Title 62.

Dept. of Labor
Division of Labor & Management
Kneip Bldg.
700 Governor's Drive
Pierre, SD 57501-227
(605) 773-3681
Fax: (605) 773-4211
www.state.sd.us/dol/dol.htm

Tennessee The statute is compulsory. Insurance is required of employers with five or more employees, with exceptions specified in the law. All subcontractors and anyone engaged in the construction business, as well as anyone engaged in the mining and production of coal, are required to carry coverage if they have one or more employees. Sole proprietors and partners are not required to carry insurance on themselves. The Workers' Compensation Division has been given the power to assess a fine equal to two and a half times the average yearly workers' compensation insurance premium and there is no maximum. Failure to comply on second or subsequent occasions results in discontinuation of business operations.

Tennessee Code Annotated. Section 50-6-101 et seq.

Dept. of Labor & Workforce Development
Workers' Compensation Division
710 James Robertson Pkwy.
Andrew Johnson Tower, 2nd Fl.
Nashville, TN 37243-0661
(615) 253-6267
Fax: (615) 253-6256
TTD: 800-332-2667
www.state.tn.us/labor-wfd/wcomp.html

Texas The statue is elective. Insurance is required of employers who accept the statute. There is no penalty for the failure to insure. However, the injured worker may sue the employer.

Vernon's Texas Labor Code Annotated. Sections 401.001-506.001.

Workers' Compensation Commission
7551 Metro Center Dr., Ste. 100
Austin, TX 78744-1645
(512) 804-4636
Fax: (512) 804-4101
www.twcc.state.tx.us

Utah The statute is compulsory. Insurance is required of all employers. Any employer, including officers, that fails to insure is guilty of a class B misdemeanor. Each day is a separate offense. The employer is subject to a fine of no less than $1,000. The employer is also subject to imprisonment for from 30 days to six months. A civil penalty can be assessed against the uninsured employer of the greater of $1,000 or three times the premium for any time period of noncompliances. The injured worker may elect compensation under the statute or file suit against the employer, when the employer is uninusred. Workers' compensation in the State of Utah is a no-fault insurance. A 15 percent penalty can be added on to an award for an employer's willful neglect in the cause of an injury.

Utah Code Annotated. Section 34 A-2 et seq.

Industrial Accidents Division
160 E. 300 S., Third Floor
P.O. Box 146610
Salt Lake City, UT 84114-6610
(801) 530-6800
Fax: (801) 530-6804
http://laborcommission.utah.gov

Vermont The statute is compulsory. Insurance is required of all employers. Failure to insure is subject to a fine of $50 per day, per occurrence, and $150 per day, per occurrence, after five days after notice to the employer.

Vermont Statutes Annotated. Title 21, Sections 601 to 710.

Dept. of Labor & Industry
National Life Bldg. Drawer 20
Montpelier, VT 05620-3401
(802) 828-2286
Fax: (802) 828-2195
www.state.vt.us/labind/

Virginia The statute is compulsory. Insurance is required of all employers with three or more employees regularly in service in the same business in the State of Virginia (if the employer is a farm, more than two full-time employees). Failure to insure is subject to a fine from $500 to $5,000. The intentional failure is a class 2 misdemeanor. The commission may order the employer to cease and desist all business transactions and operations until found by the commission to be in compliance with the provisions. The injured worker may sue the employer instead of seeking compensation under the statute. If the employer has failed to insure, the traditional common-law defenses in negligence actions are not available.

Code of Virginia. Section 65.2-100 et seq.

Workers' Compensation Commission
1000 DMV Drive
Richmond, VA 23220
(877) 664-2566
Fax: (804) 367-9740
www.vwc.state.va.us

Washington Workers' compensation coverage is mandatory. Insurance is required through the Washington State Fund or, if the employer qualifies, through Washington's self-insurance program. Workers hired by an out-of-state employer to work temporarily in Washington are covered by Washington. Workers hired by out-of-state employers who were working for the employer prior to a temporary assignment in Washington are not covered by Washington except for construction workers. Generally, all workers of an out-of-state employer engaged in construction activities in Washington are covered by Washington, unless the employer is from a state with which Washington has a reciprocal agreement (Idaho, Montana, Nevada, North Dakota, South Dakota, Oregon or Utah) with the exception of Montana and Nevada. Montana and Nevada require all construction employment to be reported in those states. Therefore, Washington State requires that any construction work performed in Washington by an employer from Montana or Nevada to be reported to Washington.

Failure to insure subjects an employer to a penalty of $500 or double the amount of unpaid premiums, whichever is greater. If the failure to insure is intentional, the employer is guilty of a Class C felony.

Revised Code of Washington Annotated. Title 51.

Dept. of Labor & Industries
P.O. Box 44274
Olympia, WA 98504-4274
(360) 902-4750
Fax: (360) 902-4853
http://www.lni.wa.gov/

West Virginia West Virginia is a monopolistic state. All persons, firms, associations, and corporations regularly employing another person or persons for the purpose of carrying on any form of industry, service or business in our state are defined as employers. There are exceptions to employers that are not required to subscribe to WV Workers' Compensation, but may elect to so do: (1) employers of employees in domestic services; (2) employers of five of fewer full-time employees in agricultural services; (3) employers of employees while said employees are employed without the state except in cases of temporary employment without the state; (4) casual employers (when the number of employees does not exceed three and the period of employment is temporary, intermittent, and sporadic in nature and does not exceed 10 calendar days in any calendar quarter); (5) churches; (6) employers engaged in organized professional sports activities, including employers of trainers and jockeys engaged in thoroughbred horse racing; and (7) any volunteer rescue squad or volunteer police auxiliary unit organized under the auspices of a county commission, municipality or other government entity or political subdivision; West Virginia will allow certain owner, partners and corporate officers to elect out of compensation coverage. Failure to subscribe and maintain good standing status will deprive the employer of civil immunity and certain defenses in tort proceedings. Employee benefits can be paid regardless of employer collections status.

West Virginia Code. Chapter 23

Workers' Compensation Division
Underwriting Unit
P.O. Box 3064
Charleston, WV 25334-3604
(304) 926-5000
Fax: (304) 926-1996
www.wvwcc.org

Wisconsin The statute is compulsory. Insurance is required of all employers who usually have three or more employees or have paid $500 or more in wages in any calendar quarter (or for farmers with six or more employees on 20 or more days during a calendar year). Failure to insure is subject to a fine of double the amount of premium evaded while uninsured. (The minimum fine is $100 per day for the first seven days and $750 thereafter.) An uninsured employer is subject to a closure order to cease business until it is in compliance with the insurance requirements. The employer is personally liable for all benefits, if uninsured.

In addition, an uninsured employer is personally liable for reimbursement to the Uninsured Employers Fund for benefit payments made by the fund under section 102.81(1) of the Wisconsin Statutes to an injured employee (or the employee's dependents) of the uninsured employer and do not have the normal exemptions of property from seizure and sale on execution of a judgment. The penalties and reimbursements to the fund are mandatory and nonnegotiable.

Wisconsin Statutes Annotated. Section 102.01 et seq.

Workers' Compensation Division
Dept. of Workforce Development
P.O. Box 7901
Madison, WI 53707
(608) 266-1340
Fax: (608) 267-0394
http://dwd.wisconsin.gov/wc

Wyoming An exclusive state fund since 1915. Mandatory coverage is required for employments enumerated as extrahazardous by the Wyoming Legislature. Employees not classified as extrahazardous may be covered if the employer elects to obtain coverage through written request. Coverage shall go into effect after receipt of the written request and approval by the Division. An employer electing coverage cannot withdraw for a period of two years.

Wyoming Statutes Annotated. Section 27-14-108(j) et seq.

Dept. of Employment
Workers' Safety & Compensation Division
1510 E. Pershing Blvd.
Cheyenne, WY 82002
(307) 777-7441
Fax: (307) 777-6552
http://wydoe.state.wy.us

District of Columbia The statute is compulsory. Insurance is required of all employers. Failure to insure is subject to a fine up to $10,000.

District of Columbia Code. Section 36-301 et seq.

Office of Labor Standards
Office of Workers' Compensation
1200 Upshur Street NW, 3rd Floor
Washington, DC 20011
(202) 576-6265
Fax: (202) 541-3595
http://does.ci.washington.dc.us

American Samoa The statute is compulsory. Insurance is required of all hazardous employment and for all employers with three or more employees. Failure to insure is subject to a fine of up to $1,000, or imprisonment for up to one year, or both. The employer may also be sued.

Workmen's Compensation Commission
Department of Human Resources
Pago Pago, AS 96799
(684) 633-4485
Fax: (684) 633-1139
http://americansamoa.gov

Guam The statute is compulsory. Insurance is required of all employers engaged in a trade, occupation, or profession. Failure to insure is subject to a fine up to $1,000, imprisonment up to one year, or both.

Workers' Compensation Commission
414 West Soledad Avenue, Ste 205
Hagatna, Guam 96910
(671) 475-7033/34
Fax: (671) 475-7026/45
No website available

Puerto Rico The statute is compulsory. Insurance with the State Insurance Fund Corporation is required of all employers with one or more employees. Failure to insure is subject to fines, imprisonment from 15 days to six months or both. There is an additional penalty equal to a percent of the compensation paid out (not less than $10). The uninsured employer may also be sued. Minors employed in violation of the law are entitled to receive from their employers an amount equal to the compensation awarded to them.

Laws of Puerto Rico Annotated. Title 11.

Puerto Rico State Insurance Fund
G.P.O. Box 5028
San Juan, PR 00936-5028
(809) 793-5959
Fax: (809) 793-7735
www.gobierno.pr/gprportal/inicio

Virgin Islands The statute is compulsory. Every employer affected shall file with the Government Insurance Fund not later than February 28 of each year on forms supplied, an Actual Report for the previous year and an Estimated Report for the current year showing the number of workmen employed, and the kind of occupation. The premium shall be computed and paid on $8,424 for each worker for each year. An employer who fails to comply within the term fix shall be considered an Uninsured Employer, liable for compensation expenses, and a 30 percent penalty of the total. Instead of receiving compensation under this statute, the injured employee of an Uninsured Employer, or the employee's beneficiaries, may elect to bring suit for damages against the employer, just as if this statute were not applicable. An employer having paid premiums of $1,000 or more during the period of three consecutive years immediately before the rating date, and having paid premiums in each of these three years, shall be eligible for an Experience Rating. The amount of charges to be considered in such Experience Rating shall consist of the payments actually made by the Government Insurance Fund during such consecutive periods of three years on account of accidents, inclusive of benefits, medical, hospital, and funeral costs.

Dept. of Finance
Government Insurance Fund
2314 Kronprindsens Gade
St. Thomas, VI 00802
(809) 774-4750 ext 2255
Fax: (809) 776-4028
www.vidol.gov

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APPENDIX: Occupational Safety— State Agencies and Addresses

(Enforce safety standards for the protection of employees in places of employment.)

ALABAMA
State of Alabama Dept. of Labor
RSA Union Street, 6th Floor
P.O. Box 303500
Montgomery, AL 36130-3500
(334) 242-3460
FAX (334) 240-3417
www.alalabor.state.al.us

ALASKA
Dept. of Labor
Labor Standards & Safety
Occupational Safety & Health
P O Box 21149
Juneau, AK 99802-1149
(907) 465-4855
FAX (907) 465-6012
www.state.ak.us/lss/home.htm

ARIZONA
Industrial Comm. of Arizona
Arizona Division of Occupational Safety and Health
P.O. Box 19070
Phoenix, AZ 85005-9070
(602) 542-5795
FAX (602) 542-1614
www.ica.state.az.us

ARKANSAS
Arkansas Dept. of Labor
OSHA Consultation Division
10421 W. Markham
Little Rock, AR 72205
(501) 682-4523
FAX (501) 682-4532
www.arkansas.gov/labor

CALIFORNIA
Occupational Safety & Health
Dept. of Industrial Relations
455 Golden Gate Avenue, 10th Floor
San Francisco, CA 94102
(510) 286-7000
FAX (510) 286-7037
www.dir.ca.gov

CONNECTICUT
State of Connecticut
Dept. of Labor
Division of Occupational Safety & Health
38 Wolcott Hill Road
Wethersfield, CT 06109
(860) 566-4550
FAX (860) 566-6916
www.ctdol.state.ct.us

DELAWARE
Dept. of Labor
Div. of Industrial Affairs
OSHA Consultation Services
4425 North Market Street
Wilmington, DE. 19802
(302) 761-8219
FAX (302) 761-6602
www.delawareworks.com

GEORGIA
Georgia Dept. of Labor
Safety Engineering
1700 Century Circle
Atlanta, GA 30345
(404) 679-0687
FAX (404) 679-5818
www.dol.state.ga.us

HAWAII
Hawaii Occupational Safety & Health Division
830 Punchbowl St., Rm. 425
Honolulu, HI 96813
(808) 586-9100
FAX (808) 586-9104
www.hawaii.gov/labor

IDAHO
Division of Building Industrial Safety Section
1090 E. Watertower Street
Meridian, ID 83642
(208) 334-2129
FAX (208) 855-9494
http://dbs.idaho.gov

ILLINOIS
Ill. Dept. of Labor
Safety Inspection & Education Div.
#1 West Old State Capitol Plaza, Rm. 300
Springfield, IL 62701-1217
(217) 782-9386
FAX (217) 785-8776
www.state.il.us/agency/idol

INDIANA
Dept. of Labor
402 West Washington St., Rm. W195
Indianapolis, IN 46204-2751
(317) 232-2655
FAX (317) 233-3790
www.state.in.us/labor

IOWA
Iowa Workforce Development
Labor Services Division
Occupational Safety & Health
1000 E. Grand Avenue
Des Moines, IA 50319-0209
(515) 242-5870
FAX (515) 281-7995
www.iowaworkforce.org/index.html

KANSAS
Dept. of Human Resources
Division of Workers' Compensation
Industrial Safety & Health Section
512 SW Sixth Avenue
Topeka, KS 66603-3174
(785) 296-4386
FAX (785) 296-1775
www.hr.state.ks.us

KENTUCKY
Dept. of Labor
Office of Occupational Safety & Health
1047 US Highway 127 S, Ste. 4
Frankfort, KY 40601
(502) 564-3070
www.labor.ky.gov

LOUISIANA
Dept. of Labor
Occupational Safety & Health
P.O Box 94094
Baton Rouge, LA 70804-9094
(225) 342-9601, (800) 201-2495
FAX (225) 342-5158
www.laworks.net

MAINE
Bur. of Labor Standards
Workplace Safety & Health Division
45 State House Station
Augusta, ME. 04333-0045
(207) 624-6400
FAX (207) 624-6449
www.state.me.us/labor

MARYLAND
Department of Labor, Licensing & Regulation
Div. of Labor & Industry
Occupational Safety & Health
1100 N. Eutaw Street
Baltimore, MD 21201
(410) 767-2189; (410) 767-2215
FAX (410) 767-2003
www.dllr.state.md.us

MASSACHUSETTS
Commonwealth of Massachusetts
Dept. of Labor Division of Occupational Safety
399 Washington St., 5th Floor
Boston, MA 02108-5215
(617) 727-3452
FAX (617) 727-0726
www.mass.gov/dos

MICHIGAN
Michigan Occupational Safety & Health Administration
P.O. Box 30643
Lansing, MI 48909
(517) 322-1814
FAX (517) 322-1775
www.michigan.gov/cis

MINNESOTA
Dept. of Labor & Industry
Occupational Safety & Health Division
443 Lafayette Road N
St. Paul, MN. 55155-4307
(651) 284-5050
FAX (651) 284-5741
www.doli.state.mn.us

MISSISSIPPI
Center of Safety & Health
Mississippi State University
2151 Hwy 18, Ste. B
Brandon, MS. 39042
(601) 825-0783
FAX (601) 825-6609
www.msstate.edu/dept/csh

MISSOURI
Missouri On-Site Safety & Helath Consultation Program
Division of Labor Standards
3315 West Truman Blvd., Rm. 205
Jefferson City, MO 65102
(573) 751-3403
FAX (573) 751-3721
www.dolir.mo.gov/ls/safetyconsultation

MISSOURI
Dept. of Labor & Industrial Relations
3315 W. Truman Blvd., Rm. 213
P.O. Box 504
Jefferson City, MO 65102
(573) 751-4091
FAX (573) 751-9691
www.dolir.mo.gov

MONTANA
Montana Dept. of Labor & Industry
Occupational Safety & Health Bureau
1625 11th Avenue
P.O. Box 1728
Helena, MT 59624-1728
(406) 444-6401
FAX (406) 444-9396
www.montanasafety.com

NEBRASKA
Dept. of Labor
Labor & Safety Standards
301 Centennial Mall South
P.O. Box 95024
Lincoln, NE. 68509-5024
(402) 471-4717
FAX (402) 471-5039
www.dol.state.ne.us/

NEVADA
Division of Industrial Relations
OSHA
1301 North Green Valley Pkwy., Ste. 200
Henderson, NV 89074
(702) 486-9020
FAX (702) 990-0360
www.dirweb.state.nv.us/osha/oshes.htm

NEW HAMPSHIRE
Dept. of Labor
95 Pleasant Street
Concord, NH 03301
(603) 271-3176
FAX (603) 271-6149
www.labor.state.nh.us

NEW JERSEY
NJ Dept. of Labor & Work Force Development
Labor Standards & Safety Enforcement
P.O. Box 054
Trenton, NJ 08625
(609) 984-1389
FAX (609) 292-4409
www.state.nj.us/labor/index.html

NEW MEXICO
Environment Dept.
Occupational Health & Safety Bureau
P.O. Box 26110
Santa Fe, NM 87502-6110
(505) 476-8700
FAX (505) 476-8734
www.nmenv.state.nm.us

NEW YORK
Dept. of Labor
Division of Safety & Health
Workplance Safety & Loss Prevention Program
Rm. 167, Bldg. 12 State Campus
Albany, NY 12240
(518) 457-1125
FAX (518) 457-1167
www.labor.state.ny.us

NORTH CAROLINA
Dept. of Labor
Occupational Safety & Health Division
1101 Mail Service Center
Raleigh, NC 27699-1101
(919) 807-2796
FAX (919) 807-2856
www.nclabor.com/osha/osh.htm

NORTH DAKOTA
Dept. of Labor
600 E. Boulevard Avenue
Dept. 406
Bismarck, ND 58505-0340
(701) 328-2660
FAX (701) 328-2031
www.state.nd.us/labor/

OHIO
Div. of Safety & Hygiene
Ohio Center for Occupational Safety & Health
13430 Yarmouth Dr.
Pickerington, OH 43147-8310
(614) 995-8622
FAX (614) 365-4974
www.ohiobwc.com/employer/programs/safety

OKLAHOMA
Occupational Safety & Health Consultation Division
Dept. of Labor
4001 N. Lincoln Blvd.
Oklahoma City, OK 73105
(405) 528-1500; (888) 269-5353
FAX (405) 557-1214
www.labor.ok.gov

OREGON
Occupational Safety & Health Division
Consumer & Business Services
350 Winter St., NE, Rm. 430
Salem, OR 97301-3882
(503) 378-3272
FAX (503) 947-7461
www.cbs.state.or.us/osha/

PENNSYLVANIA
Occupational & Industrial Safety
Dept. of Labor & Industry
Rm. 1700
7th & Forster Sts.
Harrisburg, PA 17120
(717) 787-3323
FAX (717) 787-8363
www.dli.state.pa.us

RHODE ISLAND
RI Div. of Occupational Safety
Dept. of Labor & Training
Center General Complex
1511 Pontiac Drive
Cranston, RI 02920
(401) 462-8570
FAX (401) 462-8576
TTD (401) 462-8006
www.dlt.state.ri.us

SOUTH CAROLINA
Occupational Safety & Health
SC Dept. of Labor, Licensing & Regulation
P.O. Box 11329
Columbia, SC 29211-1329
(803) 896-4300
FAX (803) 896-7670
www.llr.state.sc.us/osha/index.asp

SOUTH DAKOTA
South Dakota Dept. of Labor
Division of Labor & Management
700 Governors Drive
Pierre, SD 57501-2291
(605) 773-3681
FAX (605) 773-4211
www.sdjobs.org

TENNESSEE
Dept. of Labor & Workforce Dev.
Division of Occupational Safety & Health
Andrew Johnson Tower, 3rd Floor
701 James Robertson Parkway
Nashville, TN. 37243-0655
(615) 741-2793
FAX (615) 253-1623
www.state.tn.us/labor-wfd/tosha.html

TEXAS
Texas Department of Insurance
Division of Workers Comp/ Workplace and Medical Services
7551 Metro Center Drive, Ste. 100
Austin, TX 78744-1609
(512) 804-4805
FAX (512) 804-4801
www.tdi.state.tx.us

UTAH
Labor Commission
Utah Occupational Safety & Health Division
P.O. Box 146650
160 E. 300 S., 3rd Floor
Salt Lake City, UT 84114-6650
(801) 530-6901
www.uosh.utah.gov

VERMONT
Department of Labor & Industry
Vermont Occupational & Safety Health Admin.
National Life Bldg.
Drawer 20
Montpelier, VT 05620-3401
(802) 828-2765
FAX (802) 828-2195
www.labor.vermont.gov

VIRGINIA
Dept. of Labor & Industry
13th S. Thirteenth Street
Richmond, VA 23219-4101
(804) 371-2327
FAX (804) 371-6524
www.dli.state.va.us

WASHINGTON
Division of Occupational Safety and Health
Dept. of Labor & Industries
P.O. Box 44600
Olympia, WA 98504-4600
(360) 902-5495
www.lni.wa.gov/safety/

WEST VIRGINIA
Division of Labor
State Capitol Complex
Bldg. 6, Rm. B749
Charleston, WV 25305
(304) 558-7890
FAX (304) 558-3797
www.labor.state.wv.us

WISCONSIN
Terry Moen
OSHA Consultation Program
WI State Lab of Hygiene
University of Wisconsin
2601 Agriculture Dr.
Madison, WI 53718
(608) 226-5240
FAX (608) 226-5240
www.slh.wisc.edu/wocp

WYOMING
Workers' Safety & Compensation
1510 E. Pershing Blvd.
Cheyenne, WY 82002
(307) 777-7441
FAX (307) 777-6552
www.wydoe.state.wy.us

DISTRICT OF COLUMBIA
Office of Occupational Safety & Health
Dept. of Employment Services
609 H Street NE
Washington, DC 20002
(202) 671-1800
FAX (202) 673-2380
www.does.dc.gov

AMERICAN SAMOA
Dept. of Administrative Serives
American Samoa Government
Executive Office Bldg., Utulei
Territory of American Samoa
Pago Pago, AS. 96799
(684) 633-4158
FAX (684) 633-1841
www.asg-gov.com

GUAM
Dept. of Labor
Occupational Safety & Health Admin.
P.O. Box 9970
Tamuning, GU 96931-9970
(671) 475-7067
FAX (671) 475-7070
www.labor.gov.gu

NORTH MARIANA ISLANDS
Dept. of Labor & Immigration
Caller Box 10007
Saipan, MP 96950
(970) 664-2000
FAX (670) 664-3453
www.saipan.com/gov/

PUERTO RICO
Jose I. Droz-Alvarado
Assistant Secretary for OSHA
PR Occupational Safety & Health Administration
505 Munoz Rivera Avenue
Hato Rey, PR 00918
(787) 754-2172
FAX (787) 767-6051
www.dtrh.gobierno.pr

VIRGIN ISLANDS
Dept. of Labor
21-31 Hospital Street
Christiansted
St. Croix, VI 00802
(340) 772-1315
FAX (340) 772-4323
www.vidoi.gov

Unemployment Insurance

UNEMPLOYMENT INSURANCE

See also CD Toolkit for updates, links and additional resources.

1. INTRODUCTION

1.1 Background

Unemployment insurance provides income to people who have lost their jobs through no fault of their own and who are actively seeking suitable employment—a concept many states apply quite liberally. In theory, unemployment insurance spreads the cost of unemployment equitably among many employers.

Unemployment insurance is designed to provide a means of support to people who have involuntarily left the labor force and are actively attempting to return.

1.2 Federal-State Interaction

The Federal Unemployment Tax Act (FUTA) levies a tax against wages paid to employees and allows a credit to the employer of up to 90 percent of the tax owed. The tax is 6.2 percent of the first $7,000 of wages paid to each employee in the calendar year (IRC Sec. 3301). Employer credit for tax paid to state unemployment funds is as much as 5.4 percent (90 percent on a deemed 6-percent federal tax rate) of taxable wages (IRC Sec. 3302). Amounts paid to unemployment insurance funds are used to fund claims and pay administrative expenses. The federal portion is used to make advances to states that run short of funds in their own unemployment insurance system; advances that states must repay. The federal portion is also used to fund payments made to employees under extended benefits provisions, as described in Section 1.3.

1.3 Employee Unemployment Assistance

States establish unemployment benefit rules within a broad federal framework, with the maximum level of benefits at 26 weeks in all but two states. Under a Federal-State Extended Benefits Program, up to 13 more weeks of benefits are available in states suffering severe economic distress. Under the Job Creation and Worker Assistance Act of 2002 (P.L. 107-147), up to an additional 13 weeks of temporary extended unemployment benefits are available for eligible displaced workers. These benefits are available in any state entering into an agreement with the Secretary of Labor to provide such extended benefits and are available to workers who filed an initial claim for unemployment benefits on or after March 15, 2001, and who remain unable to find work after having exhausted their regular unemployment benefits.

Eligibility rules apply for receipt of the extended benefits. As an example, under P.L. 107-147, individuals only qualify for the lesser of 13 weeks of extended benefits or 50 percent of the length of time they qualified for regular unemployment benefits under the laws of their state. Additionally, to ensure that workers with a strong attachment to the work force qualify, individuals must have worked 20 weeks of full-time insured employment or earned the equivalent in insured wages to be eligible for the extended benefits.

The extended benefits are 100 percent federally funded and are available until the state terminates its agreement.

> **Observation:** Regular unemployment benefits are funded by state taxes levied on employers, while additional unemployment benefits under the Federal-State Extended Benefits Program for states suffering severe economic distress are 50 percent federally funded.

2. DEFINITIONS

Employer

— Any person or organization that during the current or preceding year either (a) paid wages of $1,500 or more in any calendar quarter, or (b) had one or more employees for some part of a day in any twenty different weeks (IRC Sec. 3306(a)(1)).

— Any agricultural employer who during the current or preceding year either (a) paid cash wages of $20,000 or more for farm labor in any calendar quarter, or (b) employed ten or more farm workers during some part of a day for at least one day during any twenty different weeks (IRC Sec. 3306(a)(2)).

— Any household employer who during the current or preceding year paid wages of at least $1,000 during any calendar quarter for domestic services in a private home, local college club, or fraternity/sorority (IRC Sec. 3306(a)(3)).

Employee. An individual who performs services under the direction and control of an employer.

Successor employer. One who acquires substantially all the property used in a trade or business of another employer and who immediately after the acquisition employs in the trade or business one or more individuals employed by the preceding employer.

Common paymaster. Any member of a group of related corporations that disburses remuneration to employees of two or more of those corporations and is responsible for keeping books and records for those employees.

Normal or 90-percent credit. Credit that allows an employer to use the state unemployment insurance contribution as an offset against the greater portion (90 percent) of the federal unemployment tax liability.

Additional credit. Credit against an employer's federal unemployment tax liability equal to the difference between the amount of contributions actually paid to the state and the amount that would have been required to be paid if a reduced experience rating had not been obtained.

Experience rating. The method by which employer contributions under the state unemployment compensation laws may be varied on the basis of each individual employer's experience with unemployment. Also called *merit rating.*

Voluntary contribution. Contribution to the state unemployment fund by an employer to achieve a better experience rating. The contribution is allowed as an offset against benefits charged to the employer's account.

3. FEDERAL UNEMPLOYMENT TAX ACT (FUTA)

3.1 Purpose

The FUTA is designed to provide unemployment compensation to workers who have lost their jobs through layoff, reduction in labor force, or other reasons beyond their control.

3.2 Covered Employment

All employment is considered to be covered employment except as described in section 3.8.

3.3 Successor Employer

A successor employer acquires substantially all the property used in another employer's trade or business and continues to employ one or more of the same individuals. The successor employer

(Text continued on page 5)

— May count the wages paid by the first employer during the current year in figuring the $7,000 wage limit.
— Is not subject to pass the twenty-weeks or $1,500-wages-in-a-calendar-quarter test. Since the first employer has already met these tests, the successor employer is automatically liable.

The manner of acquisition is immaterial. All the following situations result in successor employers:

— Purchase of trade or business
— Incorporation of previously unincorporated trade or business
— Continuation of an existing partnership by a new partnership

3.4 Statutory Merger

A statutory merger or consolidation does not result in successor employers. No adverse tax effect results either, since the new entity following the merger or consolidation is considered the same employer and taxpayer as the previous employer. The new employer may thus consider wages paid by the absorbed entity as having been paid by it (the new employer) when computing FUTA tax.

3.5 Credit for Successor Employers

A successor employer may not count wages paid by a predecessor who did not qualify as an employer under the Federal Unemployment Tax Act. However, a credit is allowed against the successor's FUTA tax based on the percentage of employees retained by the successor employer.

> *Example:* Jones Partnership sells to Smith, Inc. all its property before Jones has met employer qualifications under the Federal Unemployment Tax Act. Smith retains 20 percent of Jones' employees, representing 20 percent of total wages paid. Smith cannot count the wages paid by Jones when figuring the $7,000 wage limit. Instead, Smith is entitled to a credit against its FUTA tax based on the amount of credit Jones could have claimed for the employees retained by Smith if Jones had qualified as an employer. If Jones could have claimed a $1,000 credit against its FUTA tax liability, Smith is entitled to claim a $200 credit since it retained 20 percent of Jones' employees.

3.6 Common Paymaster

Related corporations with a common paymaster who have employees working for all the corporations do not have to pay FUTA tax on the first $7,000 of wages paid to each employee by each of the related corporations.

Example: Bill Doe works for two related corporations—Red, Inc. and Blue, Inc. Doe earns $25,000 annually from Red, Inc. and $25,000 from Blue, Inc. He devotes his time equally between the two corporations. Red, Inc. is the common paymaster, so the corporations are treated as one employer. Therefore, FUTA tax is calculated on only $7,000 of Doe's wages, not on $14,000.

3.7 Corporations Entitled to Use Common Paymaster

Three criteria must be met to qualify for this special treatment:

— *Related corporations.* Corporations that meet any one of the following tests are considered related (Reg. 31.3121(s)-1(b)(1)):

- The corporations are members of a "controlled group of corporations" as defined in Internal Revenue Code Section 1563. Generally, a controlled group of corporations are parent–subsidiary, brother–sister, or some other combined group of corporations connected through common stock ownership.
- In the case of a corporation that does not issue stock, fifty percent or more of the board of directors of one corporation are members of the other corporation's board of directors.
- Fifty percent or more of one corporation's officers are concurrently officers of the other corporation.
- Thirty percent or more of one corporation's employees are concurrently employees of the other corporation.

— *Common paymaster.* The common paymaster is not required to pay every one of the employees of the related corporations. But, for the special provision to apply, the particular employees' wages must be disbursed through a common paymaster. The remuneration may be paid by one combined paycheck drawn on one account or by separate paychecks drawn on different accounts (Reg. 31.3121(s)-1(b)(2)).

— *Concurrent employment.* Employees must perform services for the benefit of the employing corporation in exchange for remuneration paid contemporaneously from two or more corporations (Reg. 31.3121(s)-1(b)(3)).

3.8 Exemptions

Regs. 31.3306(c)-2 and 31.3306(c)-3 generally describe covered and excepted employment for FUTA purposes. Employers (as defined in section 2 of this chapter) are subject to FUTA tax except for:

— Agricultural employment when total cash wages paid by the employer are less than $20,000 in a quarter or the employer does not employ ten or more employees on twenty days in different weeks (Reg. 31.3306(c)(1)-1).

— Domestic service when the employer pays wages less than $1,000 in any calendar quarter in the current or preceding year (Reg. 31.3306(c)(2)-1).

— Service not in the course of the employer's trade or business unless wages equal or exceed $50 and work is performed by an individual regularly employed to perform such services (Reg. 31.3306(c)(3)-1).

— Employment of child or spouse, or child under twenty-one in employ of parent (Reg. 31.3306(c)(5)-1).

— Employment by U.S. government or instrumentality of the United States owned in whole or in part by the United States, or exempt under IRC Section 3301 (Reg. 31.3306(c)(6)-1).

— Employment by a state political subdivision or instrumentality owned in whole or in part by the state (Reg. 31.3306(c)(7)-1).

— Service in employ of religious, charitable, educational, or other institution exempt from tax under IRC Section 501(a) (Reg. 31.3306(c)(8)-1).

— Employment under the Railroad Unemployment Insurance Act (Reg. 31.3306(c)(9)-1).

— Students enrolled in a college or university employed at same (Reg. 31.3306(c)(10)-1).

— Work study (Reg. 31.3306(c)(10)-2).

— Service performed in the employ of a foreign government or in the employ of an instrumentality wholly owned by a foreign government (Reg. 31.3306(c)(11)-1).

— Student nurses or interns in the employ of a hospital or training school (Reg. 31.3306(c)(13)-1).

— Insurance agents paid wholly by commission (Reg. 31.3306(c)(14)-1).

— Individuals under eighteen with paper routes (Reg. 31.3306(c)(15)-1).

— Employment by an international institution (Reg. 31.3306(c)(16)-1).
— Employment for commercial fishing (Reg. 31.3306(c)(17)-1).
— Nonimmigrants under worker's visas (Reg. 31.3306(c)(18)-1).

3.9 Tax Rate

The gross FUTA tax rate is 6.2 percent of the taxable wages paid during a calendar year (IRC Sec. 3301). Employers receive a credit against their FUTA tax liability for contributions made to their state fund. The maximum credit is limited to 90 percent of a deemed 6-percent federal tax rate, or 5.4 percent (IRC Sec. 3302(c)). The net FUTA tax rate for many employers is 0.8 percent.

A reduction in the net federal unemployment rate from 0.8 percent to 0.6 percent was to occur January 1, 1997. However, the 0.8 percent rate has been extended through December 31, 2007, when the rate is scheduled to decrease to 0.6 percent.

3.10 Covered Earnings

Employers are liable for FUTA tax on the first $7,000 paid to each employee during a calendar year (IRC Sec. 3306(b)).

3.11 Compliance

Penalties, fines, interest, and levies are imposed upon employers who do not comply with FUTA tax rules.

3.11.1 Penalties and interest

— A four-tier penalty for failure to make timely deposits is imposed as follows (IRC Sec. 6656):

2% if the failure is for five days or less,
5% if the failure is for six days but not more than fifteen days,
10% if the failure is sixteen days or more, and
15% if the tax is not deposited on or before the earlier of

— The day ten days after the date of the first delinquency notice to the taxpayer under IRC Section 6303, or
— The day on which notice and demand for immediate payment is given under IRC Section 6861 or Section 6862, or

the last sentence of IRC Section 6331(a) (dealing with the determination that the collection of tax is in jeopardy). The penalty will not be imposed if it can be shown that failure is due to reasonable cause and not to willful neglect.

— Bad checks result in a penalty of 2 percent of the amount of the check or a flat $15 if the check is for less than $750 (IRC Sec. 6657).
— A 5-percent penalty of the net tax to be reported is imposed per month up to a maximum penalty of 25 percent for each month or part of a month that employment tax returns are late (IRC Sec. 6651(a)(1)).
— A penalty of half of one percent up to 25 percent of the tax due is imposed for each month during which the failure to pay continues (IRC Sec. 6651(a)(2)).

Taxes due and unpaid will bear interest at the current federal rate, compounded daily.

3.11.2 Levies

The IRS may authorize a levy on, and seize the property and property rights of, an employer if the employer fails to pay any tax liability within ten days after notice and demand for payment.

3.12 Deposit Requirements

Employers must compute their FUTA tax liability quarterly as follows:

FUTA Taxable Wages × Net FUTA Tax Rate = FUTA Tax Liability

3.12.1 Deposit rules

— If the aggregate undeposited FUTA tax liability is more than $500 at the end of a quarter, a deposit of the tax must be made by the due date.
— If in any of the first three quarters the FUTA tax liability is $500 or less, the liability is carried over to the next quarter and added to that quarter's liability.
— If fourth-quarter FUTA tax liability is over $500, the liability must be deposited by January 31 of the following year.
— If the FUTA tax liability for the fourth quarter is under $500, it may be remitted directly to the IRS with Form 940.

— If the employer wishes to receive a ten-day extension of the due date for Form 940, all FUTA tax must be deposited by January 31 of the following year, even if the liability is less than $500.

3.12.2 Where and how to deposit

The Treasury has developed the Electronic Federal Tax Payment System (EFTPS) to remit payroll taxes and convey deposit information directly to the Treasury. All employers who deposited more than $200,000 of taxes in the year two years prior to the current year are required to use EFTPS. Voluntary participation in EFTPS is also allowed.

If a taxpayer is not required to use the EFTPS, Form 8109, Federal Tax Deposit Coupon, is used to make deposits of FUTA tax. Deposits are to be made at a Federal Reserve bank or an authorized depository. Deposits made by mail should be by check or money order payable to the depository bank. The date of receipt determines the timeliness of the deposit. A deposit received after the due date is considered timely if the employer can establish that it was mailed on or before the second day before the due date.

3.12.3 Deposit due dates

When a FUTA tax deposit is required, it is due the last day of the month following the end of the quarter (April 30, July 31, October 31, and January 31). If the due date falls on a Saturday, Sunday, or legal holiday, the due date becomes the next business day.

4. REPORTING REQUIREMENTS UNDER FUTA

Employers subject to FUTA tax during a calendar year generally must file an annual return on Form 940 or 940-EZ, "Employer's Annual Federal Unemployment Tax Return." Employers can use Form 940-EZ if all the following apply:

— Unemployment taxes were paid to only one state.

— These taxes were paid by the due date of the Form 940-EZ.

— All wages that were taxable for FUTA were also taxable for state unemployment tax.

Form 940-EZ is an abbreviated form consisting of a half page, whereas Form 940 is more detailed. Hereafter, all references to Form 940 include Form 940-EZ.

Household employers generally report and pay FUTA tax on Schedule H of Form 1040. However, if the household employer owns a business as a sole proprietor, the FUTA tax for the household employees is included on the business Form 940. See IRS Publication 926 and section 7.1.2 of the Employment Regulations chapter for further information regarding payroll taxes for household employees.

4.1 Who Must File

— If there is a change of ownership or transfer of business during the year, each employer who qualifies as an employer under FUTA requirements must file Form 940 reporting the wages paid during the year.

— If there is a statutory merger or consolidation, the resulting corporation is considered the same employer and only one Form 940 must be filed.

— If a successor-predecessor relationship exists and the predecessor was not an employer under FUTA requirements, the successor, if considered an employer under FUTA requirements, must file Form 940 for the portion of the year following acquisition of the business.

4.2 Filing Due Date

Form 940 is due on or before January 31 of the following year. If the employer has made timely deposits and the FUTA liability is paid in full by January 31, the employer receives an automatic ten-day extension until February 11 of the following year. If the due date falls on a Saturday, Sunday, or legal holiday, Form 940 is due the next business day.

A mailed return bearing a postmark indicating that it was mailed on or before the due date will be considered timely filed. The registration date of a return sent by registered mail will be considered the postmark. If a return is sent by certified mail, the postmark date on the employer's receipt is considered the postmark date.

4.3 Signing Form 940

The return should be signed by:

Type of Entity	Signer
Sole proprietorship	Individual
Corporation	Principal officer
Partnership or unincorporated organization	Partner or officer
Trust or estate	Fiduciary of trust or estate

An unsigned Form 940 will not be considered a return.

4.4 Where to File Form 940

The completed Form 940 should be sent to the IRS center of the region in which the employer's principal place of business or office or agency is located. Where to file depends on whether or not a payment is included with Form 940. Specific mailing addresses for filing Form 940 can be found in the IRS Instructions for Form 940.

(Text continued on page 13)

5. FUTA AND STATE UNEMPLOYMENT INSURANCE

Two types of credit are applicable against the FUTA tax for contributions made to state unemployment agencies—normal (or 90 percent) credit and additional credit.

5.1 The "Normal" or "90-Percent" Credit

The Federal Unemployment Tax Act permits an employer to offset against the FUTA tax liability 90 percent of the FUTA tax. This credit is available only for contributions made to U.S. Department of Labor (DOL) approved state unemployment compensation plans and only if the contributions are actually paid by the employer in the year in which the credit was claimed.

Although the FUTA gross tax rate is 6.2 percent, only 90 percent of a deemed 6-percent federal tax rate is allowed. The 0.2 percent difference will continue in effect until December 31, 2007, when the rate is scheduled to decrease to 6 percent.

> *Example:* An employer is subject to both federal and state unemployment tax. The taxable payroll for both laws is $50,000. The state contribution rate is 2.9 percent, so the state tax liability is $1,450 ($50,000 × 2.9%). The federal tax liability before deducting the 90-percent credit is $3,100 ($50,000 × 6.2%). The employer may take a credit of $2,700 ($50,000 × 6% × 90%) against the federal tax. The net federal tax is $400 ($3,100 – $2,700).

5.2 Requirements to Qualify for 90-Percent Credit

The total credit against federal tax for a calendar year may not exceed 90 percent of 6 percent, including the 90-percent credit and the additional credit described in section 5.4, below. The lowest net federal tax rate therefore cannot be lower than .8 percent (6.2 percent less 5.4 percent).

The full 90-percent credit applies only if all state contributions are paid on or before the due date of the federal return. A partial credit is allowed for the amount of state contributions paid after the due date. This partial credit is limited to 90 percent of the amount that would have been allowed if the state contributions had been timely made. The partial credit would be 81 percent (90 percent of 90 percent) of the federal tax.

5.3 Proof of Employer-Claimed Credits

Each state provides to the IRS proof of employer credit claims by certifying certain information. The appropriate officer of the state to which the employer paid required contributions reports to the IRS proof of the normal credit claimed by the employer. Required state contributions paid after the due date of Form 940 are also reported to the IRS.

If an employer wants to use the maximum allowable credit but is unable to pay state contributions by the due date of Form 940, an extension of not more than 90 days may be granted to file Form 940. If the extension is granted, the employer is entitled to the normal credit if the state contributions are paid on or before the extended due date.

5.4 Additional Credit

For an employer who had obtained a good experience rating, the amount paid for state contributions would be considerably less than 90 percent of the deemed federal rate (90 percent × 6 percent = 5.4 percent; see section 5.2, above). In this case there would not be any benefit in a favorable rating, since the employer would be paying considerably more in FUTA tax.

For this reason an additional credit is allowed. The federal government allows the employer to take an additional credit against the federal tax equal to the difference between the contributions actually paid to the state and the amount that would have been paid if the reduced rate had not been in effect.

5.5 State Loans and Shortages

Title XII of the Social Security Act allows a state to borrow funds from the federal unemployment account to enable the state to pay unemployment benefits. This allows a state to continue to pay benefits when its funds run low because of poor economic conditions. Repayment of this loan, without interest, may occur in three ways:

1. A reduction of the state's share of the amount of any excess in the employment security administration account that would have been transferred to the state's account in the unemployment trust fund.
2. A transfer of funds from the state's account in the unemployment trust fund to the federal unemployment account.
3. A reduction in the total credit otherwise allowed an employer.

This reduction of the credit against federal tax is computed on Part 1 of Form 940. Each quarter the employer should compute the federal tax liability, using the net FUTA rate. The credit reduction is not computed and paid until Form 940 is filed.

> *Example:* Blake, Inc. has a net FUTA rate of .8 percent. Taxable wages for the calendar year were $100,000, or $25,000 per quarter. For the first three quarters, Blake should deposit $200 ($25,000 × .8%) each quarter. The state Blake resides in has borrowed funds from the federal government because its unemployment funds have run low. The IRS has enforced a credit reduction of .9 percent on this state in order to collect the loan repayment. Blake's fourth-quarter FUTA deposit is calculated as follows:
>
> Fourth-Quarter Taxable Wages $25,000
> Net FUTA Rate .8%
> Fourth-Quarter FUTA Tax ($25,000 × .8%) $200
>
> Credit Reduction:
> Total Taxable Wages for the Year $100,000
> Credit Reduction Rate .9%
> Additional FUTA Tax ($100,000 × .9%) $900
> Deposit Due January 31 ($200 + $900) $1,100

6. STATE UNEMPLOYMENT INSURANCE

All states have unemployment compensation laws that require contributions from employers. Some states require contributions from employees. Each state is responsible for the content and development of its unemployment insurance laws.

Each state governs

— Amount and duration of benefits, with minor limitations.

— Coverage and contribution rates.

— Eligibility requirements and disqualification provisions.

— Direct administration of the laws, including collecting contributions, maintaining wage records, taking claims, determining eligibility, and paying benefits.

6.1 Experience Rating

Experience ratings allow employer state contribution rates to vary based on the employer's experience with unemployment. Experience ratings permit the cost of unemployment compensation to vary depending on an employer's rate of involuntary unemployment. As a result of experience ratings, state contribution rates range from the lowest rate allowed of zero to rates that exceed 5.4 percent. All states are required to provide for experience ratings up to at least 5.4 percent because of the federal credit of 5.4 percent (6% × 90%).

6.2 Determination of Experience Rating

All formulas for calculating an experience rating are devised to determine the experience of each employer with unemployment or benefit costs. This list indicates the type of plan used to determine experience ratings:

Experience Rating

Alabama	Benefit ratio
Alaska	Payroll decline
Arizona	Reserve ratio
Arkansas	Reserve ratio
California	Reserve ratio
Colorado	Reserve ratio
Connecticut	Benefit ratio
Delaware	Benefit-wage ratio
District of Columbia	Reserve ratio
Florida	Benefit ratio
Georgia	Statewide reserve ratio
Guam	None
Hawaii	Reserve ratio
Idaho	Reserve ratio
Illinois	Benefit-wage ratio
Indiana	Reserve ratio
Iowa	Benefit ratio
Kansas	Reserve ratio
Kentucky	Reserve ratio
Louisiana	Reserve ratio
Maine	Reserve ratio
Maryland	Benefit ratio
Massachusetts	Reserve ratio
Michigan	Benefit ratio
Minnesota	Benefit ratio
Mississippi	Benefit-wage ratio
Missouri	Reserve ratio

Experience Rating *(continued)*

Montana	Reserve ratio
Nebraska	Reserve ratio
Nevada	Reserve ratio
New Hampshire	Reserve ratio
New Jersey	Reserve ratio
New Mexico	Reserve ratio
New York	Reserve ratio
North Carolina	Reserve ratio
North Dakota	Reserve ratio
Ohio	Reserve ratio
Oklahoma	Benefit-wage ratio
Oregon	Benefit ratio
Pennsylvania	Benefit ratio/reserve ratio
Puerto Rico	Reserve ratio
Rhode Island	Reserve ratio
South Carolina	Reserve ratio
South Dakota	Reserve ratio
Tennessee	Reserve ratio
Texas	Benefit ratio
Utah	Benefit ratio
Vermont	Benefit ratio*
Virgin Islands	Reserve ratio
Virginia	Benefit ratio
Washington	Benefit ratio
West Virginia	Reserve ratio
Wisconsin	Reserve ratio
Wyoming	Benefit ratio

*Benefit ratio is used for experienced employers only. New employer rates are assigned by industry classification.

6.3 Reserve-Ratio Formula

An account for each employer shows total payroll, employer contributions, and benefits paid to workers. Benefits are subtracted from contributions. The net amount is then divided by total payroll to determine the size of the balance in terms of potential liability. While a balance of $5,000 may be adequate for a total payroll of $50,000, it would be low for a total payroll of $200,000.

The size of an employer's reserve ratio determines the experience rating. The larger the reserve ratio, the lower the experience rating. The formula is designed to give a better experience rating to those employers who have contributed more than benefits paid out.

6.4 Benefit-Ratio Formula

This formula compares benefits to payrolls. The basis for this formula is the fact that if each employer pays a rate that meets the benefit ratio, the program will be adequately funded.

6.5 Benefit-Wage-Ratio Formula

This experience rating is measured by separations of workers that result in the payment of benefits; the duration of their benefits is not considered. The separations are weighted with the workers' wages earned from each base-period employer and are recorded on each employer's experience record. These wages are termed *benefit wages.* For any one employer, only one separation per beneficiary per benefit year is recorded on the record.

The experience factor of each employer is determined by dividing the total benefit wages into the total taxable wages. This experience factor is then multiplied by the state's experience factor. A table is then used to determine the experience rating.

6.6 Payroll-Decline Formula

This experience rating formula is measured by the decline in an employer's payrolls from year to year or quarter to quarter. No benefit or contribution amounts are considered. This formula operates on the assumption that if an employer's payroll declines, the employer is not offering as much employment and is therefore considered a source of potential unemployment.

7. FACTORS AFFECTING EMPLOYER'S EXPERIENCE RATING

Certain factors affect an employer's experience rating. Among these are benefit charges, seasonal workers, voluntary contributions and successor employer situations.

7.1 Benefit Charges

When an employee receives unemployment benefits, those benefits either have to be charged to the state's fund or to the employer or employers who had paid wages to the employee for which the benefits were received. In reserve-ratio and benefit-ratio states, a claimant's benefits need to be charged. In benefit-wage states the benefit wages need to be charged. There is no charging of benefits in payroll-decline states.

There are three methods of charging benefits to employers.

7.1.1 Charging most-recent employers

A few states charge the most-recent employer on the theory that this particular employer is primarily responsible for the unemployment. In most of these states the charges are limited to the most-recent employer who employed the employee for a certain number of weeks. Other states do not charge an employer unless a specified amount of wages was paid.

7.1.2 Charging base-period employers in inverse chronological order

Some states charge base-period employers but limit the amount for each employer. The charge first is applied to the most-recent employer, then in inverse chronological order to previous employers. This method is based on the assumption that responsibility lessens for unemployment as time goes by.

A limit is placed on the amount any one employer may be charged. When the limit is reached, the next-previous employer is charged with the remainder. The limit is determined as either a fraction of the wages paid by the employer or as a specified amount in the base period or quarter, or both.

If the last employer in a base period employed a claimant for a considerable part of the base period or the claimant's unemployment is short, this method of charging base-period employers in inverse chronological order has the same effect as charging the most recent employer. If the claimant's unemployment is long, this method results in charging all base-period employers proportionately.

7.1.3 Charging proportionate base-period wages

Most states charge benefits to all base-period employers based on the wages earned from each employer by the claimant. This method is based on the assumption that unemployment is a result of the general conditions of the labor market rather than separation from a given employer.

7.2 Seasonal Workers

Several states have specific guidelines for identifying the employers of seasonal workers and charging them with benefits paid to these seasonal employees. Seasonal employers are generally charged only for benefits paid for unemployment during the seasonal period. Nonseasonal employers are charged for benefits for all periods.

7.3 Noncharging of Benefits

Depending on the particular state, some benefits are not charged to employers

— If the duration of unemployment is very short.

— If benefits are paid on the basis of a determination in a case that is appealed and later reversed.

— If benefits are paid following a period of disqualification for voluntary quitting, misconduct, or refusal of suitable employment.

— If the employer who employs a claimant part time in the base period continues to provide that claimant with equal part-time employment.

— If the benefits are being paid to a claimant who is taking approved training.

7.4 Voluntary Contributions

About half of the states allow employers to make voluntary contributions. The voluntary contribution increases the balance in the employer's reserve so the employer is assigned a lower rate. An employer who will be increasing the number of employees in the coming year, for example, may benefit from making a voluntary contribution. This may result in a lower experience rating being applied to the larger wage base.

State agencies usually do not supply employers the amount of the voluntary contribution necessary to lower the experience rating, but worksheets are available to compute it. It is important to make the payment large enough to result in a lower rate since the voluntary contribution is often not refunded if it does not result in a reduced rate.

Voluntary contributions cannot be credited against the federal unemployment tax.

7.5 Successor Employers

Although laws vary from state to state, most states provide that the predecessor's experience rating be transferred to a successor employer. In order to receive this transfer of rating, certain conditions must be met, depending on the particular state:

— Successor assumes responsibility for contributions of predecessor.

— No substantial reduction of personnel takes place after the transfer.

— There is continuity of ownership or management.

— Successor continues same type of trade or business.

— Predecessor has ceased to do business.

If the successor employer was not subject to unemployment laws before the transfer, the successor will normally be required to use the predecessor's rate for the remainder of the year. If the successor was subject to unemployment laws prior to the transfer, the successor usually must continue to use that same rate for the remainder of the year, although some states recompute the successor's rate at the time of transfer.

When a business transfer occurs, both the predecessor and the successor should notify the appropriate state agencies. Most states provide special forms for this purpose and require filing within a limited time period.

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Tax Withholding and Estimated Tax. Publication 505 (12/2004). Washington, D.C.: Department of the Treasury—Internal Revenue Service. Annual. Pdf format download at www.irs.gov/publications/p505/index.html.

UWC staff. *Controlling Unemployment Insurance Costs: An Employer's Guide.* Washington, D.C.: UWC—Strategic Services on Unemployment Compensation & Workers' Compensation, 2004.

Vroman, Wayne. *Topics in Unemployment Insurance Financing.* Kalamazoo, Mich.: W.E. Upjohn Institute for Employment Research, 1998.

APPENDIX: State Unemployment Tax Agencies

The following list contains addresses, telephone numbers, and Internet sites of state unemployment tax agencies provided by the U.S. Department of Labor through the IRS. See www.irs.gov/publications/p926/ar03.html#d0e1864. *Note:* Information is subject to change.

ALABAMA
Unemployment Compensation Agency
649 Monroe Street
Montgomery, AL 36131
(334) 242-8467
FAX (334) 242-2068
uctax@dir.alabama.gov

ALASKA
Alaska Department of Labor & Workforce Development
P.O. Box 115509
Juneau, AK 99811-5509
(907) 465-2757
FAX (907) 465-2374
www.labor.state.ak.us/estax

ARIZONA
Arizona Dept. of Economic Security
P.O. Box 6028
Phoeniz, AZ 85005-6028
(602) 771-6606
FAX (602) 532-5538
www.de.state.az.us

ARKANSAS
Dept. of Workforce Services
#2 Capitol Mall
P.O. Box 2981
Little Rock, AR 72203
(501) 682-3253
FAX (501) 682-2394
www.accessarkansas.org/esd or www.ark.org/esd/unempins/

CALIFORNIA
Employment Development Dept.
3321 Power Inn Road, Ste. 220
P.O. Box 826880
MIC40
Sacramento, CA 95826-6110
(916) 464-3502; (916) 654-8117
FAX (916) 654-8599
www.edd.cahwnet.gov

COLORADO
Colorado Dept. of Labor & Employment
633 17th Street, Suite 400
Denver, CO 80202-3610
(303) 603-8254; (800) 480-8299
FAX (303) 620-4988
www.coworkforce.com

CONNECTICUT
State of Connecticut
Dept. of Labor
Employer Status Unit
200 Folly Brook Blvd.
Wethersfield, CT 06109-1114
(860) 263-6550
FAX (860) 263-6567
www.ctdol.state.ct.us

DELAWARE
Dept. of Labor
Division of Unemployment Insurance
4425 N. Market Street
Wilmington, DE 19802
(302) 761-8484
FAX (302) 761-6638
www.delawareworks.com

DISTRICT OF COLUMBIA
DC Dept. of Employment Services
64 New York Avenue NE, 3rd Fl.
Washington, DC 20002
(202) 724-7000; (877) 319-7346
FAX (202) 673-6993
www.does.dc.gov

FLORIDA
Agency for Workforce Innovation
UC Services
107 East Madison Street, MSC 229
Tallahassee, FL 32399-4135
(850) 245-7105
FAX (850) 921-3265
www.floridajobs.org

GEORGIA
Georgia Dept. of Labor
148 Andrew Young Int'l. Blvd. NE, Ste. 850
Atlanta, GA 30303-1751
(404) 232-3301
FAX (404) 232-3285
www.dol.state.ga.us

HAWAII
Unemployment Insurance Administration
830 Punchbowl Street, Rm. 325
Honolulu, HI 96813
(808) 586-9070
FAX (808) 586-9077
www.hawaii.gov/labor

IDAHO
Idaho Commerce & Labor
317 W. Main
Boise, ID 83735-0760
(208) 332-3576
FAX (208) 334-6301
www.cl.idaho.gov

ILLINOIS
Dept. of Employment Security
401 S. State Street
Chicago, IL 60605
(312) 793-4880
FAX (312) 793-6296
www.ides.state.il.us

INDIANA
Dept. of Workforce Development
10 N. Senate Ave. Rm. 104
Indianapolis, IN. 46204-277
(317) 232-7436 or
(800) 891-6499 UI Tax;
(800) 437-9136 UI Benefits
FAX (317) 232-6950 Tax or
(317) 233-2706 UI
www.in.gov/dwd

IOWA
Iowa Workforce Development Tax Bureau
1000 E. Grand Avenue
Des Moines, IA 50319-0209
(515) 281-5339
FAX (515) 242-6301
www.iowaworkforce.org

KANSAS
Dept. of Labor
Division of Unemployment Security
Contributions Branch
401 S.W. Topeka Blvd.
Topeka, KS 66603-3182
(785) 296-5027
FAX (785) 291-3425
www.dol.ks.gov

KENTUCKY
Division of Unemployment Insurance
P.O. Box 948
Frankfort, KY 40602-0948
(502) 564-6838 or
(502) 564-2272
FAX (502) 564-5442 or
(502) 564-9332
www.oet.ky.gov

LOUISIANA
Dept. of Labor
P.O. Box 94186
Baton Rouge, LA 70804-9186
(225) 342-2978
FAX (225) 342-1943
www.ldol.state.la.us or www.laworks.net

MAINE
Maine Dept. of Labor
Bureau of Unemployment Compensation
P.O. Box 259
Augusta, ME. 04332-0259
(207) 287-3176
FAX (207) 287-3733
www.maine.gov/labor

MARYLAND
Office of Unemployment Insurance
Dept. of Labor, Licensing & Regulation
1100 N. Eutaw Street, Rm. 411
Baltimore, MD 21201
(410) 767-2412
FAX (410) 767-2501
www.dllr.state.md.us

MASSACHUSETTS
Division of Employment & Training
Charles F. Hurley Bldg.
19 Staniford Street
Boston, MA 02114
(617) 626-5075
www.mass.gov/dwd

MICHIGAN
Bureau of Workers' & Unemployment Compensation
Cadillac Place
Tax Office—Suite 11-500
3024 W. Grand Blvd.
Detroit, MI 48202
(313) 456-2180; (800) 638-3994 Employer Customer Relations
FAX (313) 456-2130
www.michigan.gov

MINNESOTA
Job Service & Unemployment Insurance Division
Dept. of Economic Secrity
390 N. Robert Street
St. Paul, MN. 55101
(651) 296-6141
FAX (651) 297-5283
www.mnworkforcecenter.org

MISSISSIPPI
Employment Security Commission
Attn: C & S. Dept.
P.O. Box 22781
Jackson, MS 39225-2781
(601) 321-6228
FAX (601) 321-6173
www mdes ms.gov

MISSOURI
Division of Employment Security
421 E. Dunklin
Box 59
Jefferson City, MO 65104-0059
(573) 751-3215
FAX (573) 751-4945
www.dolir.mo.gov/es

MONTANA
Unemployment Insurance Division
Dept. of Labor & Industry
Box 8020
Helena, MT 59604
(406) 444-3783
FAX (406) 444-2699
TTD (406) 444-0532
http://uid.dll.mt.gov

NEBRASKA
Dept. of Labor
Unemployment Insurance Division
State House Station
P.O. Box 94600
Lincoln, NE 68509-4600
(402) 471-9839
FAX (402) 471-2318
www.dol.state.ne.us
www.uiconnect.state.ne.us

NEVADA
Dept. of Employment, Training & Rehabilitation
Contributions Section
500 E. Third Street
Carson City, NV 89713-0030
(775) 687-4599 Chief of Contributions; (775) 687-1632 Procedures Officer
FAX (775) 687-3186
www.nvdetr.org

NEW HAMPSHIRE
New Hampshire Employment Security
32 S. Main Street
Concord, NH 03301-4857
(603) 228-4045
FAX (603) 229-4323
www.nhes.state.nh.us

NEW JERSEY
NJ Dept. of Labor
Division of Employer Accounts
P.O. Box 947
Trenton, NJ 08625-0947
(609) 633-6400
FAX (609) 292-7801
www.state.nj.us/labor

NEW MEXICO
Unemployment Insurance Bureau
Dept. of Labor
P.O. Box 2281
Albuquerque, NM 87103
(505) 841-2000
FAX (505) 841-8480
www.dol.state.nm.us

NEW YORK
Unemployment Insurance Division
State Campus, Bldg. 12
Albany, NY 12240-0001
(518) 457-2878; (888) 209-8124 Claims within New York state; (877) 358-5306 Claims out of state
FAX (518) 485-8604
www.labor.state.ny us

NORTH CAROLINA
North Carolina Employment Security Commission
P.O. Box 26504
Raleigh, NC 27611
(919) 733-7395
FAX (919) 733-1255
www.ncesc.com

NORTH DAKOTA
Job Service North Dakota
P.O. Box 5507
Bismarck, ND 58506-5507
(701) 328-2791; (800) 472-2952
FAX (701) 328-1882
www.jobsnd.com

OHIO
Ohio Dept. of Job & Family Services
P.O. Box 182404
Columbus, OH 43218-2404
(614) 466-2319
FAX (614) 752-4811
www.jfs.ohio.gov/ouc

OKLAHOMA
Unemployment Insurance Division
Employment Security Commission
P.O. Box 52003
Oklahoma City, OK 73152-2003
(405) 557-7131
FAX (405) 557-7271
www.oesc.state.ok.us

OREGON
Employment Department
875 NE Union Street
Salem, OR 97311-0030
(503) 947-1488
FAX (503) 947-1487
www.oregon.gov/employ

PENNSYLVANIA
Dept. of Labor & Industry
Unemployment Compensation Tax Services
Labor & Industry Bldg. Rm. 915
7th & Forster Streets
Harrisburg, PA 17121
(717) 787-7679; (866) 403-6163
FAX (717) 787-8373
www.dli.state.pa.us

RHODE ISLAND
Division of Labor & Training
One Capitol Hill, Ste. 36
Providence, RI 02908-5829
(401) 222-3696
FAX (401) 222-3694
www tax.state ri us (forms)
www.dlt.state.ri.us

SOUTH CAROLINA
Employment Security Commission
1550 Gadsden Street
P O Box 995
Columbia, SC 29202
(803) 737-3070
FAX (803) 737-2659
www.sces.org

SOUTH DAKOTA
Division of Unemployment Insurance
Dept. of Labor
420 S. Roosevelt
P.O. Box 4730
Aberdeen, SD 57402-4730
(605) 626-2452
FAX (605) 626-3172
www.state.sd.us/dol

TENNESSEE
Dept. of Labor & Workforce Development
Division of Employment Security
500 James Robertson Parkway
Davy Crockett Tower, 8th Fl
Nashville, TN. 37245-3555
(615) 741-2486
FAX (615) 741-7214
www.state.tn.us/labor.wfd

TEXAS
Texas Workforce Commission
101 E. 15th Street
Austin, TX 78778-0001
(512) 463-2734
FAX (512) 463-9111
www.twc.state.tx.us

UTAH
Dept. of Workforce Services
140 E. 300 South, 3rd Fl.
P.O. Box 45288
Salt Lake City, UT 84145-0288
(801) 526-9400
FAX (801) 526-9236
www.jobs.utah.gov/ui

VERMONT
Unemployment Compensation Division
Dept. of Labor
5 Green Mountain Dr.
P.O. Box 488
Montpelier, VT 05601-0488
(802) 828-4344
FAX (802) 828-4248
www.labor.vt.gov

VIRGINIA
Employment Commission
P.O. Box 1358
Richmond, VA 23211
(804) 371-6325
FAX (804) 786-8020
www.vec.state.va.us

WASHINGTON
Employment Security Dept.
Experience Rating Unit
P.O. Box 9046
Olympia, WA 98507-9046
(360) 902-9670
FAX (360) 902-9202
www.wa.gov/esd

WEST VIRGINIA
Bureau of Employment Programs
Unemployment Compensation Div.
112 California Avenue
Charleston, WV 25305-0112
(304) 558-2675
FAX (304) 558-1324
www.wvbep.org/bep

WISCONSIN
Division of Unemployment Insurance
Dept. of Workforce Development
P.O. Box 7942
Madison, WI 53707-7942
(608) 261-6700
FAX (608) 267-1400
www.dwd.state.wi.us/ui

WYOMING
Dept. of Employment
Unemploymnet Tax Division
P.O. Box 2760
Casper, WY 82602
(307) 235-3217
FAX (307) 235-3278
http://wydoe.state.wy.us

GUAM
Dept. of Labor
P.O. Box 9970
Tamuning, GU 96911-2970
(671) 475-7000
FAX (671) 475-7045
www.guamdd.net

PUERTO RICO
Labor & Human Rsources Dept.
Bureau of Employment Security
505 Munoz Rivera Avenue
P.O. Box 1020
San Juan, PR 00919
(787) 282-0694
FAX (787) 753-2097
www.interempleo.org or www.dtrh.govierno.pr

VIRGIN ISLANDS
Employment Security Agency
P.O. Box 789
St. Croix, VI 00821
(340) 776-3700
FAX (340) 773-1515
www.gov.vi

Hiring Foreign Nationals

HIRING FOREIGN NATIONALS

See also CD Toolkit for updates, links and additional resources.

1. BASIC PREMISES

1.1 Source and Scope of the Federal Power to Regulate Immigration

The right of a foreign national to enter or stay in the United States is set by Congress.[1] The principal statute governing the status of non-U.S. citizens (aliens) in this country is the Immigration and Nationality Act. The act's goal, relative to aliens working in the United States, is that jobs should go first to U.S. citizens. The act presumes that any person who wants to enter the United States is seeking to stay permanently, and that the person is or will become an immigrant. The burden is on the alien to prove that he or she is entitled to temporary admission by showing that he or she falls within one of the nonimmigrant visa categories.

A visa is permission to apply to enter the country. It is issued by a U.S. consulate and is presented to an officer of the U.S. Customs & Border Protection (CBP) at the port of entry. A visa permits the alien to travel only to seek entry at a United States entry port; the CBP then admits the alien to the United States.

1.2 Government Agencies and Their Functions

1.2.1 Department of Homeland Security

On November 15, 2002, the U.S. Congress passed legislation that created the Department of Homeland Security (DHS). This legislation abolished the Immigration and Naturalization Service (INS) and created three separate entities to carry out INS functions. These entities operate as part of the DHS.

U.S. Immigration and Customs Enforcement (ICE) is responsible for interior enforcement functions, including the detention and removal programs. The CBP is responsible for border patrol functions and border inspections. U.S. Citizenship and Immigration Services (CIS) is responsible for administration of benefits and immigration services for applicants.

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[1]For the original organization and development of this chapter, we relied on *The Immigration Handbook: Employment of Foreign Nationals,* 2d ed., rev., American Council on International Personnel, Inc., New York, 1985. Since then this chapter has been substantially revised and updated.

1.2.2 Department of State

The U.S. Department of State (DOS) operates U.S. consulates in foreign countries. The U.S. consulate is the office that actually issues both nonimmigrant and immigrant visas. It determines whether the alien qualifies for a nonimmigrant visa, rules on the alien's intent to leave the United States at the expiration of his or her visit, and determines whether the alien is ineligible for a visa under the nine major grounds of inadmissibility.

The appropriate U.S. consulate receives the approved petition from the CIS, makes the final determination (including whether any of the nine major grounds of inadmissibility apply), and interviews the petitioner.

1.2.3 Department of Labor

Certain categories of immigrant visas are granted based upon an offer of permanent employment. Department of Labor (DOL) approval is necessary only if the offer of employment is itself the basis for eligibility for immigration.

The DOL must certify to the CIS that:

- — There are not sufficient U.S. workers who are able, willing, qualified, and available to perform the work.
- — The employment of a foreign national in the position offered will not adversely affect the wages and work conditions of United States workers similarly employed.

For nonimmigrant visas, the DOL plays a limited role. For H-2B visas, the DOL certification is limited to temporary labor certification for certain visa petitions and is advisory only. For H-1B visas, the DOL certifies the labor condition attestation (LCA), which contains employer attestations regarding wage and working conditions.

2. NONIMMIGRANT VISAS

Unlike immigrant visas, most nonimmigrant visas are not subject to numerical limitations and thus have a simplified application process. The alien applies to the U.S. consulate of his or her country of residence or citizenship. Temporary workers, trainees, or intracompany transferees, or fiancé(e)s of U.S. citizens must first apply for CIS approval before submitting the visa application to the U.S. consulate.

The alien's passport must be valid for at least six months beyond the expiration of his or her intended stay in the United States. If not, the U.S. consulate will not issue the visa.

Canadian citizens do not need nonimmigrant visas to enter the United States for temporary periods (except if they seek entry as an E treaty trader or investor). They can simply go to the port of entry with the supporting documentation; that is, they skip going to the U.S. consulate and go directly to the CBP at the border. On January 23, 2007, new passport requirements became effective. In addition to all other countries, citizens from the U.S., Canada, Mexico and Bermuda traveling to the U.S. by air from the Western Hemisphere will be required to have passports to enter the U.S. As early as January 1, 2008, this requirement may apply to land and sea travel to the U.S.

When a nonimmigrant alien enters the United States, the immigration officer staples a small white card, known as an I-94, to the alien's passport. The I-94 indicates how long the alien may legally stay in the United States. The I-94 is important because it serves as proof of the alien's legal status in the United States. A nonimmigrant visa may be issued for one or more entries into the United States. Most common are visas for "one," "two," or "multiple" entries. Thus, an alien with a visa that allows for more than one entry can depart and reenter the United States as many times as the visa allows and as long as the visa itself has not expired. It is important to note that a visa only allows an alien to make an *application* for admission. Admission is not guaranteed, and an alien may be refused admission if she or he does not have a proper visa or proper documentation, or is otherwise determined to be inadmissible. Visas are now issued with biometric identifiers incorporated into the visa. At inspection, most visitors with visas will undergo a biometric check of photo and fingerprints at inspection. This biometric information is used to check the "watch list" for inadmissible aliens. The visa is used only for the initial entrance into the United States; once the alien has been inspected and admitted, it has served its primary purpose.

2.1 Presumption of Immigrant Intent

The Immigration and Nationality Act presumes that every alien applying for a visa to enter the United States intends to stay, and it is up to the alien to prove that he or she qualifies under one of the nonimmigrant categories, and that the stay will be a temporary one. The act, however, recognizes that certain employment-based nonimmigrants may legitimately intend to depart the United States at the end of their authorized stay or seek to become permanent residents. This concept is known as *dual intent.*

2.2 Evidence That Alien Will Depart

For most nonimmigrant categories, an alien must show that he or she has a residence in a foreign country and has no intention of abandoning it.

The U.S. consulate will consider the following factors to show that the alien intends to return to a home in a foreign country:

— Employment

— Property ownership

— Substantial assets outside the United States

— Membership in religious, social, political, or cultural organizations

— Family ties

2.3 Nonimmigrant Categories (Generally)

In the wake of the terrorist attacks on September 11, 2001, many changes have been made regarding the admission of aliens to the United States and the monitoring of aliens during their stay in the United States. The National Security Entry-Exit Registration System (NSEERS) requires that nonimmigrants from many Middle Eastern or predominately Muslim countries are required to register upon admission to the United States or after their admission. The NSEERS registration obligation is determined by place of birth and not by "citizenship." Because of this, Canadian business travelers who were born in a Middle Eastern country can be required to register during a business trip to the United States. In addition to NSEERS, all males between the ages of 16 and 45 must complete security clearance Form DS-157 as part of the nonimmigrant visa application. Processing of this form can take several months for aliens from specified Middle Eastern countries. Foreign students and exchange visitors are now required to report all changes of address, major, class registration, and work assignment to the CIS through their Designated School Officer to comply with the Student and Exchange Visitor Information System (SEVIS) requirements.

Because of these fluctuating requirements, it is critical for all nonimmigrant visitors to the United States to keep abreast of changes in U.S. immigration laws. U.S. entry and visa requirements are normally available at the DOS Embassy or Consulate web site for the alien's country of nationality. A list of U.S. Embassy web sites can be found at www.travel.state.gov.

The following list includes those nonimmigrant categories of most interest to prospective employers. Omitted, for example, are visas for diplomats or crews of foreign vessels passing through United States ports.

2.3.1 B-1 business visitors

B-1 is the category for aliens visiting the United States temporarily for business purposes.

A visitor for business purposes may be intending to negotiate a contract, consult with business associates, engage in litigation, attend a business convention, or perform independent research. If the alien receives any payment, other than reimbursed expenses, from a United States source, he or she ordinarily cannot qualify under this category. He or she may, however, qualify as a temporary worker under another nonimmigrant category.

Under current regulations a B-1 visitor can be admitted for up to one year, with six-month extensions. The reciprocity granted by the alien's country to United States visitors controls the maximum period of validity of the visa.

The initial application is made at the U.S. consulate in the country where the alien resides. It should include a letter from the employer explaining the business purpose for traveling to the United States and proof of financial arrangements to demonstrate that the alien does not need to accept local employment for support while in the United States. The alien must also prove intention to return to the foreign residence. Extensions may be obtained by filing Form I-539 with the CIS service center having jurisdiction over the alien's location in the United States or by E-filing using the CIS Web site at http://uscis.gov. The application should be accompanied by a letter from the alien's foreign employer explaining why the extension is needed and providing further proof of financial support.

2.3.2 B-2 visitors for pleasure

The B-2 category includes tourists, those coming to the United States for medical treatment, attendees at nonbusiness conventions, and amateur entertainers and athletes. The visa is generally granted on a reciprocity basis. For most European countries that do not require U.S. citizens to have visas to visit, the old indefinite duration visa has been replaced by a 10-year visa. At the point of entry, the CBP generally admits visitors for periods of six months. Extensions can be obtained if the alien can demonstrate sufficient ties to the home country and the financial resources to accommodate a long visit without the need to accept local employment.

As with category B-1, the B-2 visitor applies at his or her local U.S. consulate and submits proof of financial arrangements and intent to return to the foreign residence. To ease the application process, a B-2 visitor may submit an affidavit or letter of invitation from a friend or relative in the United States. Proof of financial arrangements can be facilitated by submitting a completed affidavit of support (Form I-134) from a U.S. sponsor, friend, or relative, with supporting documentation on the income and assets of the sponsor, friend, or relative.

2.3.3 Visa waiver program

Visitors for business or pleasure may be eligible to have the B-1/B-2 visa requirement waived under a program known as the Visa Waiver Program (VWP). This program allows aliens from certain countries to enter the United States as visitors for up to 90 days without first obtaining a visa. VWP applicants must have a biometric (machine readable) passport to participate. Visitors who enter the United States under this program must depart within 90 days and are not eligible to extend their stay, change their status, or apply for permanent residence, other than as an immediate relative of a U.S. citizen. Currently there are 27 participating countries in the VWP: Andorra, Australia, Austria, Belgium, Brunei, Denmark, Finland, France, Germany, Iceland, Ireland, Italy, Japan, Liechtenstein, Luxembourg, Monaco, the Netherlands, New Zealand, Norway, Portugal, San Marino, Singapore, Slovenia, Spain, Sweden, Switzerland, and the United Kingdom.

2.3.4 E-1 treaty traders

If an alien is a national of one of the approximately 60 countries that have a trading treaty with the United States, he or she may enter the United States solely to carry on substantial trade principally between the United States and the country of which he or she is a national.

The enterprise must be majority owned by the nationals of the treaty country. The alien must be employed in a supervisory or executive capacity or in a position involving skills essential to the enterprise's operation. The volume of trade must be substantial.

Trade means the exchange, purchase, or sale of goods and services. It includes international banking, insurance, transportation, communication and data processing, advertising, accounting, design and engineering, management, consulting, tourism, and technology transfer.

An E-1 visa is ordinarily granted for multiple entries for a duration of four or five years. The validity and duration of the visa is based on reciprocity between the United States and the country of nationality. Some countries only permit single entry 90-day visas.

E-1 treaty trader countries include Argentina, Australia, Austria, Belgium, Bolivia, Bosnia & Herzegovina, Brunei, Canada, Chile, China (Taiwan), Colombia, Costa Rica, Croatia, Denmark, Estonia, Ethiopia, Finland, France, Germany, Greece, Honduras, Iran, Ireland, Israel, Italy, Japan, Jordan, S. Korea, Latvia, Liberia, Luxembourg, Macedonia, Mexico, Netherlands, Norway, Oman, Pakistan, Paraguay, Philippines, Singapore, Slovenia, Spain, Suriname, Sweden, Switzerland, Thailand, Togo, Turkey, the United Kingdom, and Yugoslavia.

The CBP generally admits treaty nationals for one year, with extensions in increments of up to two years. Every time treaty traders travel, they are given a new one-year admission, so extensions are rarely needed.

Changes from another nonimmigrant status and extensions are applied for on Form I-129, plus Supplement E, "Petition for Nonimmigrant Worker." Treaty traders are usually permitted to stay as long as they are employed by the treaty enterprise, which can be 10 or even 20 years, as long as they manifest an intention to return home eventually.

A treaty trader applies for an E-1 visa at a U.S. consulate located outside the United States. No preliminary CIS application is needed. The application is made on DOS Form DS-156E, or if the treaty trader is in the U.S. as a business traveler, on CIS Form I-129, and submitted with evidence that:

— The trading enterprise is majority owned by treaty country nationals.

— The enterprise is engaged in substantial trade principally between the United States and a treaty country.

— The alien is a citizen of that country.

— The alien will be employed in a qualifying position with the treaty enterprise.

A spouse of the treaty trader may apply for an employment authorization document for local employment in the United States. If otherwise admissible, E-1 dependents may apply for an E-1 visa at a U.S. consulate outside the United States.

2.3.5 E-2 treaty investors

The E-2 visa category is for the benefit of nationals of treaty countries who make a substantial investment in the United States or who are executives, managers, or key employees of a treaty investor enterprise. The treaty investor must be coming to develop and direct the enterprise. The enterprise must be majority owned by the nationals of the treaty country.

The investment must be an active one, that is, not a passive one, such as one in equities or real estate. The amount invested must be at risk, and must be substantial. The enterprise cannot be a marginal one—it must have the present or future capacity to generate more than a minimal living for the investor and the investor's future.

In other respects, the E-2 classification is like the E-1 category.

Treaty or investor countries include Albania, Argentina, Armenia, Australia, Austria, Azerbaijan, Bahrain, Bangladesh, Belgium, Bolivia, Bosnia & Herzegovina, Bulgaria, Cameroon, Canada, Chile, China (Taiwan), Colombia, Congo (Brazzaville) & Congo (Kinshasa), Costa Rica, Croatia, Czech Republic, Ecuador, Egypt, Estonia, Ethiopia, Finland, France, Georgia, Germany, Grenada, Honduras, Iran, Ireland, Italy, Jamaica, Japan, Jordan, Kazakhstan, S. Korea, Kyrgyzstan, Latvia, Liberia, Lithuania, Luxembourg, Macedonia, Mexico, Moldova, Mongolia, Morocco, Netherlands, Norway, Oman, Pakistan, Panama, Paraguay, the Philippines, Poland, Romania, Senegal, Singapore, Slovak Republic, Slovenia, Spain, Sri Lanka, Suriname, Sweden, Switzerland, Thailand, Togo, Trinidad & Tobago, Tunisia, Turkey, Ukraine, the United Kingdom, and Yugoslavia. The treaty with Vietnam is not currently in force, but the treaty with Iran is. United Kingdom nationals who are nonresidents in the United Kingdom proper or Gibraltar are not considered treaty nationals.

A spouse of the treaty investor may apply for an employment authorization document for local employment in the United States. If otherwise admissible, E-2 dependents may apply for an E-2 visa at a U.S. consulate outside the United States.

2.3.6 E-3 treaty aliens in specialty occupations

The E-3 category is intended for Australians going to the U.S. to work temporarily in a specialty occupation. No more than 10,500 E-3 visas can be issued per year.

The definition of a specialty occupation and the labor condition application requirements are the same as for the H-1B specialty occupation and are detailed in section 2.3.8 below. To qualify for an E-3 visa, an applicant must demonstrate:

— That there is a legitimate offer of employment in the United States

— That the position qualifies as specialty occupation employment

— That he or she is an Australian citizen

— That he or she qualifies for the position

— That his or her stay will be temporary

A spouse of the treaty alien in a specialty occupation may apply for an employment authorization document for local employment in the United States. If otherwise admissible, E-3 dependents may apply for an E-3 visa at a U.S. consulate outside the United States.

2.3.7 F-1 students

An F-1 visa is granted to students who have no intention of abandoning their foreign residences and who enter the United States temporarily in order to attend an academic program.

— The school must be approved for F-visa purposes by the CIS.

— The student will not attend a public elementary school (K–8) or publicly funded adult education program and will not attend a public secondary school (9–12) unless the program is not greater than one year and the student fully reimburses the school for the complete cost of the program.

— The student must be enrolled in a full course of study.

— The student must be proficient in English or enrolled in English-proficiency courses.

— The student must have sufficient funds for the expenses for the full course of study.

The F-2 visa is for the family of an F-1 student. The school issues Form I-20 to the student. Application for entry is made at the U.S. consulate abroad; no advance CIS permission is needed. Form DS-156 is used, accompanied by the I-20 from the school. The student must also submit financial documentation and evidence that he or she will depart at the end of his or her course of study.

The student's visa is generally granted for the duration of status—that is, the time necessary to finish the course of study. To transfer from one school to another or to change programs within the same school, the student must obtain a new I-20 and present it to the new school or program's designated school official (DSO). The DSO must submit the I-20 to the CIS Data Processing Center. A student may not transfer from a private school to a public elementary or publicly funded adult education program or to a public secondary school unless the student pays the cost for the secondary school and attends for a maximum period of 12 months.

— F-1 students may not be employed during their first year of academic studies except for on-campus employment. On-campus employment requires no CIS approval.

— Off-campus employment is only available if the student can document severe economic hardship caused by unforeseen circumstances. The student must apply for employment authorization to the CIS on Form I-765 accompanied by a certified I-538 and an annotated I-20.

— Employment through Curricular Practical Training is available to students whose academic programs utilize employment as an integral part of the curriculum. No CIS approval is required; however, the DSO must annotate the student's I-20.

— Finally, students are authorized to accept employment through Optional Practical Training (OPT) in a field related to the student's major area of study. OPT is authorized for a total of one year, whether the employment occurs before or after completion of the academic program. OPT may be applied for up to ninety days prior to completion and must be applied for within sixty days after completion of the academic program. Application is made to the CIS on Form I-765 and must be accompanied by a certified I-538 and an annotated I-20.

2.3.8 H-1B aliens with specialty occupations

The H-1B category includes several classes of aliens, including aliens engaged in specialty occupations, aliens with exceptional merit and ability related to a project administered by the Department of Defense, and fashion models with distinguished merit and ability. In addition, a new H-1B1 nonimmigrant category was created for "professionals" from Chile and Singapore. An H-1B *specialty occupation* requires the theoretical and practical application of highly specialized knowledge. To qualify, the job must require a minimum of a bachelor's or higher degree (or the equivalent in experience) as an entry-level requirement. Specialty occupations include, but are not limited to, architecture, engineering, mathematics, physical and social sciences, medicine and health, education, business, accounting, law, theology, and computer-related positions.

To qualify, an alien must have the required U.S. degree or foreign equivalent (or the equivalent in experience) and, if required by the occupation, be licensed to practice in the specialty occupation. A petitioner must obtain a labor condition application for the position involving a specialty occupation.

A second H-1B visa category is designated for *aliens who will perform services of an exceptional nature related to a cooperative Department of Defense (DOD) research and development project.* The DOD H-1B alien must have the minimum of a bachelor's or higher degree in the area in which he or she will be providing services. The employer must show that the alien will be working for a DOD project and describe the alien's duties and projected dates of employment. The employer is also required to provide the names of nonimmigrants who are currently employed on the project and whose employment on the project ended within the past year. A labor condition application is not required for DOD aliens.

The third H-1B category includes *aliens of distinguished merit and ability* in fashion modeling. To qualify as an alien of distinguished merit and ability, the alien must have documented prominence in the field of fashion modeling, demonstrated by, but not limited to, sustained national or international acclaim, performed services in events of distinguished reputation, national or international recognition for achievements or successes, or commands a high salary. The work that the alien is coming to perform must require the services of such a prominent alien or group.

A petition for an H-1B worker is made on Form I-129, "Petition for Nonimmigrant Worker." It must be accompanied by an approved labor condition application, on Form ETA-9035, if required. The petitioner must also submit evidence that the alien and petitioner meet the requirements of the statute. Chileans and Singaporeans may apply directly at the U.S. Embassy abroad.

An H-1B alien with a specialty occupation or of distinguished merit and ability may be admitted for an initial period of up to three years (maximum six years). A DOD alien may be admitted for an initial period of up to five years (maximum 10 years). Yearly extensions beyond the maximum period of admission are available to H-1B aliens with qualifying pending green card applications. Three year extensions are available if the alien has an approved I-140 and is not able to file for adjustment of status because the priority date is not current (see section 3.0 of this chapter). H-1 aliens who wish to be readmitted as H-1s longer than the time limits allow may apply after first residing outside the United States for the immediate preceding year. Chileans and Singaporeans may be admitted initially for one year and may apply to extend their stay in one-year increments indefinitely, as long as they continue to demonstrate that they do not intend to remain permanently. The labor condition application (LCA) requires the employer to make several attestations regarding wage and working conditions for U.S. and H-1B workers. The attestations are:

— To offer to H-1Bs the greater of the actual wage level paid by the employer to all other individuals with similar experience and qualifications for the specific employment at the place of employment or the prevailing wage for the occupation.

— To provide working conditions for H-1Bs that will not adversely effect other workers similarly employed.

— To attest that there is no strike or lockout.

— To provide notice to the bargaining representative if any, or to post notice that a labor condition application has been filed.

The LCA must be made available for public inspection with other wage data in a public access file within one day of filing with the DOL. A copy of the LCA must be given to the H-1B worker no later than the date he or she reports to work. The prevailing wage referred to in the attestation is obtained by filing a request to the state Department of Labor. This wage determination is often very high and employers often must seek alternative prevailing wage sources. LCAs are specific to the position and geographic area listed on the application. Employers must be careful to maintain LCAs for all locations where workers are employed.

The number of H-1B visas available is 65,000. For the past two years, the 65,000 visa cap has been reached six months prior to the beginning of the fiscal year. This means, for example, that as of May 2006 all H-1B visas have been exhausted until October 2007. This has resulted in an extreme lack of H-1B visas for employers who are seeking to employ foreign nationals. The H-1B Visa Reform Act of 2004 was enacted to make available 20,000 new H-1B numbers, limited to H-1B nonimmigrant aliens who possess a U.S. Master's degree or higher degree. This cap has also been met quickly in the past few years. In addition, the new H-1B1 nonimmigrant category for Chileans and Singaporeans provides 1,400 visas annually for Chileans and 5,400 annually for Singaporeans. The annual 6,800 H-1B1 numerical cap is counted against the H-1B numerical cap. H-1B applications require the payment of a substantial fees in addition to the filing fee. These fees can range between $750 and $2,000, depending on the circumstances of the case. New fee hikes proposed in early 2007 will mean even higher fees in years to come. Many of these fees must be paid by the employer and may not be reimbursed by the employee. H-1B employers must be careful to fulfill the requirements of the H-1B category throughout the employment of the H-1B alien. The employer must pay the stated salary and must maintain the full-time or part-time status of the alien as stated on the I-129 application. An H-1B employer must examine the use of any cost-cutting measures, such as leave without pay or layoffs, to ensure they do not violate the H-1B prohibition against benching workers. H-1B employers have been subject to significant orders of back pay for failing to provide work for or laying off H-1B employees without compensation. In addition, an H-1B employer must pay the reasonable cost of transportation to the alien's home country in the event the H-1B employee is laid off or otherwise terminated and must notify the CIS of the termination of employment.

2.3.9 H-1C nurses

The H-1C category is for nurses who are coming to the United States to work temporarily at hospitals in Health Professional Shortage Areas

(HPSAs). The H-1C category is limited to 500 nurses per year. The nurses must have passed the Commission on Graduates of Foreign Nursing Schools exam and must obtain a temporary nursing license once admitted to the United States. There is a temporary attestation requirement regarding working conditions, and recruitment and wage issues for the hospital that is valid for one year. The validity period for an H-1C is one year with a maximum period of admission of three years. Extensions are not allowed. H-1C status is applied for on Form I-129 at the Vermont Service Center. As a practical matter, the H-1C category is rarely used because it is not feasible for most hospitals to comply with the strict attestation requirements.

2.3.10 H-2 temporary workers; H-2A agricultural workers; H-2B nonagricultural workers

The H-2B visa category is for skilled or unskilled workers excluding foreign medical school graduates, on a temporary basis, if United States workers cannot be found to fill the positions. H-2A is for seasonal or temporary agricultural workers. The employer must show that

— There is a temporary need for the type of services or skills to be rendered by the alien.

— There are no U.S. workers available and qualified to fill the position.

The employer shows that the need is temporary through such factors as the lack of an ongoing or continuous need in the employer's organization for the skills possessed by the alien—for example, in connection with a special project or the need for an instructor or for technicians to install a new system—or work that recurs according to cyclical need, such as in agriculture (laborers are needed during harvest times) or in resort hotels (a larger staff is needed during vacation months).

The employer demonstrates that there are no U.S. workers by getting a temporary labor certification from the DOL. H-2A labor certifications are binding on the CIS. H-2B labor certifications are advisory only. The CIS makes the final decision.

Note that it is extremely difficult to move from H-2 to permanent resident status while the foreign employee is in the same position. It would be contradictory for the employer to say that the position is temporary and permanent at the same time.

For H-2A applications, the employer first obtains a temporary labor certification from the DOL by filing DOL Form ETA 750, Part A with the National Service Center or the local State Workforce Agency (SWA). For H-2B applications, the ETA 750 must be filed with the local SWA.

The temporary labor certification requires the employer to recruit qualified U.S. workers through advertisement and in-house posting. If qualified U.S. workers apply, the DOL will deny the application. H-2A labor certifications also include Form ETA 790. This is a contract between the employer and the worker with stipulations regarding required compensation, housing, and working conditions. Once the certification is obtained, or the DOL declines to certify, the employer files the nonimmigrant visa petition, Form I-129, "Petition for Nonimmigrant Worker," with the CIS. Form I-129 must be accompanied by the DOL labor certification or evidence rebutting the DOL determination that U.S. workers are available. The employer can file for more than one employee at a time.

Once the CIS approves the petition, the alien must obtain the H-2 visa at the consulate outside the United States, and be admitted to the United States under that visa. The alien does so by filing DOS Form DS-156, accompanied by the CIS approval notice, plus evidence of the alien's intention to leave the United States upon expiration of the stay.

The number of H-2B visas available yearly is 66,000. The visa is for a maximum initial period of one year. Extensions are available each year, up to a maximum of three years. The extension is obtained by having the employer obtain a temporary certification from the DOL, and then filing extension requests on Form I-129 with the CIS office covering the employer's location.

The family of an H-2 alien comes under the H-4 category.

2.3.11 H-3 trainees

The H-3 category is for aliens coming temporarily to the United States as trainees, other than for graduate medical education or training. It generally applies to employers who bring aliens to the United States for a temporary period of training in an established program. The program can be in a classroom and/or on the job, but it cannot displace any U.S. workers. The employer must show that:

— The training is pursuant to an established training program run by the employer.

— The training is not available in the home country of the alien employee.

— Any productive employment is incidental to the training program and does not displace U.S. workers.

For the last requirement, the common test is this question: If the alien were not filling the position, would the employer need to fill the position as part of normal operations? If yes, there is displacement.

The employment must be for a temporary period, and the alien must intend to be in the United States temporarily.

The employer files Form I-129, "Petition for Nonimmigrant Worker," including documentation on the training program. If similar training is available in the alien's home country, the employer must explain why training in the United States is necessary. The CIS approves it on Form I-797. The alien trainee then submits the nonimmigrant visa application, DOS Form DS-156, to the U.S. consulate together with evidence that he or she will depart at the expiration of his or her stay.

The visa is granted for the full length of the training program—but no more than two years. No extensions, change of status, or readmission is allowed after completion of two years training until the alien has resided outside the U.S. for six months.

As with H-1 and H-2, family members of H-3 aliens are category H-4.

2.3.12 J exchange visitors

The J-1 category is for a student, scholar, trainee, teacher, or other who is coming temporarily to the United States to participate in a program designated by the U.S. Department of State, Exchange Visitor Program (EVP). The EVP has the authority to designate program sponsors and the terms of the exchange visitor program. Some programs permit employment, some require it, and some prohibit it.

An alien selected to participate in a sponsor's program receives a certificate of eligibility from the sponsor on Form DS-2019. The alien then takes the form to the U.S. consulate abroad together with evidence of intent to leave the United States upon completion of participation in the program. No preliminary CIS approval is needed before the alien applies for a nonimmigrant visa on DOS Form DS-156 and DS-158, and the alien is issued a J-1 visa by the U.S. consulate.

A principal disadvantage of a J visa is that many J-visa holders have a two-year foreign residency requirement in their home countries upon completing their program. Such visa holders may not apply for any immigrant visa or for most nonimmigrant visas until they first return to and physically remain in their home country for two years.

J-visa holders are subject to the two-year requirement if:

— The program the alien is attending is financed in any way by the United States or the alien's home country;

— The alien's skills appear on a "skills list," published by the Secretary of State, for the alien's country; or

— The alien came to the United States to get graduate medical training or education.

A waiver of the two-year foreign residency requirement can be obtained if certain conditions are met. It is also advised that J-visa holders verify with the DOS that the two-year foreign residence requirement applies (or still applies) to them, regardless of what the DS-2019 indicates.

Exchange visitors are generally admitted for the duration of their programs, as indicated on their DS-2019 forms. Extensions of stay may be necessary when a program is extended beyond the period initially anticipated or when the specific program admits participants for only limited time increments. The extension application is made on Form DS-2019.

An exchange-visitor student may be employed if:

— It is on-campus employment pursuant to a scholarship, fellowship, or assistantship.

— Off campus if an urgent financial need arose since acquiring exchange-visitor status.

— The student is in good academic standing and will maintain a full course load.

— The alien obtains written approval of the exchange program's sponsor.

— The employment does not exceed 20 hours per week.

Full-time employment is permitted for J-1 students only during school vacations. No specific permission from the CIS is required. For teenage students, employment is only permitted up to 10 hours per week, and only in noncompetitive jobs such as tutoring, grass cutting, babysitting, and newspaper delivery.

The family of a J-1 alien comes under category J-2. J-2 spouses can obtain permission to work from the INS. The spouse must show that the income derived from employment is not used to support the J-1.

2.3.13 L intracompany transferees

The L-1 category is for an alien who, for one year within the preceding three years, has been employed full time by a company that seeks to transfer the alien to the U.S. temporarily to the same company—or its parent, subsidiary, or affiliate—to render managerial or executive services, or services that require specialized knowledge.

The foreign and the U.S. employer must be related as a parent, subsidiary, affiliate, or branch. To be a parent, subsidiary, or affiliate, one company must have effective control of the other, or a third company, individual, or group of individuals must have effective control over both the foreign and the U.S. employer. Less than 50 percent control is permissible if the party with less than 50 percent has authority to name top managers, make important corporate decisions, and direct the day-to-day operations—for example, the control group owns a substantial block of stock and the rest of the stock is widely dispersed.

The qualifying relationships are defined as follows:

— A *branch* is a division or office of the same organization located in a different geographic area.

— A *parent* is a firm, corporation, or other legal entity that has subsidiaries.

— A *subsidiary* is a firm, corporation, or other legal entity of which a parent (1) owns at least half of the entity and controls the entity; (2) owns half of a 50-50 joint venture and has equal control and veto power over the entity; or (3) owns less than half of the entity, but controls the entity.

— An *affiliate* is (1) one of two subsidiaries, which are owned and controlled by the same parent or individual; (2) one of two legal entities owned and controlled by the same group of individuals, each owning and controlling approximately the same proportion of each entity.

Certain accounting firms may qualify to bring aliens to the United States on L-visas. If two or more international accounting partnerships market their services under an internationally recognized name, the U.S. affiliates can apply to bring aliens working for affiliates to the United States on an L-visa. The accounting firms must be working or organized through an agreement with an international jointly owned coordinating organization.

Managerial duties means that the employee directs the organization or a recognized department subdivision, function, or component of the organization; controls the work of supervisory, professional, or managerial employees; and has authority to hire and fire or recommend the hiring or firing of personnel. Managerial duties also include the exercise of discretion over day-to-day activities over which the employee has authority. They don't include first-line supervisors, unless the employees supervised are professionals. *Executive duties* means that the employee primarily directs the management of the organization or, as a major component or function of the organization, establishes goals and policies, and has a wide latitude of discretionary decision making, and is only supervised generally by higher-level executives, a board of directors, or stockholders.

Specialized knowledge means that an employee has special knowledge of the company, product, service, research, equipment, techniques, management, and their application to international markets, or an advanced level of expertise in the company's processes and procedures.

The employer files Form I-129, "Petition for Nonimmigrant Worker," with supporting evidence, and the CIS approves it on Form I-797. The employee then goes to the U.S. consulate abroad to apply for the nonimmigrant visa. If the U.S. office has been doing business for less than one year at the time of application, additional documents are required. The application must be submitted with a copy of a lease for sufficient physical premises and evidence that the office will require the services of a manager within one year. The application for a new office L will only be approved for one year.

The CIS usually grants permission for three years; the U.S. consulate issues the visa for the same period; and the alien is then admitted at the border for the same period. Extensions of up to two years are available. Extensions may be obtained for up to five years for a worker with specialized knowledge and seven years for other L-visa holders. No extensions beyond these limits are allowed unless the alien has resided outside the United States for the immediate prior year. To get an extension, the employer files Form I-129.

If employers transfer 10 or more managerial or executive employees in the preceding year, they can get blanket approval from the CIS for intracompany transfers of specialized knowledge employees and managers and executives. The petitioner must have had an office in the United States for one year and have three or more domestic and foreign branches, subsidiaries, or affiliates. If the employer has not transferred 10 or more managers, it can still qualify for blanket approval if it has a combined annual U.S. sales total of $25 million or has a U.S. workforce of 1,000 employees. The employer applies for blanket approval on Form I-129S, plus the L supplement. The employer gives evidence of affiliated relationship of all offices, and designates all positions to or from which transfers may be made. The CIS then issues an approval notice (I-797) that names the company divisions and transferee positions that qualify. The approved blanket petition is forwarded to the U.S. consulate. The employee then only has to file Form I-129S with proof that he or she has one-year employment in a managerial or executive role, or as a professional with specialized knowledge, with the appropriate division of the organization and intends to leave the United States at the expiration of the employment. The filing of a permanent labor certification or preference petition is not a basis for denying an L-visa petition, or for an application to extend or change status. An L-visa holder may legitimately have a dual intent to depart the United States at the end of an authorized stay or seek to become a permanent resident.

A spouse of an intracompany transfer may apply for an employment authorization document for local employment in the United States. If otherwise admissible, L-2 dependents may apply for an L-2 visa at a U.S. consulate outside the United States.

2.3.14 M nonacademic or vocational students

An M-1 visa is granted to students who have no intention of abandoning their foreign residences, and who enter the United States temporarily in order to attend vocational or nonacademic training programs. This category is similar to F-1, except for the nonacademic nature of the program.

The CIS must recognize the school as a qualified institution. Then the school issues a certificate of eligibility on Form I-20M-N to the student. The student brings the form to the U.S. consulate abroad to obtain the M-1 visa. The student must present proof of financial resources to cover expenses without employment in the United States, proof of proficiency in English, and proof of intent to depart the United States at the expiration of the stay. The student must also prove that the training to be received can be used in the home country and that it is unavailable at comparable quality and cost in the home country.

The visa is granted for a maximum of one year. Extensions are requested on Form I-539, "Application to Extend—Change Nonimmigrant Status."

Vocational/nonacademic students may not accept employment outside of the training program while in the United States. However, as part of the training program, the CIS may authorize one month of practical training for every four months of education, up to a maximum of six months. The student applies for permission to take practical training on Form I-765. Training must be related to the course of study and be unavailable in the home country.

2.3.15 O temporary workers of extraordinary ability in sciences, arts, athletics, education, and business

The O visa was created by the Immigration Act of 1990 to replace the prior H-visa category of aliens with extraordinary ability in the sciences, arts, athletics, entertainment, education, and business. An alien of extraordinary ability is one whose ability has garnered national or international acclaim or has met a standard of distinction. The alien's entry must be temporary, and must be for work in the alien's area of ability.

To bring an alien in the O-visa classification to the United States, an employer or agent must file with the CIS Form I-129 plus Supplement O, "Petition for Nonimmigrant Worker." The petition must be filed within six months of the date that the alien's services will be needed. For scientists, educators, business persons and athletes, the petition should include documentation of sustained national or international acclaim and recognition for achievements in the field or expertise by providing evidence of receipt of a major, internationally recognized award, such as the Nobel Prize, or at least three of the following forms of documentation:

1. Documentation of the alien's receipt of nationally or internationally recognized prizes or awards
2. Documentation of the alien's membership in associations in the field
3. Published material in professional or major trade publications or major media about the alien
4. Evidence of the alien's participation on a panel, or individually, as a judge of the work of others
5. Evidence of the alien's original scientific, scholarly, or business-related contributions of major significance in the field
6. Evidence of the alien's authorship of scholarly articles in the field, in professional journals, or other major media
7. Evidence that the alien has been employed in a critical or essential capacity for organizations and establishments that have a distinguished reputation
8. Evidence that the alien has commanded and now commands a high salary or other remuneration

For *artists and entertainers (except those affiliated with motion pictures or television productions),* the application must be submitted with evidence that the alien meets the standard of "distinction." The application must contain documentation that the alien is recognized as being prominent in his or her field by showing that the alien has been nominated or received a significant national or international prize, such as an Academy Award and Emmy, a Grammy, or a Director's Guild Award, or with evidence that the beneficiary meets at least three of the following:

1. Has performed/will perform services as a lead/starring participant in productions/events with distinguished reputations as shown by critical reviews, ads, publicity releases, publications, contracts, or endorsements;
2. National/international recognition for achievements through critical reviews, other published materials by or about the beneficiary in major papers, trade journals/magazines, etc.;
3. Has performed in a lead, starring or critical role for organizations and establishments that have a distinguished reputation evidenced by media articles, testimonials, etc.;

4. Has a record of major commercial or critically acclaimed success;
5. Has achieved significant recognition from organizations, critics, government agencies, and recognized experts;
6. Has commanded or will command a high salary/other remunerations in relation to others in the field.

Artists and entertainers entering in connection with motion picture or television productions, as well as directors and other essential technical and creative personnel, must meet yet another definition of *extraordinary achievement,* meaning a very high level of accomplishment in the motion picture or television industry evidenced by a degree of skill and recognition significantly above that ordinarily encountered, to the extent that the person is recognized as outstanding, notable, or leading in the motion picture or television field. The same evidence listed above for artists and entertainers must be submitted for television/motion picture artists.

The petitioner must also submit an advisory opinion evidencing consultation with an appropriate peer group regarding the services to be performed, whether the position requires a person of extraordinary ability, and the alien's qualifications to perform the services.

Notice of approval will be made on Form I-797. The petition will be approved for the time determined by the CIS to be necessary to perform the services in question, but not to exceed three years. The alien's stay can be extended in increments of up to one year to permit the alien to complete the activity for which the alien was initially admitted.

If an O-1 professional athlete is traded to another team, the athlete's employment authorization will continue with the new team for 30 days. Within that 30 days, the team must submit a new I-129, which extends the employment authorization until the application is adjudicated.

If a strike or other work stoppage is in effect at the place where the alien will be employed, the petition will be denied. The filing of a permanent labor certification or preference petition cannot be a basis for denying an O-visa petition, nor for an extension or a change of status. An O-1 visa holder may legitimately have a dual intent to depart the United States at the end of an authorized stay or to seek to become a permanent resident.

An O-2 visa may be issued to an alien seeking entry solely for the purpose of accompanying and assisting an O-1 alien. The family of an O-1 alien may come to the United States on an O-3 visa but cannot work.

2.3.16 P performing artists and athletes

The P visa category was created by the Immigration Act of 1990. It allows aliens to come to the United States to perform as athletes, artists, or entertainers. P-1 visas are for athletes who compete at a demonstrated internationally recognized level or pursuant to a contract and for entertainment groups that have received international recognition or an appropriate prize or award. A P-1 athlete can enter as an individual or as a part of a group. The athlete must have either a tendered contract to perform services or be able to demonstrate the required level of performance. A P-1 entertainer can enter only as part of a group. Seventy-five percent of the group's members must have been involved with the group for at least a year and must perform an integral function for the group. A P-2 visa is for artists and entertainers entering under a reciprocal exchange agreement between a U.S. and a foreign organization that provides for the temporary exchange of entertainers and artists. A P-2 visa can be accorded to an alien individually or as a part of a group. The P-3 visa is for artists and entertainers who enter the United States to perform under a program that is culturally unique.

To bring a P-2 artist, or entertainer, a sponsoring organization or employer must file Form I-129 plus Supplement O/P, "Petition for Nonimmigrant Worker," within six months of the time that the alien's services will be needed. The petition must be accompanied by documentation of the reciprocal agreement between participating organizations, evidence that an appropriate labor organization was involved in negotiating the agreement, and an advisory opinion from the labor organization that certifies the existence of a viable exchange agreement. The petitioner must show that the performers under the agreement have comparable skill levels, and must show terms and conditions of employment.

Essential support personnel may accompany the athlete, artist, or entertainer. When this is the case, the petitioner must obtain an advisory petition that evaluates the necessity of such support staff and whether there are available U.S. workers who could perform the support services.

Approval of a petition is made on Form I-797. The petition will be approved for the period determined by the CIS to be necessary to complete the performance in question, but not to exceed one year. An extension of stay, in increments of one year, may be obtained for an additional period determined by the CIS to be necessary to complete the event or performance for which the performer was admitted. P-1 athletes may be admitted for up to five years. Extensions are allowed for an additional five years.

If a strike or other work stoppage is in effect at the place where the alien will be employed, the petition may be denied. The filing of a permanent labor certification or preference petition shall not be a basis for denying a P-visa petition, nor for an extension or change of status. A P-visa holder may legitimately have a dual intent to depart the

United States at the end of an authorized stay or seek to become a permanent resident.

Family members of a P-visa athlete, entertainer, or artist may accompany the alien as P-4 nonimmigrants and may not work.

2.3.17 Q international cultural exchange visitors

The Q-visa category was created by the Immigration Act of 1990 for international cultural exchange visitors. Its purpose is to provide practical training or employment that involves the sharing and learning of cultural history and traditions between the United States and a participant country.

To bring a Q-visa category exchange visitor to the United States, the employer must apply for exchange program approval and petition for the visitor on Form I-129, plus Supplement Q "Petition for Nonimmigrant Worker." The employer exchange program must have a cultural component designed primarily to share or explain the alien's culture and history through the alien's employment or training. The employment or training must take place in a public place such as a museum, school, or business. The employer must also pay a wage and provide working conditions comparable to those provided to similarly situated U.S. workers.

To bring a cultural exchange visitor to the United States, an employer must be in business in the United States and must maintain an established international cultural exchange program. The employer must also designate an employee to be responsible for administering the exchange program and act as a liaison with the CIS. To qualify as a participant as a cultural exchange visitor, an alien must be at least 18 years old, have English skills sufficient to communicate, must be qualified to perform the work involved, and must not have been in the United States in Q-visa status during the preceding year.

A cultural exchange visitor can stay for a maximum of 15 months.

2.3.18 R-1 religious workers

The Immigration Act of 1990 established a nonimmigrant visa category that allows religious workers to enter the United States to carry out activities of a religious nature.

To qualify as a nonimmigrant religious worker, an alien must, for at least two years immediately preceding application, have been a member of the religious denomination having a bona fide nonprofit religious status in the United States. The alien must be coming to the United States solely to work as a minister, to work in a professional capacity for the religious organization, or to work in some other religious occupation or vocation. A petitioning organization for which the alien will be working must have a bona fide nonprofit status under IRC Section 501(c)(3).

The employer may file for a religious worker on Form I-129, plus R supplement "Petition for Nonimmigrant Worker." Alternatively, the religious worker may apply directly to the U.S. Consulate on Form DS-156 with supporting documents. The employer must submit evidence that documents that the employer is a qualifying organization and the alien's qualifications meet the requirements of the statute. The employer must also certify that the alien will be compensated for the duties to be performed and in what manner.

An approved religious worker will be authorized for an initial period not to exceed three years. This initial period may be extended for up to two years.

A religious worker's family may be admitted on an R-2 visa and may not accept U.S. employment.

2.3.19 TN Trade NAFTA Professionals

The TN category is for Canadian and Mexican persons engaged in activities at a professional level. This category is similar to H-1B and E-3 specialty occupations. Unilike H-1Bs there is no 6 year limitation on stay. "Activities at a Professional Level" under NAFTA is defined as requiring "at least a baccalaureate degree or appropriate credentials demonstrating status as a professional." TNs professional occupations are defined within the NAFTA treaty and listed on NAFTA Appendix 1603.D.1 (codified at 8 C.F.R. §214.6(c)). Although the list is broad, it includes most "professions." There are very few computer-related occupations and even fewer business-related occupations, such as "Vice-President."

Canadian TNs may apply for entry at the border with proof of the job offer and the beneficiary's Canadian citizenship and educational credentials. Canadians are not required to obtain a visa. Mexican TNs must obtain a TN visa at U.S. Consulate or Embassy prior to seeking entry as a TN professional.

3. LAWFUL PERMANENT RESIDENCE

A *permanent resident* is an alien who has received indefinite permission to live and work in the United States. A permanent resident is sometimes referred to as a "green card" holder, but today, the card is beige. Permanent residence (and therefore, immigration) is granted to

— Family-sponsored immigrants.

— Employment-based immigrants.

— Asylees and refugees.

— Diversity lottery winners.

An alien qualifies for permanent residence by applying for an immigrant visa while abroad or by adjustment to permanent residence status while in the United States. Before 1994, only certain aliens who maintained lawful status before application for permanent residence were eligible to adjust their status. In October 1994, the law changed, allowing previously ineligible applicants to apply for residence in the United States by paying a substantial penalty fee in addition to the standard filing fee, along with filing Form I-485, Supplement A. That change had particular impact on aliens who were immediate relatives of U.S. citizens but who had entered the United States illegally and on other applicants who had resided illegally in the United States after an initial lawful entry. Current law prohibits most aliens who have worked without authorization, entered illegally, or resided unlawfully in the United States from adjusting status. Exceptions have been carved into the law for aliens who filed applications for either family or employment based immigration before April 30, 2001. These aliens are referred to as "grandfathered." Many grandfathered aliens must wait many years for their priority date to become current. During this time period they are subject to removal.

The law sets no limit on the number of immediate relatives who may obtain permanent residence status, but it sets a yearly limit on all others, with a maximum number in each preference category and a maximum number from each foreign state and dependent area.

Within the yearly limit, 480,000 are allocated to family-sponsored immigrants and 140,000 to employment-based immigrants. Visa numbers are also allocated to other visa categories as prescribed by law. Visas given to immediate relatives, although not subject to numerical limitation, will count against the worldwide totals, potentially limiting the number of visas available to preference immigrants.

The availability of an immigrant visa depends upon the "priority date" the alien has established. The length of time a beneficiary will have to wait for a given visa can be determined by consulting a timetable of visa availability published monthly by the State Department. The dates given on the table are the dates at which beneficiaries now getting their visas initially got their priority dates.

The priority date is established at the time of filing the first application, that is, the immigrant relative preference petition for close family members, the labor certificate application for job offer immigrants, or the preference petition for other job offer immigrants.

3.1 Based Upon Immediate Relative

3.1.1 Definition

Immediate relatives of a U.S. citizen include

— Children (unmarried and under the age of 21).

— Spouses.

— Parents (provided the citizen is over 21).

— Widows and widowers who were married to the U.S. citizen for at least two years before the spouse's death.

The term *spouse* means legally married, even if currently separated, as long as the marriage was bona fide and there has been no divorce. Marriages entered into for immigration purposes are not bona fide.

Children means unmarried sons and daughters under age 21. A stepchild is considered a child if the step relationship was formed before the child turned 18. An adopted child is considered a child if adopted before age 16, together with other residence and custody requirements. An illegitimate child is considered a child of the mother or of a father who has or who has had a bona fide parent-child relationship with the illegitimate child. For sons and daughters married or over 21, see section 3.2.

Parents of a U.S. citizen (if the U.S. citizen is over 21)—The age requirement is designed to discourage foreign nationals from coming to the United States to give birth to their children in order to have them immediately sponsor the parent for permanent residence. Natural fathers of illegitimate children will be entitled to receive or petition for benefits if they have or had a bona fide parent-child relationship.

Widow and widower of U.S. citizen (married at least two years at the time of the U.S. spouse's death)—To qualify as an immediate relative, an immigrant petition must be filed on the alien's behalf within two years after the spouse's death, and the alien relative must not have remarried.

3.1.2 Procedure

The U.S. relative is the petitioner and the alien is the beneficiary. The petition is filed on Form I-130, "Petition for Alien Relative," or I-360, "Petition for Amerasian, Widow(er) or Special Immigrant," with the CIS Service Center covering the U.S. relative's residence. If the alien is in the United States and eligible for adjustment of status, both the I-130 and the I-485 are filed with the CIS National Benefits Center (NBC). If both petitioner and beneficiary are located abroad at the time of petition filing, the petition must be submitted to the CIS office in the U.S. covering the U.S. relative's residence. Because there is no limit on the number of persons who can become permanent residents as immediate relatives of citizens, visas are always immediately available, and the adjustment application (I-485) can be filed by eligible applicants simultaneously with the immediate relative petition.

CIS documentation requirements are constantly changing. Prior to filing an application, consult an immigration attorney or the CIS to obtain a current list.

It is recommended that the petitioner and applicant submit only copies of all required documents to the CIS, rather than originals, unless originals must be submitted, as in the case of applications themselves.

The CIS may investigate when documents cannot be produced. If a marriage has attributes typical of a sham, an investigation, lasting years, is likely. To expedite the approval process and limit potential investigation, it is suggested that married applicants submit documentation in support of the bona fides of their marriage. Such documentation could include, but is not limited to, wedding invitations or announcements; wedding photos; evidence of correspondence or other communication before marriage; sworn affidavits from friends, family, and others documenting the genuineness of the relationship; joint leases, mortgages, U.S. federal income tax returns, bills, credit cards, bank accounts, loans, or major purchases; evidence of designation of a spouse as beneficiary under health, life insurance, or other benefits; and birth certificates or adoption decrees for any children.

If the alien's relationship is based upon a marriage that occurred less than 24 months previously, he or she is conditionally admitted. The alien beneficiary and the petitioner must file a joint petition, Form I-751, within the 90 days before the second anniversary of the conditional admission to prove that the marriage was bona fide. The petitioner and beneficiary may also be required to appear at a CIS interview. Upon receipt of a timely filed petition, the CIS issues a receipt notice that extends the conditional permanent resident status for one year. If no petition is filed, or the petitioner or beneficiary fail to appear for a scheduled interview, or if the petition is denied, the alien may be removed.

The CIS can waive the joint petitioning requirement and remove the condition if the alien spouse files a waiver. The alien must prove that the qualifying marriage was entered into in good faith by the alien spouse and that

— Extreme hardship (based upon circumstances that arose during the period that the spouse was a conditional resident) would result if the alien were deported;

— The marriage has been terminated; or

— During the marriage the alien spouse or child was battered or subjected to extreme cruelty by the U.S. citizen spouse or parent and that the alien was not at fault in failing to file the joint petition.

To be eligible the alien must file for the waiver before the second anniversary of obtaining permanent residence. However, if a joint petition has been timely filed but, for some reason, a U.S. spouse fails to follow through, a waiver may be filed after the second anniversary.

If a petition is filed after the expiration of conditional residence and the CIS accepts the petition, it is treated as if it were timely filed.

If a marriage is determined to have been entered into solely for the purpose of evading immigration laws, both the alien and the petitioning spouse are subject to being charged with marriage fraud, carrying penalties of up to five years in prison and $250,000 in fines.

If an immigrant relative petition is denied, the denial can be appealed to the Board of Immigration Appeals in Washington, D.C. After administration appeals are exhausted, the denial can be subject to review in the federal district courts. The denial of a joint petition or waiver thereof can be reviewed, *de novo*, by an immigration judge in removal proceedings.

3.2 Based Upon Special Immigrant Status

Special immigrants include

— Permanent residents returning from temporary visits abroad.

— Former U.S. citizens reapplying for citizenship.

— Certain victims of the September 11, 2001, terrorist attacks whose family or employment-based applications were revoked, terminated, or rendered null by the death, disability, or loss of employment of the petitioner, applicant, or beneficiary as a result of September 11.

— Ministers of religious orders and religious workers (accompanied by their spouses and children) who have been engaged in their religious vocations for at least two years and whose denominations have a bona fide U.S. organization.

— Certain U.S. consular employees from Hong Kong.

— Certain employees of the U.S. government or the Panama Canal Company.

— Doctors and their families who have been licensed to practice in a state on or before January 1, 1978, were practicing in a state on that date, entered the United States on an H or a J visa before January 1, 1978, and were continuously present and practicing or studying medicine in the United States since their date of entry.

— Certain officers of international organizations and their families who have lived in the United States for a lengthy period.

— Certain juveniles declared dependent upon a court in the United States.

— Immigrants who served honorably on active duty in the U.S. military during certain conflicts.

Practically viewed, with the exception of religious workers, very few persons qualify as special immigrants.

3.3 Based Upon Family Preferences

With the exception of immediate relatives of U.S. citizens and certain special immigrants, all other classes of immigrants are subject to numerical limitations. There is a worldwide ceiling of 480,000 family-based immigrant visas per fiscal year. (The federal government's fiscal year ends September 30.)

There is a per-country ceiling of approximately 25,620 visas per year. Presently most countries do not come close to their maximum, but certain countries have long waiting lists.

An alien is ordinarily charged to the country of his or her birth, not the country of residence.

The 480,000 family-based annual visas are apportioned among four preference categories. It is possible that a country will not have used its maximum, but that no visas are available to it in a particular preference category. The family-based preference visas include:

— *First preference.* Unmarried sons and daughters of U.S. citizens. This means sons and daughters over 21, since children under 21 are immediate relatives.

— *Second preference.* Spouses and unmarried sons and daughters of permanent residents. This means all unmarried children of residents, over or under age 21. Usually, family members of permanent residents will become residents at the same time, but children over age 21 cannot qualify for derivative status. "Unmarried" includes divorced or widowed persons.

— *Third preference.* Married sons and daughters of U.S. citizens. This includes all married offspring, whether over or under age 21. The spouse and child of a qualifying son or daughter are also included.

— *Fourth preference.* Brothers and sisters of U.S. citizens. The U.S. citizen must be 21 or over and must have a common parent. The spouse and child of a qualified sibling are included. The backlog in this category has resulted in a working period of up to 20 years.

3.4 Based Upon Employment

3.4.1 Categories of employment-based immigrants

3.4.1.1 First preference

Aliens with extraordinary ability. These aliens are defined as that small percentage of individuals who have risen to the very top of their fields in the arts, sciences, education, athletics, and business. They must have sustained national or international acclaim and documented, recognized achievements. They enter the United States to work in areas of ability and to perform work that would substantially benefit the United States.

Outstanding professors and researchers. These aliens must have international recognition as outstanding in their chosen field and a minimum of three years of teaching or research in that field. They enter to work in a tenured or tenure-track teaching or research position.

Certain multinational executives and managers. These aliens must have at least one year of employment with the petitioner within the three years preceding admission to the United States and intend to continue work for the employer. The employer must be a multinational company or its subsidiary or affiliate. This classification includes international accounting firms, as discussed in section 2.3.10, herein.

No labor certification is required for first preference applications.

3.4.1.2 Second preference

Professionals holding advanced degrees. This category is for a position for which the minimum requirement is a U.S. advanced degree or foreign equivalent. An "advanced degree" is defined as any degree beyond a bachelor's degree or equivalent experience. The position must require the degree and the alien must have earned an advanced degree.

Aliens of exceptional ability. This immigration category covers the sciences, arts, or business. It requires a degree of expertise significantly above that ordinarily encountered in the applicable field. Work must substantially benefit the United States. Second preference category applications require a labor certification unless a national interest waiver is obtained.

3.4.1.3 Third preference

Skilled workers. These immigration categories require at least two years of training or experience that is not seasonal or temporary.

Professionals. This immigration category requires a U.S. bachelor's degree or foreign equivalent as an entry-level requirement.

Other workers. This immigration category includes skilled and unskilled workers with less than two years of training or experience that are not seasonal or temporary. Historically, third preference categories have been severely backlogged. As with family preference categories (section 3.3), the length of waiting time can be determined by consulting the Visa Bulletin published by the DOS.

All third preference applications require labor certification.

3.4.1.4 Fourth preference—special immigrants

Religious workers. The alien must have been a member of a religious denomination that has a nonprofit status as a religious organization in the United States for at least two years immediately preceding the filing of the petition. The alien must have been carrying on religious work continuously either abroad or in the United States for at least two years immediately preceding the filing of the application. The alien must be coming to the United States to work as a minister, religious professional, or in some other religious capacity, such as in a religious occupation or vocation.

Certain employees of the U.S. in Taiwan, Panama or Hong Kong. Detailed requirements specific to each country are listed in the INA.

3.4.1.5 Fifth preference

Investors. This category includes aliens who invest at least $1 million in capital in a new enterprise and creates at least 10 U.S. full-time jobs or who invest $500,000 in a targeted area such as a rural or high-unemployment area. An alien can also qualify if he or she (1) invests capital in an existing enterprise that results in an increase in net worth or employees of at least 40 percent; or (2) takes over a troubled business and saves existing jobs for at least two years. Immigrant investors are subject to a two-year conditional residence.

This allocation is 10,000 visas per year, with 3,000 reserved for targeted areas.

3.4.2 Labor certification

Jobs can be separated into two broad categories: (1) those that are in chronic short supply, which have been precertified (see section 4.1.1

of this chapter); and (2) that require individual certification. The labor certification procedure is discussed in detail in section 4, herein.

3.4.3 Petitioning procedure for employment-based aliens

When an employer files a petition on behalf of an immigrant worker, the employer is the "petitioner" and the alien is the "beneficiary." The immigrant visa petition is filed on Form I-140, "Immigration Petition for Foreign Worker," or in the case of a special immigrant, on Form I-360, "Petition for Amerasian, Widow(er), or Special Immigrant." The petition is filed with the CIS service center that has jurisdiction over the place of employment.

The employer must submit evidence that it can pay the employee the proffered wage and that the employee meets the qualifications for the immigrant classification under which the alien is seeking to immigrate.

The petition might have to be accompanied by an approved labor certification. If a labor certification is required, the "priority date" for the petition is established as of the date that the application for labor certification is filed with the Department of Labor. All other priority dates are established as of the date of filing the immigrant visa petition.

Once a petition is approved, and the priority date becomes current, the beneficiary can apply for adjustment of status in the United States, if eligible, on Form I-485 "Application for Permanent Residence," or apply for an immigrant visa through consular processing. If not eligible to adjust, the beneficiary may be able to apply for an immigrant visa at a U.S. consular post outside the United States. See section 5.2 of this chapter for a discussion of grounds of inadmissibility.

3.5 Final Application for Immigrant (Permanent Resident) Status

Once the CIS has approved a petition for a preference, the alien makes the final application for residence. Two methods are used: If the alien is already lawfully present in the United States, status may be adjusted for family-based application, at the CIS district office and for employment based applications, at the CIS Service Center, with jurisdiction where the alien resides, or the alien may submit an immigrant visa application at the U.S. consulate where the alien resides or last resided abroad.

When the alien is ineligible to apply for resident status while in the United States, or is not in the United States, the petition is decided by the CIS and sent to a national visa "clearinghouse" known as the National Visa Center (NVC).

The DOS has designated certain consulates as Alpha post. Alpha post designation requires that payment of all immigrant visa-related fees and filing of all applications are completed in the United States at the NVC before the alien makes any contact with the foreign post.

For Beta posts, the NVC sends the applicants the Instruction Packet and instructs them to notify the post directly when ready to process. The instruction packet includes Form DS-230 Part I, Form DS-169, and the Affidavit of Support.

The applicant gathers all documents and notifies the consulate that he or she is ready for the final interview. Before the interview, the applicant takes a medical exam. At the interview, the applicant presents all supporting documents, and a completed DOS Form DS-230 Part II, the immigrant visa application. The usual supporting documents submitted are:

— Applicant's passport.

— Birth and marriage certificates.

— Police certificates from each place of residence of six months or more.

— Any court and prison records.

— Military service records.

— Photos.

— For most employment-based applicants, evidence of financial support in the United States, such as a letter from a prospective employer or an affidavit of support from a relative. All documents must be in English or be presented along with English translations.

For family-based applicants, and employment-based applicants where a relative is the petitioning employer or has significant (5 percent or more) ownership in the petitioning entity, evidence of financial support must be documented using Form I-864, "Affidavit of Support." The petitioning relative must submit the affidavit of support.

At the consulate, the final decision is made, including consideration of the grounds of inadmissibility. Consular officers review immigration history, financial means, medical infirmities, criminal convictions, and political affiliations.

3.5.1 Adjustment of status

When aliens are located in the United States, they may be eligible to have their status adjusted to lawful permanent resident without having to apply to the U.S. consulate abroad. This process is called adjustment of status.

An alien present in the United States may have status adjusted to that of permanent resident if:

— The alien is eligible to receive an immigrant visa.

— A visa is immediately available. (This means that either the alien is applying under a category without a numerical limit, or the backlog for his or her preference class has caught up to the priority date.)

— The alien is a preference immigrant who has maintained continuous legal nonimmigrant status in the United States to the date of the adjustment application or is the immediate relative of a U.S. citizen.

"Grandfathered" aliens who have a visa immediately available to them but do not meet all of the other requirements listed above may be able to adjust status in the United States upon submitting a penalty fee and Form I-485, Supplement A (see section 3 in this chapter). Certain employment-based immigrants who have failed to maintain legal status may adjust status without paying the penalty fee. This is the case if the alien has been lawfully admitted and the immigration violation occurred through overstaying, engaging in unauthorized employment, or violating the terms and conditions of admission and the period of the violation of status has not exceeded an aggregate period of 180 days by the time the adjustment application is filed.

An alien is not eligible for adjustment of status if he or she has been:

— Admitted as a crewman.

— Admitted in transit without a visa.

— Admitted on a finance visa, unless married to the citizen who initially filed the finance petition.

— Admitted on the Visa Waiver Program, unless the immediate relative of a U.S. citizen.

— Entered without inspection.

— Admitted on an S nonimmigrant visa.

— Engaged in unauthorized employment or otherwise violated the terms of a nonimmigrant visa and is not an immediate relative of a U.S. citizen or certain special immigrants.

Aliens who obtain immigrant status through marriage to a U.S. citizen or lawful permanent residence are granted conditional residence are accorded the same rights as other permanent residents, except that their conditional residence is valid for only two years.

The advantage to adjustment of status is that the alien may remain in the United States while his or her application is processed in the United States. While the adjustment application is pending, the alien may not leave the U.S. unless he or she first obtains a travel document called "advance parole." An exception to this travel rule has been carved out for aliens in H or L status. An alien precluded from applying for adjustment of status may apply to a U.S. consul abroad.

Because there is no limit on the number of persons who can become permanent residents as immediate relatives of citizens, visas are always immediately available, and the adjustment application can be filed by eligible applicants simultaneously with the immediate relative petition. For family preferences with a backlog, the adjustment application cannot be filed with the petition. Employment-based applications without backlogs in the preference category can now file the I-140 petition and adjustment application simultaneously with the appropriate CIS Service Center.

The adjustment application for employment-based cases is filed on Form I-485, "Application for Permanent Residence," at the Nebraska Service Center. If the immediate relative or family-based preference petition is filed simultaneously with the adjustment application, both forms are filed together at the CISCIS National Benefits Center.

The application is filed with a biographical information form, Form G-325A, the completed medical exam form with vaccination supplement, and two identical photos. The same forms are required for each family member, except that there is no need to file separate Forms G-325A for family members under fourteen years of age. Documents must establish the family relationship.

For family-based cases, the interview is next. The CIS determines whether any of the grounds for inadmissibility apply. At the interview, the applicant presents his or her passport and Form I-94 (arrival/departure card), together with updated supporting documents, including evidence of financial support, such as a letter from a current employer.

For family-based applicants, and employment-based applicants where a relative is the petitioning employer or has significant (5 percent or more) ownership in the petitioning entity, evidence of financial support must be documented using Form I-864, "Affidavit of Support." The petitioning relative must submit the affidavit of support.

4. LABOR CERTIFICATION

The Immigration and Nationality Act specifies that an alien is ineligible for a visa if he or she is seeking to enter the United States for the purpose of employment unless the Secretary of Labor certifies to the Secretary of State and the Attorney General that

— There are not enough U.S. workers who are able, willing, qualified (or equally qualified if the alien is a teacher or has exceptional ability in the arts or sciences), and available at the time of the application and the place for the job.

— The employment of the alien will not adversely affect the wages and working conditions of similar U.S. workers.

Thus, for aliens seeking visas under the second, third, and sixth preference classes, certification is first required that will meet the foregoing standards. The certification is made by the Department of Labor.

4.1 Employment Classifications

The Secretary of Labor has established two groups of occupations. There are occupations that have been "pre-certified", including those occupations for which a predetermined shortage exists (physical therapists and nurses), and occupations that the DOL recognizes have already gone through rigorous recruitment (college and university professors). Almost every other occupation that does not require exceptional or extraordinary ability requires that a labor certification application be filed with the DOL.

4.1.1 Schedule A—Professional

The occupations that are listed in Schedule A include the following groups:

These occupations are exempted from the labor certification requirement. U.S. employers may petition directly to the CIS for these positions.

— Physical therapists qualified to take the licensing examination in the state in which they will practice.

— Nurses who are licensed in the state in which they will practice or have passed the Commission on Graduates of Foreign Nursing Schools (CGFNS) examination.

4.1.2 Special recruitment category

These occupations require a limited labor certification process, and includes artists and scientists of exceptional ability (excluding performing artists) and college/university professors. The required documentation for these cases is extensive and varied. Exceptional ability cases require subject proof of the alien's abilities. College and university professors must document prior competitive recruitment within specified time frames.

4.1.3 All other occupations

Most applications fall into this category. Prior to filing the I-140 petition, the employer must engage in a pattern of recruitment and document that there are not enough U.S. workers who are able, willing, qualified, and available for the job opportunity.

4.2 Application for Permanent Labor Certification

4.2.1 Who files

The employer files the application for labor certification. An agent, who need not be an attorney, may file the application on the employer's behalf. Since a labor certification is a complex process subject to denial if not done in a certain way, it is recommended that an inexperienced employer seek the assistance of an immigration lawyer or other representative with experience in filing labor certifications. The employer is called the *petitioner* and the alien employee is called the *beneficiary*. Labor certifications are determined by the Department of Labor.

4.2.2 What must be filed

All employers must attest to the following:

— There must be a bona fide job opening available to U.S. workers;

— Job requirements must adhere to what is customarily required for the occupation in the U.S. and may not be tailored to the worker's qualifications.

— Job opportunity has been and is being described without unduly restrictive job requirements, unless adequately documented as arising from business necessity.

— The employer must pay at least the prevailing wage for the occupation in the area of intended employment;

— The employer must hire the foreign worker as a full-time employee;

— The employer conducted recruitment prior to filing the application.

4.2.3 Basic certification process

On March 28, 2005, the DOL completely revamped the labor certification program and implemented an online application program called

"PERM." Prior to filing the PERM labor certification application, the employer must engage in a specialized mandatory recruitment program. PERM recruitment requires the placement of two Sunday advertisements as well and other mandatory recruitment steps including opening a state job order and physically posting the job opportunity at the worksite. The recruitment must be completed in a period between 30 and 180 days before filing. Once the recruitment is complete, the employer must be able to document the lawful job-related reasons for rejection of U.S. applicants and provide the number of U.S. applicants rejected for each reason.

The employer must register with the DOL online and file the ETA 9089 application using the online PERM system or by mail at the National Processing Center (Atlanta or Chicago) based on the location of the job opportunity.

4.3 Temporary Labor Certification

4.3.1 Temporary agricultural workers

Due to the nature of the business, employers of temporary agricultural workers have an expedited application procedure outside of the permanent labor certification process.

The employer will be directed to recruit for the job opportunities and prove that there are not sufficient U.S. workers able, willing, and qualified, and that employment of the alien will not adversely affect U.S. workers' wages and conditions. In addition, there are multiple rigorous requirements that employers must meet, including providing

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housing, transportation, and workers' compensation. Under regulations, the Secretary of Labor may set a deadline for applications up to 60 days before the job is to start. The Secretary will give notice within seven days to the employer if there are deficiencies in the application and will issue the labor certifications at least 20 days before the job begins. The temporary labor certification is not filed using the PERM system. It is filed on Form ETA 750, Part A, with the National Service Center or the local State Workforce Agency (SWA). Agricultural associations may apply on behalf of groups of employers, and expedited administrative appeal procedures apply.

An employer's application will be denied if:

— There is a strike or lockout.

— During the previous two years, the employer hired temporary agricultural alien workers in violation of the law.

— The employer does not prove provision of workers' compensation.

— The employer does not prove an attempt to recruit U.S. workers.

Any alien violating the condition of a labor certification granted under this provision (for example, working without employment authorization) is disqualified for five years.

4.3.2 Temporary nonagricultural workers

The H-2B nonimmigrant program permits employers to hire foreign workers to come to the U.S. and perform temporary nonagricultural work, which may be one-time, seasonal, peak load, or intermittent. There is a 66,000 per year limit on the number of foreign workers who may receive H-2B status during each USCIS fiscal year (October through September). The process for obtaining H-2B certification is similar to, but less extensive and time-consuming, than, permanent certification. As with Temporary Agricultural Workers, the temporary labor certification is filed separate from the PERM process.

The employer will be directed to recruit for the job opportunities and must prove:

— The job and the employer's need must be one time, seasonal, peak load, or intermittent;

— The job must be for less than one year; and

— There must be no qualified and willing U.S. workers available for the job.

For H-2B applications the ETA 750 must be filed with the local SWA.

4.4 Labor Certification Decision and Administrative Review

When a decision has been reached on the labor certification application, the Department of Labor notifies the employer in writing, with a copy to the alien.

If the labor certification is not granted, denial is issued to the employer and the alien, showing the date and the specific reasons for the denial.

4.4.1 When to file for review

The employer has 35 days from the date of the denial to submit a Request for Review request for review to the Board of Alien Labor Certification Appeals (BALCA). The request for review must be sent to the certifying officer who denied the application. The failure to file a request for review will be deemed a refusal to exhaust administrative remedies, which means that the employer cannot request judicial or administrative review of the adverse decision.

4.4.2 Scope of filing

The request for review should contain legal argument addressing the grounds for denial. Once the employer has filed the request for review, the employer cannot file refile the PERM application until the request for review is decided by BALCA.

4.4.3 Hearings

The certifying officer prepares an appeal file after receiving the request for review. Copies are sent to the administrative law judge or Board of Alien Labor Certification Appeals (BALCA) and Solicitor of Labor in Washington, D.C., and to the employer and the alien. The employer and alien may examine the record and suggest additions. The suggestions are sent to the administrative law judge, with copies to the Solicitor of Labor.

An administrative law judge is designated to hear the case and direct the submission of briefs. The judge then can affirm the denial, direct that the certification be granted, remand the case to the certifying officer for further consideration or fact-finding, or order a hearing.

During the appeal, the Solicitor of Labor represents the Department of Labor. The administrative law judge, while able to question witnesses, is not an advocate for either party. The parties can present, examine, and cross-examine witnesses, but technical rules of evidence do not apply.

The administrative law judge decides issues of fact and law, but cannot consider any arguments that the immigration law may be invalid or unconstitutional. The judge issues a written decision, sending copies to the alien, the employer, the certifying officer, and the solicitor.

An adverse decision of the administrative law judge is subject to review by the federal courts. This should be handled by an attorney experienced in immigration cases.

4.5 Refiling After Denial

If an application for labor certification has been denied, it may be refiled immediately, provided that the recruitment period has not lapsed. In addition, an application cannot be refiled if a request for review of the original application's denial is pending. The alien will receive a new priority date when the new labor certification is filed.

4.6 Validity of Labor Certification

Once granted, a labor certification continues indefinitely for the specific job in the specific geographic area listed on the ETA 9089. If an alien is the beneficiary of an approved labor certification and has an application for adjustment of status that has been pending for over 180 days, he or she can switch to a similar job with a new employer.

A labor certification may be invalidated for fraud.

5. INELIGIBILITY FOR VISAS—INADMISSIBILITY

5.1 Determination of Inadmissibility

As described above, the U.S. consul makes the determination of inadmissibility before a visa is issued, and may be redetermined by the CBP at a port of entry to the United States and by CIS at adjustment of status.

5.2 Grounds for Inadmissibility

The Immigration and Nationality Act (INA) sets forth nine major grounds of inadmissibility to the United States. Applicants for adjustment of status are also subject to grounds of inadmissibility. The list includes:

— *Medical grounds*—Aliens with contagious disease, physical or mental disorders that pose a threat to the alien or others, drug addiction, and failure to present proof of certain vaccinations.
— *Criminal grounds*—Aliens with crimes of moral turpitude, drug convictions, multiple criminal convictions, and prostitution convictions. Even seemingly minor misdemeanor convictions that have been "dismissed" due to plea bargains often result in inadmissibility.
— *Security or related grounds*—Aliens engaged in espionage, or who are seeking to overthrow the government, who threaten U.S. foreign policy, who have present, voluntary membership in a totalitarian party, are Nazis, or are terrorists.
— *Public charge*—Aliens who are likely to become a public charge.
— *Employment*—Aliens seeking to enter on the basis of employment without a labor certification, if required, and certain foreign health care workers.
— *Immigration violations*—Aliens who have been removed, who have sought or obtained a visa by fraud; who have made a false claim to U.S. citizenship after September 30, 1996; certain aliens who have overstayed their time allowed in the United States and resided unlawfully in the United States for six months or more, or for an aggregate of twelve or more months after April 1, 1997; certain aliens who have entered the United States illegally; and stowaways and smugglers.
— *Documentation*—Aliens who seek entry without proper documentation.
— *Citizenship*—Aliens determined to be ineligible for citizenship (draft evaders and most who obtain exemption or discharge from military service on the grounds of being an alien).
— *Other*—Aliens who are practicing polygamists, who are accompanying an inadmissible alien, who withhold or retain custody outside the United States of a child of a U.S. citizen who has been granted custody by a U.S. court, certain aliens who have voted unlawfully in a U.S. election, and U.S. citizens who have renounced U.S. citizenship to avoid U.S. taxation.

Certain classes of inadmissible aliens may be eligible for a waiver of inadmissibility.

6. APPLYING FOR U.S. CITIZENSHIP

6.1 Requirements

The process of applying for U.S. citizenship is called naturalization. The requirements are

— Lawful admission as a permanent resident of the United States.

— Continuous residence (not necessarily physical presence) in the United States for at least five years immediately preceding the filing of the petition for naturalization (three years for spouses of U.S. citizens).

— Physical presence within the United States for an aggregate total of at least one-half of the period of residence (two and one-half years or one and one-half years for spouses of U.S. citizens).

— Residence for at least three months in the state in which petition for naturalization is filed.

— Ability to read, write, and speak ordinary English (waived for persons over 50 years of age who have lived in the United States for at least 20 years as a permanent resident or over 55 years of age with at least 15 years in the United States as a permanent resident); knowledge and understanding of the fundamentals of U.S. history and government.

— Good moral character, attachment to the principles of the Constitution, and proper disposition to the good order and happiness of the United States.

— Continuous residence (not necessarily physical presence) in the United States from the date the naturalization petition was filed until actual admission to citizenship.

6.2 Procedure

If an applicant satisfies the requirements, he or she files an application to petition for naturalization on Form N-400, "Application for Naturalization." It is filed with the CIS service center with jurisdiction over the applicant's residence.

After a fingerprint check is completed the applicant is scheduled for an interview by the CIS. Applicants must establish that they satisfy the physical presence requirement and that they are of good moral character. The examiner will then test for English and knowledge of U.S. government history. The examiner completes the petition at the interview and must make a decision within 120 days of the interview.

Applicants who have certain disabilities may be exempt from the English language requirement and, in some cases, the "knowledge and history of government" requirement. To obtain an exemption an applicant must submit form N-648 completed by a physician indicating that the alien has a medical condition that prevents him or her from reasonably complying with either the language requirement or both requirements.

The naturalization process and swearing in will be completed by either the federal court or the CIS itself. The Immigration Act of 1990 established administrative naturalization, which allows the CIS to carry out the naturalization hearing and ceremony. Before the provision for administrative naturalization was enacted only the federal court could conduct a naturalization hearing and ceremony. If the federal court fails to conduct a hearing within forty-five days of an examiner's positive recommendation, the petition will be returned to the CIS for an administrative naturalization hearing.

No waiting period is required, but the hearing is scheduled according to the court's or the CIS's backlog, unless expedited treatment is requested and granted. At the hearing, the applicant is sworn in and the certificate of naturalization is issued.

7. EMPLOYER RESPONSIBILITIES

Under the Immigration Reform and Control Act of 1986 (IRCA), an employer is liable and subject to penalties if he or she:

— Knowingly hires after November 6, 1986, or knowingly retains, if hired after November 6, 1986, an employee who is unauthorized to work.

— Fails to verify employment authorization or incorrectly verifies on Form I-9 upon hiring any employee hired after November 6, 1986.

— Discriminates in hiring decisions based on an applicant's national origin or citizenship status.

Each area creates separate liabilities for the employer. Violations for paperwork violations for improperly completed I-9s are punishable with fines that range from $100 to $1,000 per violation, depending upon the employer's practice and history of violations. Violations for knowingly hiring or continuing to hire unauthorized aliens range from $250 to $10,000 for each unauthorized individual. Egregious violations are punishable by imprisonment. Employers who knowingly accept false documents or documents belonging to someone other than the applicant are also subject to penalties. An employer's good faith attempt to comply, however, is sufficient if Form I-9 is properly completed, and employers may rely on the representations of an alien's status made by a state employment agency or job service office.

Certain independent contractors, "casual hires," and "sporadic, irregular, and intermittent" household workers are excluded from these provisions. Employees hired before November 7, 1986, who were unauthorized, or who later became unauthorized, are "grandfathered," and their employers are not liable as long as the employee has been continuously employed since the date of hire.

It is unlawful for any person (employer or employee) to knowingly use, possess, obtain, accept, or receive a document that is forged, counterfeited, altered, or false to satisfy a requirement of the INA. It is also unlawful to use, possess, accept, or obtain a document lawfully issued to another person. Civil penalties for these violations range from $250 to $5,000 for each document used. Employees who work illegally are violating U.S. immigration law and may be removable or ineligible for immigration benefits.

7.1 Employment Verification System

For each new employee, an employer (except for recruiters and referrers), must verify both the employee's identity and work authorization by filling out Form I-9. Form I-9 includes detailed instructions on how to complete the form. By completing the I-9, the employer is stating, under penalty of perjury, that the employer has examined the appropriate document(s) to establish work authorization. The reverse of Form I-9 lists single documents that can be used to establish both identity and work authorization, or documents that establish either identity or work authorization. In the latter case, the employer must review two documents as listed on the I-9.

The employee must also attest to being either a citizen, a permanent resident, or one who is lawfully entitled to the employment. The employer must comply with these provisions within three business days of commencement of employment. The employer must retain Form I-9 for the later of three years after hiring the employee or one year after the employee terminated employment, whichever is later.

It is recommended that employers keep an "I-9 File" separate from other employee records. Employers must allow the employee to decide which documents to present and accept them as long as they appear to relate to the individual and appear to be facially genuine.

The employer should accept only original documents and should be sure to fully complete the I-9. Employment verification regulations are in the process of being finalized that will make I-9 completion easier and less risky for employers. Section 411 of the Illegal Immigration Reform and Immigrant Responsibility Act of 1996 (IIRIRA) amended the Immigration and Nationality Act (INA) to allow employers to correct technical or procedural defects in I-9s before these defects are considered violations of the INA. This defense will be available to employers who have made a good faith attempt to comply with the employment verification system.

Section 412 of the IIRIRA reduced the number of documents that may be used for I-9 work verification. This section of law will not be implemented until a new Form I-9 is approved and distributed to employers.

The Attorney General, Secretary of Labor, and the Secretary of Health and Human Services are to jointly establish a system for validating social security numbers. Currently, employers are given three days' notice before being required to present Form I-9 to an inspector.

7.2 Prohibition of Discrimination

An employer may not discriminate against applicants on the basis of national origin or status as a citizen. Protected classes include an individual who is a U.S. citizen or national alien who is a permanent resident, a temporary permanent resident admitted under the legalization program, a refugee, or an asylee. Employers are also prohibited from retaliating against an employee who asserts a discrimination claim against the employer.

An employer is exempt (or may claim a defense) from this provision if:

— He or she has three or fewer employees.

— Title VII of the 1964 Civil Rights Act covers the claim instead.

— He or she is complying with a government contract (for example, security provisions on defense contracts).

— English language skill is a bona fide job requirement.

— The applicant is not within a protected class.

Attorney's fees are recoverable by the prevailing party in any suit brought for discrimination.

This provision of the IRCA places employers in a delicate position. Employers must be careful not to hire illegal aliens, yet they are prohibited from discriminating against applicants who may appear to be illegal aliens. Thus, employers must consider all potential applicants and be certain to inspect the required documents of any person having been given employment. Employers may also face a discrimination claim or be committing an unfair employment practice by refusing to accept an I-9 document that appears to be facially genuine or requiring that the applicant provide more documentation than that required by the I-9. Section 421 of the IIRIRA revised the law to make it more difficult to prove discrimination in this context. The law now requires that the alien claiming discrimination must prove that the employer intended to discriminate against him.

Note that applicants are required to complete Form I-9 only after having been offered employment, not when initially applying. It is a good idea to store the forms away from other personnel documents; the fewer people who have access to I-9s, the less likelihood of the documents being used to sustain a claim that the employer discriminated on the basis of age, citizenship, or national origin.

8. PENALTIES

8.1 Employer Responsibilities

Under the employer's responsibilities discussed in section 7, an employer who violates the provisions is subject to civil and criminal penalties.

An employer is entitled to notice and a hearing, if accused of violating the provisions. For a first offense, employers are subject to a civil penalty of not less than $250 and not more than $2,000 for each knowing hire of an unauthorized alien employee. For a repeat offense, the civil penalties range from $2,000 to $5,000 for each unauthorized alien employee. Employers who show a pattern of violations may be subject to civil penalties ranging from $3,000 to $10,000 per alien, and to criminal penalties of up to $3,000 per alien and up to six months' imprisonment. Additionally, the U.S. Attorney General is empowered to seek an injunction against an employer.

If the violations are merely paperwork violations, for example, failure to complete an I-9 or completing it inaccurately, the fines drop down to $100 to $1,000 for each employee. Under new guidelines, the employer will be provided 10 days to correct the technical or procedural violations.

With the passage of the Immigration Act of 1990, employers became subject to additional fines based upon a finding that the employer engaged in discriminatory conduct. The new fines parallel those already in place for hiring undocumented, unauthorized workers. The employer is now subject to fines either for overdocumenting or refusing to accept valid I-9 documents. These new fines can be imposed in addition to the antidiscrimination remedies already available, such as reinstatement, back pay, and attorney's fees.

In addition, an employer found to have engaged in discriminatory conduct may be required to:

— Post notices in the workplace about employees' rights and employer obligations under the act.

— Educate appropriate personnel about the requirements of the anti-discrimination provisions.

— Remove false performance reviews or warnings from an employee's file.

— Lift any restrictions on an employee's working conditions.

Hearings are to be held by an administrative law judge, with at least 30 days' notice. Either party may appeal an adverse decision to the U.S. Court of Appeals within 60 days.

Civil penalties are collected by the U.S. Attorney General by civil suit in federal district court.

An employer cannot require an employee to post a bond or indemnify the employer from any violations of these provisions. If an employer attempts to gain employee indemnification, the employer is subject to a civil penalty of $1,000 plus reimbursement of the indemnification or bond expenses.

SUGGESTED RESOURCES

U.S. Citizenship and Immigration Service: http://www.uscis.gov/portal/site/uscis

U.S. Customs and Border Protection: http://www.cbp.gov

U.S. Immigration and Customs Enforcement: http://www.ice.gov

U.S. Department of State: http://www.travel.state.gov

U.S. Department of Labor Foreign Labor Certification: http://www.foreignlaborcert.doleta.gov/hiring.cfm

APPENDIX: Visa Classification Symbols

A visa issued to a nonimmigrant alien within one of the classes described in this section shall bear an appropriate visa symbol to show the classification of the alien. The symbol shall be inserted in the space provided in the visa stamp. The following visa symbols shall be used:

Visa Symbol	*Class*	*Section of Law*
A-1	Ambassador, public minister, career diplomat or consular officer, or immediate family	101(a)(15)(A)(i)
A-2	Other foreign government official or employee, or immediate family	101(a)(15)(A)(ii)
A-3	Attendant, servant, or personal employee of A-1 or A-2, or immediate family	101(a)(15)(A)(iii)
B-1	Temporary visitor for business	101(a)(15)(B)
B-2	Temporary visitor for pleasure	101(a)(15)(B)
B-1/B-2	Temporary visitor for business & pleasure	101(a)(15)(B)
C-1	Alien in transit	101(a)(15)(C)
C-1/D	Combined transit and crewman visa	101(a)(15)(C) and (D)
C-2	Alien in transit to United Nations headquarters district under Sec. 11.(3), (4), or (5) of the headquarters agreement	101(a)(15)(C)
C-3	Foreign government official, immediate family, attendant, servant or personal employee, in transit	212(d)(8)
D	Crewmember (sea or air)	101(a)(15)(D)
E-1	Treaty trader, spouse or child	101(a)(15)(E)(i)
E-2	Treaty investor, spouse or child	101(a)(15)(E)(ii)
E-3	Treaty alien, specialty occupation	101(a)(15)(E)(iii)
F-1	Student	101(a)(15)(F)(i)
F-2	Spouse or child of F-1	101(a)(15)(F)(ii)
F-3	Canadian or Mexican national commuter student	101(a)(15)(F)(iii)
G-1	Principal resident representative of recognized foreign government to international organization, staff, or immediate family	101(a)(15)(G)(i)
G-2	Other representative of recognized member foreign government to international organization, or immediate family	101(a)(15)(G)(ii)

Visa Symbol	*Class*	*Section of Law*
G-3	Representative of nonrecognized nonmember foreign government to international organization, or immediate family	101(a)(15)(G)(iii)
G-4	International organization officer or employee, or immediate family	101(a)(15)(G)(iv)
G-5	Attendant, servant, or personal employee of G-1 through G-4 or immediate family	101(a)(15)(G)(v)
H-1B	Alien in a specialty occupation (profession)	101(a)(15)(H)(i)(b)
H-1C	Nurses in health professional shortage areas	101(a)(15)(H)(i)(c)
H-2A	Temporary worker performing agricultural services unavailable in the United States (petition filed on or after June 1, 1987)	101(a)(15)(H)(ii)(a)
H-2B	Temporary worker performing other services unavailable in the United States (petition filed on or after June 1, 1987)	101(a)(15)(H)(ii)(b)
H-3	Trainee	101(a)(15)(H)(iii)
H-4	Spouse or child of alien classified H-1A/B, H-2A/B, or H-3	101(a)(15)(H)(iv)
I	Representative of foreign information media, spouse, and child	101(a)(15)(I)
J-1	Exchange visitor	101(a)(15)(J)
J-2	Spouse or child of J-1	101(a)(15)(J)
K-1	Fiance(e) of United States citizen	101(a)(15)(K)
K-2	Child of fiance(e) of United States citizen	101(a)(15)(K)
K-3	Spouse of U.S. citizen	101(a)(15)(K)(ii)
K-4	Child of K-3	101(a)(15)(K)(iii)
L-1	Intracompany transferee (executive, managerial, and specialized knowledge personnel) continuing employment with international firm or corporation	101(a)(15)(L)
L-2	Spouse or child of intracompany transferee	101(a)(15)(L)
M-1	Vocational student or other nonacademic student	101(a)(15)(M)
M-2	Spouse or child of M-1	101(a)(15)(M)
M-3	Canadian or Mexican national commuter student (vocational)	101(a)(15)(M)(iii)

Visa Symbol	*Class*	*Section of Law*
N-8	Parent of an alien classified SK-3 special immigrant	101(a)(15)(N)(i)
N-9	Child of N-8 or of an SK-1, SK-2, or SK-4 special immigrant	101(a)(15)(N)(ii)
NATO-1	Principal permanent representative of member state to NATO (including any of its subsidiary bodies) resident in the U.S. and resident members of official staff, secretary general, assistant secretary general, and executive secretary of NATO; other permanent NATO officials of similar rank, or immediate family	Art. 12, 5 UST 1094; Art. 20, 5 UST 1098
NATO-2	Other representative of member state to NATO (including any of subsidiary bodies) including representatives, its advisers and technical experts of delegations, members of immediate Art. 3, 4 UST 1796 family; dependents of member of a force entering in accordance with the provisions status-of-forces agreement or in accordance with the provisions of the protocol on the status of international military headquarters; members of such a force or immediate family if issued visas	Art. 13, 5 UST 1094; Art. 1, 4 UST 1794
NATO-3	Official clerical staff accompanying representative of member state to NATO (including any of its subsidiary bodies) or immediate family	Art. 14, 5 UST 1096
NATO-4	Official of NATO (other than those classifiable as NATO-1) or immediate family	Art. 18, 5 UST 1098
NATO-5	Expert, other than NATO officials classifiable under the NATO-4, employed in missions on behalf of NATO, and their dependents	Art. 21, 5 UST 1100
NATO-6	Member of a civilian component accompanying a force entering in accordance with the provisions of the NATO status-of-forces agreement; member of a civilian component attached to or employed by an allied headquarters under the protocol on the status of international military	Art. 1, 4 UST 1794; Art. 3, 5 UST 877

Visa Symbol	*Class*	*Section of Law*
	headquarters set up pursuant to the North Atlantic Treaty; and their dependents	
NATO-7	Attendant, servant, or personal employee of NATO-1, NATO-2, NATO-3, NATO-4, NATO-5, and NATO-6 classes, or immediate family	Art. 12-20; 5 UST 1094-1098
O-1	Alien with extraordinary ability in sciences, arts, education, business or athletics	101(a)(15)(O)(i)
O-2	Accompanying alien	101(a)(15)(O)(ii)
O-3	Spouse or child of O-1 or O-2	101(a)(15)(O)(iii)
P-1	Internationally recognized athlete or member of internationally recognized entertainment group	101(a)(15)(P)(i)
P-2	Artist or entertainer in a reciprocal exchange program	101(a)(15)(P)(ii)
P-3	Artist or entertainer in a culturally unique program	101(a)(15)(P)(iii)
P-4	Spouse or child of P-1, P-2, or P-3	101(a)(15)(P)(iv)
Q-1	Participant in an international cultural exchange program	101(a)(15)(Q)(i)
Q-2	Irish peace process program participant	101(a)(15)(Q)(ii)
Q-3	Spouse or child of Q-2	101(a)(15)(Q)(ii)
R-1	Alien in a religious occupation	101(a)(15)(R)
R-2	Spouse or child of R-1	101(a)(15)(R)
S-5	Certain aliens supplying critical information relating to a criminal organization or enterprise	101(a)(15)(S)(i)
S-6	Certain aliens supplying critical information relating to terrorism	101(a)(15)(S)(ii)
S-7	Qualifying family member of S-5 or S-6	101(a)(15)(S)
T-1	Victim of a severe form of trafficking in persons	101(a)(15)(T)(i)
T-2	Spouse of a T-1	101(a)(15)(T)(ii)
T-3	Child of a T-1	101(a)(15)(T)(ii)
T-4	Parent of a T-1	101(a)(15)(T)(ii)
TN	NAFTA professional	214(e)(2)
TD	Spouse or child of a NAFTA professional	214(e)(2)
U-1	Victim of criminal activity	101(a)(15)(i)(I)
U-2	Spouse of U-1	101(a)(15)(ii)
U-3	Child of U-1	101(a)(15)(ii)

Visa Symbol	*Class*	*Section of Law*
U-4	Parent of U-1	101(a)(15)(ii)
V1	Spouse of a legal permanent resident alien	101(a)(15)(V)(i)
V2	Child of a legal permanent resident alien	101(a)(15)(V)(i)
V3	Child of a V1 or V2	203(d)

Source: 22 CFR 41.12

Insurance

INSURANCE

1. BACKGROUND

1.1 Spreading Risk

Insurance is an important method through which one can protect against future losses. An insurance policy provides that an insured will be compensated for a stated loss by the insurer. The risk to the insurer is "spread" over the pool of all those insured for similar losses because, barring catastrophe, not all insureds will suffer a loss in any given period. Furthermore, actuaries can predict, with reasonable accuracy, the number of covered losses that will occur in any given year. Thus, insurers can charge a premium that will provide for sufficient funds to cover losses and expenses while allowing for profit.

An individual purchasing an insurance policy is spreading the potential loss over the group of other people who are purchasing similar coverage. Thus, to the individual, the potential for a disastrous financial loss is reduced. All insureds pay relatively small premiums so that the few who sustain losses can receive large returns. If the insured suffers a covered loss, especially a large loss, the insured gets a return on his or her investment. If the insured is in a large pool that incurs very small or no losses, the insured still receives a valuable product: peace of mind.

1.2 Law of Large Numbers

Insurance companies predict losses in a group by the law of large numbers, the basic premise of which is that the larger the number of separate risks combined within a given group, the easier it becomes to predict a future loss within the group. They then base their premiums on the expected cost of these future losses as well as expenses and profit. Actual losses may vary from these expected losses because of

— Chance fluctuations around the expected losses.

— Errors in predicting the expected losses.

— Court interpretations.

Because the relative difference between the actual losses and the true expected losses tends to decrease as the pool of insureds increases, insurers want to cover as many insureds as possible to make future losses "more predictable."

1.3 Regulation of Insurance Companies

Insurance companies that sell property and liability insurance are regulated, for the most part, by state statute. Insurance regulation within individual states is governed by an official commonly known as the commissioner of insurance. Typically, the commissioner of insurance is appointed by the governor and is responsible for the administration of insurance laws and supervision of the insurance industry within the state.

Other matters regulated by state statutes include

— Rate control.

— Prevention of unfair practices.

— Protection of the stability and solvency of the insurer.

States require every insurer who intends to write policies in a state, as well as all agents and brokers, to be licensed by the state. Under this licensing power, states can monitor and regulate levels of

— Competence and ethics.

— The economic stability and method of operations.

— The types of investments of each insurer.

State statutes for some types of insurance also prescribe a standard form for policies governing language, required and prohibited clauses, and readability.

1.3.1 Rate control

The goal of rate regulation is to keep rates high enough to cover claims adequately and allow the insurer an expense allowance and a reasonable profit while keeping the rates nondiscriminatory among insureds facing the same risks. In many states, insurers are permitted to cooperate in calculating property and liability insurance rate schedules, which are then subject to state approval. The aim of nondiscriminatory rates is to charge premiums that accurately reflect the expected (average in the long-term) losses faced by a given insured and thus ensure that two insureds facing identical risks are charged equal premiums.

1.3.2 Prevention of unfair practices

The regulation of unfair business practices seeks to prohibit false advertising, misrepresentation, the presentation of misleading factors, and comparisons with the product of an insurer's competitor. State statutes often require that an insured be given notice of cancellation and the reasons for the cancellation within a specified time before the effective date of the cancellation, particularly for family and small business insurance. State statutes also provide the method and jurisdiction whereby insureds within their state may bring suit against out-of-state and mail order insurers.

1.3.3 Protection of the stability and solvency of the insurer

Insurance statutes uniformly require all insurance companies admitted to do business in a state to submit annual financial reports. This reporting requirement is the primary means whereby state insurance officials are alerted to the potential insolvency of an insurer.

2. TYPES OF INSURERS

Premium costs and, ultimately, insurance company strength are determined by three general criteria: claim experience, investment performance, and expense control. Actuarially determined claim experience varies little among types of insurers. However, the type of insurance company can have a direct impact on investment performance and expense control. Although insurers are not easily categorized, the following classifications are commonly referred to within the insurance industry.

2.1 Primary or Direct Insurers

2.1.1 Stock companies

Stock companies are owned by stockholders, who provide capital for the insurer and share in any profits and losses. Stockholders elect the board of directors who, in turn, elect officers to manage the company. Stock-company insurers differ little from other corporations that issue stock; capital is raised in the equity marketplace to improve financial position without relying solely on policyholders.

Most stock companies are profit-making insurers, although some nonprofit stock companies exist. Those that sell property insurance usually sell through the independent agency system. Under this system, described in section 3.1, which follows, agents are independent business people who represent more than one insurer. Some stock companies pay dividends to policyholders on certain types of insurance. Stock companies never issue "assessable policies," whereby an insured can be charged an additional premium if the company's losses are high; such losses are borne by stockholders.

2.1.2 Mutual companies

Mutual companies are owned by policyholders. They are, theoretically, nonprofit and exist solely for the benefit of their policyholders. Policyholders are similar to stockholders in that they also elect a board of directors and share in policy dividends. By not having to answer to separate policyholder and shareholder groups, mutual companies may have some overhead cost savings not enjoyed by stock companies. Smaller mutuals tend to issue assessable policies.

Class mutuals sell only a particular kind of insurance. Examples include farm mutuals and factory mutuals. General writing mutuals sell many different types of insurance. Mutuals can be participating, deviating, or both. Participating mutuals, particularly life insurance companies, often charge higher premiums than a stock company, at least initially, so that a dividend is more likely. Deviating mutuals charge a lower premium than stock companies but do not plan to pay dividends. Some mutuals combine both aspects, cutting the initial rate, and paying a dividend later if warranted.

2.1.2.1 Assessment insurers

Assessment companies retain the right to charge policyholders additional premiums if premiums paid are insufficient to meet claims. Some assessment insurers charge policyholders nothing until a loss occurs, then charge each member a pro-rated share—a policy known as an open-end contract. Mutual and reciprocal (see section 2.1.4, below) insurers that issue assessable policies constitute most of the existing assessment insurers.

2.1.2.2 Fraternals

A fraternal insurer is a nonprofit corporation, society, order, or volunteer association without capital stock, organized solely for the benefit of its members and beneficiaries. They often have a representative form of government, and are charitable and tax-exempt. Many fraternals originally started as assessment companies, but this method proved to be unsound. Most now operate on a reserve basis similar to that of other insurers, although some continue to issue assessable policies as a safety valve. Fraternals are authorized to do business under a special section of the insurance code, provided certain requirements are met.

Membership in fraternal associations is often centered around religious or patriotic orientation. Although similar to mutual companies in policyholder ownership, fraternals distinguish themselves by providing other fraternal benefits, often including grant and scholarship programs or benevolent programs for members in need. Fraternals are generally less diverse in the types of insurance provided.

2.1.3 Demutualization

Mutual insurance companies may reorganize by converting to stock companies in a process called demutualization. This typically occurs through either a full demutualization or a mutual holding company (MHC) conversion. In a full demutualization, the company's net worth is generally distributed to policyholders as stock, cash, and policy enhancements. Thus, policyholders become stockholders. The company may concurrently issue additional stock in the form of an initial public offering (IPO). The policyholders' membership rights are terminated; however, their contractual rights remain unchanged.

In an MHC conversion, policyholders do not receive stock, cash, or other policy enhancements because the surplus of the insurance company is not distributed. The mutual insurance company converts to a stock insurance company that is wholly owned by an MHC. The policyholders' contractual rights remain with the stock life insurance company, while the membership rights are transferred to the MHC.

An MHC conversion does not preclude the company from doing a full demutualization in the future. Mutual companies that pursue demutualization are better able to take advantage of the capital markets and diversification opportunities enjoyed by stock companies. Demutualizations must be approved by state regulators and at least two-thirds of the voting policyholders.

Demutualizations are normally treated as tax-free recapitalizations under IRC Sec. 368(a)(1)(E). Policyholders do not normally recognize gain or loss on the receipt of stock. Policyholders who receive stock in a tax-free recapitalization will typically have capital gain income upon the sale of stock. The holding period for such stock includes the period that a taxpayer held a mutual policy membership interest. Because the tax basis of a membership interest is generally zero, policyholders would not have basis in stock received. The IRS has ruled that policy credits issued with respect to annuity contracts held by retirement plans in a demutualization are not treated as distributions and do not trigger income or penalties.

2.1.4 Reciprocals

A reciprocal or interinsurance exchange company, like a mutual, is owned by policyholders. Unlike a mutual, however, policyholders in reciprocals appoint an individual or corporation known as an attorney-in-fact to operate the company. A key feature of reciprocals is the exchange of individual promises through a group arrangement. A reciprocal is unincorporated, with no capital other than advance premiums deposited by the owners. Early reciprocals kept separate accounts for each member. State regulations may require reciprocals to keep a reserve fund to protect subscribers from financial difficulties of the insurer. Reciprocals sell mainly automobile insurance and, like mutuals, may or may not be assessment insurers.

2.1.5 Lloyd's associations

Lloyd's is an organization joined together to provide certain services or insurance which is sold individually by the members. Each member assumes risks personally and does not bind the organization to the risk obligations.

Lloyd's of London operates worldwide, and in much of the United States sells what is known as a surplus-line market, consisting of risks that domestic insurers have rejected. In some states, Lloyd's is licensed to sell other lines. Standards for membership in Lloyd's are strict.

American Lloyd's are authorized by statute in some states. Generally, only certain types of insurance may be underwritten by Lloyd's groups. Most state statutes have minimum standards and requirements for American Lloyd's. The American Lloyd's are much smaller than Lloyd's of London and may write only a few lines.

2.1.6 Service insurers

Service insurers are technically not insurers in most states. They are unique to health insurance and provide prepaid plans for hospital, medical, and surgical expenses to the insured. They pay the provider of the service rather than provide cash benefits. The best known is probably Blue Cross/Blue Shield. Most service insurers are incorporated under special state laws and are given favorable tax treatment.

2.1.7 Government insurers

The federal government provides life and health insurance to military personnel and certain other federal employees. Some examples are the U.S. Government Life Insurance Plan, the National Life Insurance Plan, and the plans available to employees under the Railroad Retirement Act, the Civil Service Retirement Act, and the Federal Employees' Compensation Act. The Federal Crime Insurance program provides crime insurance to those who cannot otherwise obtain it. A similar program for flood-prone areas is available through the National Flood Insurance program.

States administer Fair Access to Insurance (FAIR) plans to ensure that properties that would be insurable except for their environment can be insured. FAIR plans operate in about half the states.

Social Security is probably the best-known government insurance program and is discussed further in section 9, which follows, and in the separate chapter on Social Security in this manual.

2.2 Reinsurance Companies

Reinsurance shares the risks written by one insurance (ceding) company with one or more (reinsurance) companies. This is sometimes done through agreements or treaties that specify the ways a group of risks will be shared between the ceding company and the reinsurer. In addition, a ceding company can cede individual risks to a reinsurer on a per-item basis.

Reinsurance is ceded in two general ways:

1. On an excess basis, whereby the ceding company keeps a certain dollar amount (retention) on each loss and pays a price to have a reinsurer pay all losses in excess of the retention
2. On a pro rata basis, whereby the ceding company and reinsurer share all specified losses and premiums in a given proportion

Reinsurance thus passes a given risk from a primary insurer to a secondary insurer.

Generally, insurance companies purchase reinsurance for these reasons:

1. To reduce the effect of unanticipated losses and protect projects
2. To allow the capacity to write longer risks
3. To assist in financing product lines by providing capital

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3. AGENTS AND BROKERS

3.1 Agents

An agent represents the insurance company and operates under authority granted by an agency contract. Agents generally must be licensed by the state and may be required to complete certain courses or take an examination.

3.1.1 Authority

An agent's authority varies with the type of insurance being sold. A life insurance and health insurance agent usually does not have the authority to issue or modify insurance contracts. The agent primarily solicits, receives, and forwards applications from clients to the company. The agent can accept the first premium and may issue a binding receipt, which will cover the insured immediately (assuming the insured is later determined to be insurable).

Property and casualty agents have much broader authority than life and health insurance agents. They may bind the company by written or oral agreement. These agents may inspect risks for the company and collect premiums, and may be authorized to issue insurance contracts from their own offices.

3.1.2 General and local agents

Agents can be general or local. A general agent supervises all the company's business within a region, usually from a central headquarters with satellite offices staffed by local agents in surrounding areas. A local agent may also staff an independent retail office and represent several insurance companies. Agents are paid commissions on the insurance policies they sell or that pass through their hands although sold by another agent.

3.1.3 Exclusive and independent agents

Agents can work independently or with a company branch or district. Those who represent only one company are called captive or exclusive agents. Independent agents sell and service policies from many companies, and own renewal privileges. Thus, if the relationship between an independent agent and a company dissolves, the right to renew belongs to the agent. Independent agents have the advantage of drawing from several different companies and are frequently able to "shop around" for the best premium for clients.

3.1.4 Statutory employees

Agents are either independent contractors or common law employees under the Internal Revenue Code (IRC) for income and Social Security (FICA) tax purposes. However, for FICA tax purposes, certain full-time life insurance agents are considered statutory employees under IRC Section 3121(d)(3)(B). That is, they are independent contractors (self-employed) for income tax purposes but receive a Form W-2 with only Social Security withholding. Also, such statutory employees may be covered under company-sponsored retirement plans, since IRC Section 7701 permits self-employed agents to be covered.

3.2 Brokers

A broker is not a direct representative of any particular company. A broker is an independent salesperson who selects insurance coverage from whichever insurance company will best fill the client's needs, not unlike an independent agent. A broker orders the policies to be prepared by the insurer. When they are written, the broker delivers the policy to the client and is responsible for collecting premiums as they become due. Whereas the agent legally represents the insurer, a broker represents the insured. Hence the broker may not bind the insurance company before contacting it. Not all states license brokers. Some brokers are extremely large organizations providing many services in addition to ordering insurance.

3.3 Other Marketing Methods

In recent years, a proliferation of companies offering Internet-based insurance quotes and issuance of contracts have surfaced. Many of these companies provide valuable information to assist individuals in making decisions about insurance. Often, they do not endorse or recommend specific companies or insurance policies, but will provide competitive quotes from a number of insurance companies. In those cases, an authorized agent of an insurance company typically follows up through an online application process to complete the transaction.

A user may choose from a variety of companies by conducting an online word search for "insurance quotes." Such companies generally provide their service free of charge as they are paid a referral fee or commission from the insurance company the user chooses.

Direct writing companies do not deal through agents or brokers but often market their insurance by having their employees deal directly with insureds. Some of these companies do business only by mail, particularly for life insurance.

4. HEALTH INSURANCE

The Social Security chapter herein discusses Medicare benefits. Essentially, Medicare is a federal health insurance program for people sixty-five or older. It is divided into two parts: hospital insurance and medical insurance. To be eligible for Medicare, people age sixty-five or older must meet at least one of the following criteria:

— They are entitled to monthly Social Security or railroad retirement benefits.

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— They have worked long enough to be insured under the Social Security or railroad retirement system.

— They have worked long enough as federal employees to be insured for Medicare purposes.

See the Social Security chapter herein for more details regarding Medicare.

4.1 Individual Medical-Expense Insurance

Medical-expense insurance provides benefits for expenses arising from injury or sickness; many different kinds of policies are presently available. Health insurance differs as to the underwriting methods; the types of injuries, illnesses, and losses covered; the types of insurers providing coverage; and the benefits available.

4.2 Underwriting Factors

Five basic factors are considered in underwriting health insurance policies: age, physical condition, occupation, sex, and moral hazard.

Age. Age is a major factor in health insurance. Older people are more likely to become ill, suffer more serious injury in an accident, and not recover as quickly as younger people. The extent to which risk increases with age varies with the type of coverage being provided.

Physical condition. A history of certain health problems, a disability, or poor physical health in general may result in an insurer's declining to cover the potential insured or refusing to provide coverage for specific problems. A specialty company may be found to cover a particular existing health problem for a higher premium.

Occupation. Occupations are classified by the frequency and severity of injuries, exposure to hazards, nature of the work, and the length of the most likely disabilities faced by its members. Most insurance companies rank occupations numerically according to occupational hazards.

Sex. Statistics appear to indicate that women have more health problems than men, but studies also show that women are more likely to take better care of themselves and are less reluctant to visit doctors when problems are suspected.

Moral hazard. Moral hazards are most important in policies that have high disability-income benefits. Such a hazard exists when the insured is inclined to malinger, collect benefits, and not return to work.

4.3 Typical Policy Coverages and Provisions

Medical-expense insurance can generally be categorized as basic-expense insurance, major medical, and comprehensive and special policies.

4.3.1 Basic expense

Basic medical expense policies usually cover hospital stays, at a prestated per day limit or for a fixed maximum duration, and surgical costs in full or on a prestated scale based on the procedure and the services of the physician in addition to the hospital ancillary charges.

4.3.2 Major medical

Major medical coverage is designed to cover the catastrophic aspects of a prolonged and serious illness or injury, covering the days of hospitalization that exceed the coverage limits of the "Base Plan," physical therapy, equipment rental, etc. Major medical policies usually have a deductible of at least $100, however, much larger deductibles are not uncommon. After the deductible has been met, payment is usually made on a co-insurance basis of 80 percent/20 percent. This means that the policy will pay 80 percent of covered charges above the deductible, while the individual is responsible for 20 percent. Many major medical policies have a lifetime maximum benefit limit of up to one million dollars.

4.3.3 Comprehensive

Comprehensive major medical coverage combines the basic and major medical coverage into a single policy or contract. This type of coverage has become the most common and widely used type of policy. A claim is first paid under basic medical with a possible deductible. Then some percentage of the remainder of the claim is paid through major medical until the benefit limits are reached.

4.3.4 Special health

A variety of special health insurance policies provide limited coverage in specific circumstances. Specified disease policies provide limited coverage for certain diseases, such as cancer or heart disease. Hospital indemnity policies pay a certain amount on a periodic basis to an insured while hospitalized. The benefit paid is not related to actual expenses incurred or wages lost during the insured's hospital stay.

Accident insurance provides coverage exclusively for accidental injury. Benefits may be paid for death, disability, dismemberment, or hospital and medical expenses.

4.4 Group Health Plans

Group health insurance is the most common form of employer-provided health insurance. The majority of health insurance is written on a group basis and covers many people under a single policy. Usually, group coverage is not written for fewer than ten people. Benefits included in many group health plans include medical expense, disability, accidental death and dismemberment, and dental insurance.

Medicare and the Medicare + Choice medical savings account (MSA) plans are covered in the Social Security chapter.

4.4.1 Underwriting group policies

Underwriting of group policies is structured so that every member of the group is insured regardless of age, physical condition, gender, or occupation. Underwriting factors such as age, gender, occupation, and physical condition applying to a group are likely to be factors in determining the overall cost of the package.

4.4.2 Special provisions

Certain special provisions are unique to group insurance. A conversion privilege allows insured members to change to individual coverage in certain circumstances when they are no longer eligible for group coverage. All employers with twenty or more employees, with health insurance plans, are required by the Federal Consolidated Omnibus Budget Reconciliation Act of 1986 (COBRA) to offer continuation of insurance coverage upon termination of employment or death. (See also the Employment Regulations chapter of this manual.) Certificate provisions require an explanation of the coverage provided under the group policy.

Under a coordination-of-benefits provision, an insured under two plans will be paid under each plan only to the extent of medical expenses incurred rather than the full benefits under each plan. When there are two plans covering one insured, one plan is usually the primary plan—that is, it pays benefits first and without regard to other plans. An individually written plan, however, would not be included as a plan for coordination-of-benefits purposes.

4.4.3 Benefits and services

Benefits and services under group health plans are provided in several ways. Probably the best known are the "Blues": Blue Cross/Blue Shield.

Blue Cross/Blue Shield is not an insurer per se, but rather a service organization. It contracts with certain physicians and hospitals on a nonprofit basis and pays for services directly to the service provider, as opposed to the insured. In certain circumstances, cash benefits are paid to subscribers.

4.4.4 Health maintenance organizations (HMOs)

Health maintenance organizations (HMOs) are a relatively new approach to providing health care. Employers with twenty-five or more employees are required by federal law to offer coverage under an HMO if a federally certified plan is available nearby.

HMOs focus on preventive health care by providing medical exams and early treatment. Members usually pay a set fee on a regular basis. Medical care is provided through contracts with hospitals, clinics, group practices, and individual physicians. HMOs are usually sponsored by nonprofit organizations such as hospitals, unions, consumer groups, and governments. To be eligible to enroll in an HMO, an individual must generally be part of a designated group. Individuals are occasionally allowed to enroll, but coverage is meant to be provided on a special group basis. This field of medical coverage is very complex and is changing rapidly.

4.4.5 Preferred provider organizations (PPOs)

A preferred provider organization is a hybrid of a health maintenance organization and a traditional fee for service care. A preferred provider organization is a group of private practitioners who collectively sell their services at discounted rates to insurance companies, HMOs, and employers. Many of these currently exist under contract to Blue Cross and Blue Shield plans.

Similar to HMO subscribers, preferred provider subscribers have all their medical needs taken care of for a fixed monthly amount. Participants are not restricted to the doctors or hospitals of a preferred provider organization, but if a different doctor or hospital is used, participants must pay an additional charge over and above the annual premium of the preferred provider organization.

4.4.6 Franchise health insurance

Franchise health insurance is individual insurance administered on a group basis. It is provided to persons who cannot be written on a regular group basis. It is usually offered to employees of a common employer or to members of an association or professional society. Premiums are generally lower than with individual plans because they are collected by the employer and then paid to the insurer. Individual policies are issued and insureds may select optional and additional benefits. Franchise policies are underwritten individually if the number being insured is small.

4.4.7 Archer MSAs

The Health Insurance Portability and Accountability Act of 1996 (HIPAA) makes Archer MSAs (medical savings accounts) available to employees covered under an employer-sponsored, high-deductible health plan of a small employer and to self-employed individuals. Individuals with Medicare supplemental insurance are not eligible to have an Archer MSA. An Archer MSA is a trust or custodial account, similar to an IRA, to cover out-of-pocket medical expenses. Contributions to an Archer MSA are tax deductible; if made by an employer, they are tax free to the employee. Earnings on an Archer MSA are not currently taxable, and distributions from an Archer MSA for medical expenses are also not taxable.

Archer MSAs are only available to small employers, defined as an employer who employed, on average, no more than fifty employees during either the preceding or second preceding year. Contributions may be made either by an employee or the employer, but an individual is not eligible to make contributions for any year in which employer contributions are made on behalf of the individual.

Individual contributions to an Archer MSA are deductible in determining AGI, but are limited to 65 percent of the deductible under the high-deductible plan for individuals and 75 percent for family coverage. For 2007, a high-deductible plan is a health plan with an annual deductible of: (1) at least $1,900 but no more than $2,850 for individual coverage; and (2) at least $3,750 but no more than $5,650 for family coverage. Maximum out-of-pocket expenses are $3,750 for individuals and $6,900 for families (per Rev. Proc. 2006-53).

Distributions for qualified medical expenses are nontaxable, but other distributions are taxable and subject to an additional 15 percent penalty unless made after age 65, or because of death or disability. Any balance remaining in the Archer MSA of a decedent is includible in the decedent's estate (with special rules for surviving spouse and other named beneficiaries). After December 31, 2005, no new contributions may be made to Archer MSAs except by, or on behalf of, individuals who previously had contributions made on their behalf and employees who are employed by a participating employer [IRC Sec. 220(i)(2)]. Archer MSA accounts may be rolled over to HSAs tax free.

4.4.8 Health reimbursement arrangements

An employer may provide medical reimbursement to employees through a health reimbursement arrangement (HRA). The IRS has authorized HRAs to permit employers to reimburse employees' out-of-pocket medical expenses and health insurance premiums (IRS Notice 2002-45). Under the HRA, an employee may carry over any unused medical reimbursement authorization to future years. Unlike a Section 125 Cafeteria Plan, all payments are made solely by the employer. Upon substantiation, medical expenses incurred by an employee may be reimbursed subject to a maximum dollar amount for a coverage period. Any unused portion at the end of the coverage period is carried forward to increase the maximum reimbursement amount and subsequent coverage. An HRA may reimburse medical expenses to former or retired employees even where the employee does not elect COBRA coverage.

4.4.9 Health savings accounts (HSAs)

A health savings account (HSA) is a tax-exempt trust or custodial account set up with a qualified HSA trustee to pay or reimburse certain medical expenses. No permission or authorization from the IRS is necessary to establish an HSA. A qualified HSA trustee can be a bank, an insurance company, or anyone already approved by the IRS to be a trustee of individual retirement arrangements (IRAs) or Archer MSAs. The HSA can be established through a trustee that is different from the taxpayer's health plan provider.

The benefits of an HSA include:

- Taxpayers may claim a tax deduction for contributions made to the HSA even if no deductions are itemized on Form 1040.
- Contributions to an HSA made by an employer (including contributions made through a cafeteria plan) may be excluded from the employee's gross income.
- The contributions remain in the individual's account from year to year until used.
- The interest or other earnings on the assets in the account are tax free.
- Distributions may be tax free if used to pay qualified medical expenses.
- An HSA is "portable," so it stays with the individual even if he or she changes employers or leaves the workforce.

To be eligible for an HSA, an individual must obtain a high deductible health plan (HDHP), have no other health coverage and not be claimed as a dependent on someone else's tax return. Each spouse who is an eligible individual who wants an HSA must open a separate HSA. Joint HSAs are not permitted. For 2007, an HDHP has a minimum annual deductible of $1,100 for single coverage or $2,200 for family coverage. The maximum annual deductible is generally $5,500 single and $11,000 family (per Rev. Proc. 2006-53).

Any eligible individual can contribute to an HSA. For an employee's HSA, the employee, the employer, or both may contribute to the employee's HSA in the same year. For an HSA established by a self-employed (or unemployed) individual, the individual can contribute. Family members or any other person may also make contributions on behalf of an eligible individual. Contributions to an HSA must be made in cash. Contributions of stock or property are not allowed.

For 2007, contributions are allowed up to the amount of the annual health plan deductible, but not more than $2,850. For family coverage, the limit is $5,650. An eligible individual who is age 55 or older may increase the contribution limit by $800. Contributions are deductible if made no later than April 15 of the following year. Roll over contributions are permitted from Archer MSAs and other HSAs into an HSA. Rollover contributions do not need to be in cash. Rollovers are not subject to the annual contribution limits. Contributions made by an employer are not included in the employee's income. Contributions to an HSA are reported on Form 8889, Health Savings Accounts (HSAs), and filed with Form 1040.

Tax-free distributions from an HSA may be used to pay or reimburse qualified medical expenses incurred after establishing the HSA. Distributions received for other reasons are subject to income tax and may be subject to an additional 10 percent tax.

If the spouse is the designated beneficiary of an HSA, it will be treated as the spouse's HSA after the taxpayer's death. If the spouse is not the designated beneficiary, the account stops being an HSA, and the fair market value of the HSA becomes taxable to the beneficiary in the year of death. If the estate is the beneficiary, the value is included on the individual's final income tax return.

Under final regulations issued by the IRS (Regs. 54.49806) guidance has been provided on the comparable contribution rules that must be followed by an employer who contributes to an employee's HSA. A family high deductible health plan (HDHP) may be subdivided into categories of self plus one, self plus two, and self plus three or more.

4.5 Disability Insurance

Disability insurance provides periodic payments when the insured is unable to work because of injury or sickness. Benefits replace a portion

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of the wages or salary the insured is losing because of an inability to work. Policies are available on an individual or group basis. Most policies cover only the wage earner, not family members or dependents. Disability insurance policies vary by definition of disability, amount of payments, waiting period, and maximum benefit period. Coverage may or may not be provided in addition to workers' compensation.

4.5.1 Total disability

Disability policies can cover both total and partial disability. Total disability may be defined as an inability to work at any gainful occupation or at a specific occupation for which the insured is qualified. Some older policies also required that the insured be confined to the home and under the treatment of a physician. A more current and practical definition defines disability as an inability to perform the duties of an occupation for which the insured is suited by training, education, or experience. Typically, a policy will provide that, for a specified time after the beginning of the disability, the insured is deemed totally disabled if completely unable to work in his or her previous occupation.

4.5.2 Partial disability

Partial disability is the inability to perform one or more important duties of the occupation. Partial disability often pays a substantial percentage of the indemnity payable for the total disability, for a period of three to six months. A residual benefit pays for lost earnings after the insured returns to work if the insured cannot earn as much as prior to the disability.

4.5.3 Benefits and waiting period

The amount the insured receives on a weekly or monthly basis is generally based upon the insured's gross earnings and is limited to a percentage of earned income. The insured will have a waiting period, usually a number of days, immediately after the onset of the disability, during which benefits are not payable. The waiting period, also called the elimination period, serves the same purpose as a deductible.

The length of the waiting period is a factor in determining the cost of the insurance. Typical waiting periods range from weekly intervals, seven or fourteen days, to monthly intervals of thirty, sixty, ninety, 180, even 360 days. Some policies provide that if the insured is disabled a specified number of days beyond the waiting period, benefits will be paid retroactively to the onset of the disability.

All policies have a maximum benefit period during which benefits will be paid. The benefit period can range from six months to a lifetime.

The most common periods are up to three years, five years or ten years, up to age sixty-five, or through the insured's lifetime. The length of the benefit period is determined by whether the policy covers a long- or short-term disability; some policies cover both.

If a worker meets Social Security's definition of a disabling condition and has accumulated enough work credits based on age, he or she may be eligible to receive Social Security disability payments. (See also the Social Security chapter herein.) Most group benefits are likely to be limited by the insurer to the extent that they duplicate Social Security benefits received by the insured for the same disability. Insurers often adjust their payment downward if both Social Security and disability benefits become payable simultaneously.

4.5.4 Renewable and noncancelable

Individual policies can be noncancelable or renewable. A noncancelable policy is preferable to an insured because the insured has the option to renew until age sixty-five or seventy at a premium that will never be increased. With guaranteed renewable policies, the insurer retains the right to increase premiums on all policies in the same category. Policies renewable at the option of the company preserve the right of the insurer to refuse to renew.

4.5.5 Obtaining coverage

Disability insurance can be obtained in a number of special forms. As a rider to life insurance, disability provides for monthly payments should the insured become totally disabled before age fifty-five or sixty. The waiting period is usually six months with a maximum benefit period to age sixty-five, providing that if the insured is still disabled the life insurance benefits will be paid as an endowment.

Disability coverage can also be purchased to cover business overhead and operation expenses. This is most useful to self-employed professionals and sole proprietors. Coverage for key employees pays for outside help to come into a business when a key employee is disabled. Buy-out insurance provides funds for members of a partnership or corporation to purchase the business interests of a totally disabled partner or stockholder. Certain policy terms will be based on the term of the buy-and-sell agreement.

4.6 Long-Term Care Insurance

Long-term care insurance has become increasingly popular due to skyrocketing nursing home costs and an increase in average life expectancy.

Long-term care insurance can provide peace of mind to the insured in addition to the preservation of quality of life into retirement years.

Although Medicaid pays for long-term care, it is a need-based program. To qualify for coverage, an individual must meet stringent income and asset limitations.

Individuals with a low net worth may not be good candidates for long-term care insurance because the premiums may be cost-prohibitive. Also, such individuals will likely qualify for Medicaid after assets have been spent down. Individuals with a high net worth may be tempted to self-insure, hoping coverage will never be needed.

Under the 1996 Health Insurance Portability and Accountability Act, a long-term care insurance contract is treated as a medical plan for tax purposes, with employers permitted to provide long-term care insurance to employees [other than through a cafeteria plan or flexible spending arrangement (FSA)], and individuals permitted to deduct premiums for long-term care insurance similar to health insurance contracts.

Benefits received under a long-term care policy are nontaxable to the recipient, limited to $175 per day, unless the recipient can show that the excess over the $175 amount was used to pay unreimbursed costs for long-term care services.

Premiums paid for long-term care insurance are treated as medical expenses for purposes of Schedule A itemized deductions, and are also eligible for the self-employed health insurance deduction, limited to the following amounts for 2007 (per Rev. Proc. 2006-53):

In the Case of an Individual With an Attained Age Before the Close of the Taxable Year of:	*The Limitation on Premiums Paid for Such Taxable Years Is:*
Not more than 40	$ 290
More than 40 but not more than 50	550
More than 50 but not more than 60	1,110
More than 60 but not more than 70	2,950
More than 70	3,680

These provisions are effective for contracts issued after 1996.

4.6.1 Types of policies

The majority of long-term care insurance policies are sold directly by insurance companies to individuals. A number of employers offer group policies to employees. Under these group policies, the employee usually pays the premium on the policy, which covers the employee, spouse, and often their parents. Various organizations, such as the American

Association of Retired Persons (AARP), also offer long-term care policies on a group basis.

Long-term care insurance may also be purchased as a rider to some life insurance policies. The rider allows a portion of the death benefit or cash value to be used to fund long-term care expenses.

4.6.2 Choosing the right policy

Analysis of long-term care policies requires time and patience because the policies are not standardized. For analysis purposes, sample policies and coverage terms should be obtained from various carriers. Premium quotes from each carrier should be compared and used as a bench mark.

Insurance companies should also be reviewed using a rating service such as A. M. Best and Moody's. These services provide details of the company's financial strength and track record. Nursing homes should be contacted to determine the long-term care cost in the area in which the insured plans to retire.

4.7 Insurance Continuation

4.7.1 Health Insurance Portability and Accountability Act

In 1996, the Health Insurance Portability and Accountability Act (HIPAA; also known as the Kassebaum-Kennedy bill) became law. This legislation included new protections for individuals who move from one job to another, who are self-employed, or who have preexisting medical conditions. It is designed to improve the availability of health insurance to working families and their children.

Under HIPAA, small businesses (fifty or fewer employees) are guaranteed access to health insurance. No insurer can exclude an employee or a family member from coverage based on health status. For example, a business will be able to obtain group coverage where it had been unable to buy insurance for its workers because insurance companies wanted to exclude one employee from the policy because he has been diagnosed with cancer.

Once an insurer sells a policy to any individual or group, it is required to renew coverage regardless of the health status of any member of the group. People who lose their group coverage (for example, because of loss of employment or change of jobs to a firm without insurance) will be guaranteed access to coverage in the individual market, or states may develop alternative programs to ensure that comparable coverage is available to these people. The coverage will be available without regard to health status, and renewal will be guaranteed.

Workers covered by group insurance policies cannot be excluded from coverage for more than twelve months due to a preexisting medical condition. Such limits can be placed only on conditions treated or diagnosed within the six months before their enrollment in an insurance plan. Insurers cannot impose new preexisting condition exclusions for workers with previous coverage.

If states fail to act, the secretary of Health and Human Services can impose civil monetary penalties on insurers. The secretary of labor will enforce these rules for self-insured (that is, ERISA) plans. The tax code is modified to impose tax penalties on employers or insurance plans that are out of compliance. Civil monetary penalties can also be imposed on noncompliant insurers.

4.7.2 Family and Medical Leave Act

The Family and Medical Leave Act (FMLA) requires employers to continue group health benefits for employees on FMLA leave. The employer is responsible for the same proportion of insurance premiums as when the employee is at work. The employer may attempt to recover such premiums should the employee fail to return to work after the FMLA leave.

5. LIFE INSURANCE

Three main types of life insurance make up most of the life insurance sales: term, whole, and universal life. They differ primarily in length, investment characteristics, and cost.

5.1 Term Insurance

Term insurance provides coverage for a specific time period. The time period is frequently one year but can be as long as to age sixty-five. If the insured dies during the time period covered, the insurer pays the beneficiaries the face amount of the policy.

Term insurance is initially less expensive than whole or universal life insurance. Premiums increase as the insured gets older, but as a rule, annual premiums will stay constant during each policy term, at least with the shorter-term policies. The insurance company may guarantee that it will renew the policy for another term without requiring that the insured show insurability. Many term policies are convertible to permanent types of policies without evidence of insurability.

5.1.1 Select and ultimate pricing

Some companies have adopted "select and ultimate" pricing, whereby a new policyholder gets a price break and pays less than existing policyholders of the same age who are renewing their policies. Purchasers should use caution with this type of arrangement because the insured ultimately pays for the coverage one way or another. Over a long term, the cost tends to stabilize to much the same level that a renewing insured pays. Companies also offer revertible policies that require the insured to take a medical exam at each renewal. The insured who passes the exam gets a lower rate than is normally charged. The insured who does not pass, however, will have to pay the often steeply increasing regular premium.

5.1.2 Death benefits

Most term policies offer death benefits only, without any savings element. During the term, the face amount of the coverage usually remains constant, although it can increase or decrease. Usually, a policy with a changing face amount is purchased to cover a specific contingency the insured wants to protect against should death occur. For example, credit life insurance, bought to cover a mortgage, would decrease the death benefit as the outstanding balance of the loan decreases.

5.1.3 Term policy features

A policyholder can purchase many features in a term policy although not all are necessarily unique to term policies. The following may be considered.

- A convertible policy allows the insured to convert the term policy to a cash-value policy such as whole or universal.
- Participating policies, which are issued mostly by mutual companies, pay dividends.
- A nonparticipating policy, usually issued by a stock company, does not pay dividends.
- A waiver-of-premium rider pays for the premiums if the insured becomes unable to pay because of disability; however, this will increase the cost of the policy.
- Accidental death benefits pay double or triple the face amount of the policy within a specific time period after the accident if the insured dies of accidental causes. This also increases the cost of the policy.

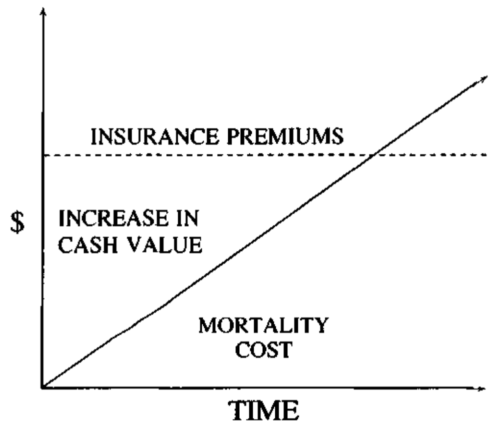
Term policies can be considered the most basic life insurance coverage available. Term coverage is low-cost and does not have any fringe benefits. Term insurance may not provide all the investment features an insured may want. Whole life and universal life are popular among purchasers who want more than simple death benefit protection, and are seeking an investment vehicle.

5.2 Whole Life Insurance

A whole life policy, or a "cash-value policy," allows the insured to cash in the value of the policy. The policy is designed to cover the insured's entire life. It has two basic elements, death benefit and cash value.

5.2.1 Whole life premiums

A whole life premium usually remains constant through the entire life of the policy, because a portion represents the mortality cost and the excess premium builds the cash value. The premium during the early years of the policy exceeds the actual cost of the protection. This inequity, however, is gradually reduced and eventually reversed in the later years of the policy by using a part of the cash value to fund the mortality cost. The insured, in essence, overpays in the early years and underpays in the later years.



Whole life policies are initially more expensive than term policies. For example, a thirty-five-year-old man purchasing a whole life policy might pay two thousand dollars a year for a $200,000 whole life policy, whereas his initial annual premium for a top-rated term policy of equal face value would start at several hundred dollars. Whole life policies, however, offer other elements that are attractive to consumers.

5.2.2 Cash value

Whole life policies contain an investment element in addition to mortality protection. Upon termination of the contract, policyholders can cash in the value of their policies. When the insured does so, he or she receives the cash value that has accumulated to that point from payments on the insurance. The rate of return on a cash-value policy is known as the "Linton yield." There will be a negative Linton yield during the early years of the policy because expenses charged against the policy use up most, if not all, of the accumulated cash value. The yield can rise considerably, however, during the later years of the policy. The rate of return on a whole life policy is, therefore, indefinite. To set a respectable return on the insurance investment, an insured usually must keep the policy for a substantial period of time.

Policyholders can borrow against the cash value of the policy without terminating the contract, usually at a specified interest rate. If the insured dies or cashes in the policy, the amount received by the beneficiary or the insured will be reduced by the amount due on the loan.

5.2.3 Dividends

Whole life policies, like term policies, can be participating or nonparticipating. If the policy is participating (that is, if it pays dividends), the amount of dividend each policyholder receives is determined by the age of the policyholder, how long the policy has been in effect, and the kind of policy each insured holds. Dividends are usually paid annually and in certain amounts per thousand dollars of coverage. For example, if an insured had a $100,000 policy and the insurer declared a dividend of $2, the insured would receive $200. The dividends may be paid in cash, used to purchase insurance, or added to the cash value of the policy. Interest earned on accumulated dividends, which are not used to purchase additional paid-up insurance, is generally taxable to the policyholder.

5.2.4 Tax benefits

Whole life policyholders can realize special tax benefits from a whole life policy. Currently, the cash-value buildup in a whole life policy is

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tax-deferred and partially tax-sheltered. The insured need not pay tax on the cash-value increase of the policy until it is withdrawn. When the money is withdrawn, only the portion that exceeds what the insured paid in premiums minus dividends received is taxable. In addition, life insurance dividends are not taxable. For tax purposes, dividends are considered a refund of a prior overcharge.

5.3 Universal Life Insurance

In many ways, universal life insurance offers the best of term and whole life policies. Younger individuals with greater insurable risks can obtain low-cost coverage, whereas older individuals can look more toward the retirement planning aspect of the cash value. The insured receives an annual statement detailing the amount of death-benefit protection, the cash value, and the premiums paid. The annual premium is credited to the insured's account, then deductions are made for the insurance protection and company expenses. What then remains is the cash value of the policy.

Policyholders may borrow against the account, and can withdraw all or part of the cash value. As with whole life insurance, policyholders are not taxed on the cash-value increase until the amount is withdrawn. The insured is then taxed only to the extent that the value paid exceeds the premiums paid throughout the life of the policy.

Universal life can be purchased in two forms. Option A pays only the face amount of the policy to beneficiaries at the insured's death. Option B, the more expensive policy, pays the face amount and the accumulated cash value.

5.3.1 Basic features

Most universal policies have three basic elements. First is the interest rate, which determines the amount earned on the insured's premium and investment to be credited to the insured's cash value. Usually a baseline rate will be guaranteed by the company, typically 4 or 4.5 percent. The rate may vary by action of the board of directors or by a market index ratio. Second, the mortality charge is the amount charged against the cash value to cover the insurance protection. Third, company expense is charged against the cash value, but this is usually stable throughout the life of the policy. Some companies may pay for expenses by charging a one-time policy fee of, say, $250.

5.3.2 Options

An insured has the option of changing the premium amount paid, depending on circumstances. Most often the insured can pick the premium he or she wants to pay. The insured can pay the target premium, which is an amount established by the company. The insured can also pay less than the target amount, but if that amount falls low enough, no cash value will accumulate and the policy will be much like a term policy. Insureds can also pay more than the target premium, up to a point, in which case the insured may not be required to pay premiums for a certain time period.

Unlike whole life contracts that require a separate policy for additional purchased coverage, a universal policyholder can also increase coverage, within limits. If the policyholder does so, the same premium can be paid, but the cash value of the policy will rise more slowly. The important thing to remember with the last two options is that, somewhere, the policyholder will pay for the coverage. The accumulated cash value functions as a reserve that gives the insured and the company the ability to decrease premiums, increase coverage, and charge for mortality protection and expenses.

5.3.3 Unique features

Some universal life policies have unique features. As mentioned above, some policies have minimum-interest guarantees of 4 to 4.5 percent. Policyholders can borrow against the policy at a fixed or a variable rate. Some companies guarantee that the policy will not lapse during the early years of the policy, provided the minimum premiums are paid.

Some companies do not credit premium payments to the policy until the end of each month, which is comparable to a bank holding a deposit for several days before crediting it to the account.

Policies that have a guaranteed interest rate sometimes also have an excess-interest penalty. Any interest paid by the company on the cash value that is above the guaranteed rate is forfeited by the insured upon surrendering the policy for cash. Finally, some companies limit the percentage of cash value policyholders can withdraw within a certain time period.

5.3.4 Variable universal life

One of the newest offshoots of universal life is variable universal, sometimes called variable adjustable. Under a variable policy, the insured may choose the type of investment that earns a return on the cash value. The insured's policy is then paid whatever yield that particular underlying investment earns. The insured is essentially taking the risk of a good or bad investment, with the cash value and the insurance protection at risk from a bad investment. To mitigate the impact that such a situation might have, some companies guarantee to keep the policy in force for the first few years and pay a death benefit even if the cash value is insufficient to pay the cost of the insurance.

Investment options for variable policies normally include equity and bond mutual funds, as well as money market funds. Policyholders generally have the opportunity to periodically change investment vehicles as they perceive changes occurring in the financial markets. Accordingly, variable policies are often viewed as important retirement planning tools in addition to the death benefit protection they afford.

5.4 Key Person Insurance

A key person life insurance policy is written to insure the life of important business employees. The policy indemnifies the company for economic loss suffered from the death of a key employee. Key person insurance can be written on any employee who has special skill or knowledge, such as sole proprietors, directors, officers, managers, salespeople, and department heads.

The insurance pays for costs to keep the business going, recruiting and training a replacement, and for other problems that arise from the loss of a key employee. The amount of insurance usually purchased is three to five times the key person's annual salary. It is not uncommon, however, for a corporation to insure its executives for millions of dollars.

5.5 Group Term Plans

The other major type of business life insurance is the employee group plan. Group life insurance is usually provided through group term insurance. It can usually be written to include spouses and dependents of the group members.

5.5.1 Basic characteristics

Group term insurance normally requires a minimum of ten people under one contract, and coverage is usually provided without regard to individual insurability. Premiums are based on the characteristics of the group so that a policy covering older people would be more expensive than one covering younger people. Individuals within the group may not choose their benefit level.

Most group term insurance is one-year renewable term insurance. Premiums are most often paid by the employer, although employees may be required to pay a small part. Individuals in the group generally lose the coverage when they leave their employment, but most states have statutes that require that the resigning employee have the option to convert the plan to an individual policy upon resignation. The coverage is automatically continued in force for a thirty-day period. Employees may not be required to show evidence of insurability.

5.5.2 Group permanent life

Some group life insurance policies provide "permanent" rather than term coverage. In essence, this policy is a group form of a cash-value policy such as whole or universal life. The cash and nonforfeiture values in permanent life are available to employees to supplement a retirement plan. Group permanent life insurance makes up only a very small percentage of the total employer plans written. Employer contributions to a permanent life insurance policy may be taxable in part, as imputed income to the employee.

5.5.3 Noncontributory plans

Group life insurance is underwritten on the basis of the whole group and may be either contributory or noncontributory. A noncontributory plan requires no contribution from the employee to the cost of the policy. These individuals are therefore not allowed a choice as to whether they will be covered; coverage is automatic.

5.5.4 Contributory plans

A contributory plan requires employees to pay a portion of the insurance premium. Under a contributory plan, 75 percent of all eligible employees must choose to participate in the plan. This requirement protects the insurer from adverse selection, the tendency of the employees in poorer health to participate in the plan.

5.5.5 Amount of coverage

The amount of insurance an employee is provided usually depends upon the employee's salary and job class. Only a few states still limit the amount of coverage that can be written under a group plan. Employees who are provided with more than $50,000 in group term insurance coverage must annually include in income an amount determined, by reference to the IRS table defined at Regulation Section 1.79-3(d)(2), to be the value of the coverage that exceeds $50,000.

5.6 Single-Premium Policies

Single-premium policies provide life insurance plus a pool of savings dollars to invest. Single-premium policies pay variable market interest rates, or may wrap insurance around other investment vehicles such as stocks, bonds, and mutual funds.

Single-premium policies are available for whole life insurance, under which an interest rate for the savings dollars is declared by the company. These rates are changed at various intervals, normally once a year. Variable life insurance policies also offer the single-premium option. Under these policies, the individual is allowed to pick from a variety of investment alternatives.

Earnings on single-premium policies, as on other life insurance policies, are currently tax-deferred. If certain limitations regarding funding are met, the earnings may be withdrawn tax free by borrowing against the policy. Any borrowings are deducted from the value of the policy upon death.

For insurance contracts entered into after June 20, 1988, the Technical and Miscellaneous Revenue Act of 1988 restricts the ability to take tax-free withdrawals and tax-free loans against certain single-premium policies. Special rules apply to life insurance contracts funded at a more rapid rate than that allowed by the payment of seven level annual premiums. Pre-death distributions are treated as income first and then as recovered basis. Loans are treated as distributions, and an additional 10 percent early withdrawal penalty would be imposed unless the distribution occurs on account of disability or when the taxpayer is age fifty-nine-and-a-half or older.

Most companies do have a surrender charge if a single-premium policy is canceled in the first few years. Upon cancellation, the earnings of the policy will be taxed.

Single-premium policies, which were available in a variety of alternatives, have lost some of their popularity. Investment fees are often included in single-premium policies, and the net rate of return, rather than the gross rate of return, should always be analyzed.

5.7 Split Dollar Life Insurance Arrangements

A split dollar life insurance arrangement is generally one in which an employer pays premiums for insurance on the life of an employee, and the employer and employee's beneficiaries split the insurance proceeds upon the death of the employee (with the employer generally recovering the cost of the premiums it paid, and the employee's beneficiaries keeping the remainder). Before 1996, the employee was taxed only on the portion of the premium paid by the employer equal to the one year term insurance rate (this amount is also known as the P.S. 58 cost). As a result of those rules, split dollar life insurance became a very attractive investment vehicle for senior executives. The IRS became concerned that split dollar life insurance transactions were becoming abusive and, beginning in 1996, issued a series of rulings intended to reduce the tax benefits of split dollar life insurance.

The IRS rulings culminated in regulations issued in 2003 (see Treas. Reg. Sec. 1.61-22). The final regulations govern split dollar life insurance arrangements that are entered into or materially modified after September 17, 2003. Under the final regulations, split dollar life insurance transactions are taxed under one of two regimes—the economic benefit regime or the loan regime—depending upon whether the employer or the employee is the owner of the life insurance policy.

If the employer owns the life insurance policy, the transaction is taxed under the economic benefit regime. Under that regime, the employee is taxed on the economic benefit of the life insurance coverage (generally determined under actuarial tables). Depending on the facts and circumstances, the benefit may be taxed as compensation, a dividend, a gift, or otherwise.

If the employee owns the life insurance policy, the transaction is taxed under the loan regime. Under that regime, each premium paid by the employer is treated as a separate loan to the employee, with interest payable at a rate at least equal to the applicable federal rate.

Note that, if the insurance policy is owned by a life insurance trust, premium payments may be treated as taxable gifts, and the insurance proceeds may be includible in the decedent's gross estate.

5.8 Second-to-Die Life Insurance

This type of life insurance policy names a married couple as joint insureds and pays the death benefit only upon the death of the second spouse. The premiums are significantly lower because of the two-death requirement. This policy variation is becoming popular because current federal estate tax law provides an unlimited marital deduction, which effectively delays payment of any estate tax until the second spouse dies. Estate planners often recommend life insurance to provide cash to pay estate taxes and prevent the sale of nonliquid assets. If the policy is owned by the decedents it is considered part of their estate, so an irrevocable life insurance trust may be established to hold the policy in its name and receive the proceeds. (See the chapter on Trusts, herein).

5.9 Living Benefits Insurance

Most insurance companies now offer *living benefits* or *accelerated benefits* coverage as an attachment to their whole life and universal life insurance policies. This alternative allows a terminally ill insured to withdraw part of the future death benefit to pay for large medical expenses. Insureds with extended stays in nursing homes also may withdraw funds to pay for these expenses. The sum eventually received by the beneficiaries is reduced by the amount withdrawn. Favorable tax treatment is awarded to pre-death withdrawals by some terminally ill insureds.

5.10 Annuities

Although not an insurance contract directly, annuities are products marketed through insurance companies that enjoy some of the tax privileges of cash value life insurance products. Annuities allow investors to establish a retirement plan while providing a tax-sheltered investment. They can be purchased in a lump sum or through a series of premium payments. Tax-deferred annuities present a valuable long-term investment option. They allow the investor to earn interest on the principal tax-deferred until the investor withdraws certain amounts or begins to receive payments under the annuity. Reference the chapter on Investment Vehicles for a more thorough discussion of annuity investments.

6. PROPERTY INSURANCE

Property insurance indemnifies against loss resulting from destruction of or damage to the insured's property or from its disappearance through theft. Property insurance can be purchased to cover real and personal property, the cost of reconstructing valuable papers, computer files, and accounts receivable, and expenses to keep a business operating after damage to buildings and equipment. Loss of income because of property damage or destruction can also be covered under property insurance.

There are two distinct areas of property insurance. One addresses direct losses, such as buildings, contents, and other tangible items. The second area addresses indirect losses, such as loss of income, loss of rents, and extra expenses. In many cases, the indirect loss may exceed the direct loss. For example, a retail commercial or manufacturing establishment may have a building fire that does substantial damage to the building (say $100,000), but by the time the owner can rebuild, substantial income has been lost (perhaps $200,000).

6.1 Perils/Property Commonly Insured

The perils and property of an insured will depend in part on the type of business the insured operates, the property owned, and the perils likely to be encountered by the insured. Property insurance is available on a named-peril basis, broad-form basis, or comprehensive basis.

6.1.1 Named-peril policies

Named-peril coverage insures against damage caused by listed perils such as fire, lightning, wind, hail, explosion, riot, smoke, aircraft, non-owned vehicles, and vandalism. On a named-peril policy, only the perils specifically listed are covered.

6.1.2 Broad-form policies

Broad-form or optional-perils policies provide coverage for the base perils listed above, in addition to damage by water; glass breakage; weight of ice, snow, or sleet; falling objects; and damage by owned vehicles.

6.1.3 Comprehensive perils

Comprehensive perils policies insure the insured against risk of physical loss from all perils, except those specifically excluded in the policy. The additional perils usually covered in addition to those covered by the named-peril and broad-form policies are theft, collapse, sewer back-up, earthquake, electrical damage, spillage of chemicals, and scorching.

Nonowned and hired auto coverage can be endorsed to a policy covering owned vehicles, rather than requiring a separate nonowned and hired automobile policy. It is normally much less expensive to simply add this as an endorsement to a policy covering owned vehicles. If the employer does not own any vehicles, this coverage may be added to the general liability policy.

6.1.4 Automobile liability coverage

Most businesses and individuals carry policies to protect against liability arising from automobile accidents. Such policies normally cover both liability and property damage and offer optional coverage for medical expenses.

Businesses should closely review the liability coverage amounts on policies to assure that single and aggregate liability coverages are adequate.

6.1.5 Nonowned and hired cars automobile liability

If an employee uses his or her personal car on company business and causes bodily injury or property damage to another party, the employer will most likely be named as a party in any ensuing lawsuit. Nonowned and hired cars automobile liability insurance gives the employer protection in such a situation. Additionally, excess liability coverage (see section 7.4) will not protect an employee in this situation unless there is primary nonowned and hired cars coverage.

Nonowned and hired auto coverage can be endorsed to a policy covering owned vehicles, rather than requiring a separate nonowned and hired automobile policy. It is normally much less expensive to simply add this as an endorsement to a policy covering owned vehicles. If the employer does not own any vehicles, this coverage may be added to the general liability policy.

6.1.6 Drive other car endorsement (DOC)

This endorsement to a commercial auto policy is necessary when and if an owner, partner, or officer of the business does not have a personal auto policy and the only auto available to the owner, partner, or officer is a company car. Auto insurance follows the vehicle, so if the owner, partner, or officer borrows a friend's auto and has an at-fault accident, the friend's auto policy will not cover the owner, partner, or officer. In addition, a commercial auto policy will not respond to liability, unless the DOC endorsement is made a part of the policy.

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6.1.7 Commercial inland marine

Commercial inland marine coverages can be extremely important to certain businesses in order to cover personal property off premises, or in transit, such as equipment, motor truck cargo, and electronic data processing equipment. Normal property coverage covers property only on, in, or within 100 feet of the insured premises.

6.2 Amount of Insurance

An important question to purchasers of property insurance is the amount to buy. The answer depends on the needs of the insured and the type of property to be insured. The first decision is whether to insure for actual cash value or for replacement cost.

6.2.1 Actual cash value

Actual cash value is the replacement cost of the lost or damaged property minus the decline in value because of age and normal wear and tear. For example, if it costs $50,000 to rebuild a damaged or destroyed building that is seventy-five years old and only in fair condition, the insurer will pay a cash amount that is much lower than the $50,000 replacement cost because of the decline in value because of age and condition of the building. Actual cash value puts the insured in the same financial condition with respect to the property after the loss as before the loss.

6.2.2 Replacement cost

Replacement cost covers the cost of replacing the property or goods without deduction for decline in value. Replacement cost cannot be added to a policy unless there is first 80 percent or higher co-insurance or agreed-value endorsement (see section 6.2.4 of this chapter). Replacement-cost policies usually require that the insured actually replace the property. The insured will be covered to replace, repair, or rebuild with like materials and labor. If the insured does not replace the property, the insured will be paid the actual cash value.

The insured must also decide what amount of coverage to purchase. Buildings should be appraised to determine both actual-cash-value and replacement-cost amounts. An inventory of personal property and equipment should include not only furniture and fixtures but also consumable supplies.

6.2.3 Co-insurance

Most insurance policies include a provision that penalizes the insured who fails to purchase coverage at a minimum percentage of the value of the insured item, a provision known as the co-insurance clause. The minimum percentage is 80 percent on direct damage, but can be as low as 50 percent for indirect damage. For example, in purchasing insurance to cover property valued at $100,000, if the co-insurance percentage is 80 percent, the insured should purchase at least $80,000 of insurance so that the insurer will pay 100 percent of any loss up to the $80,000 maximum. Co-insurance is a prerequisite to replacement cost (see section 6.2.2 of this chapter), agreed-value endorsement (section 6.2.4), and inflation guard coverage (section 6.2.5).

If the insured fails to insure at least to the minimum co-insurance percentage, the company will pay an amount that is a percentage of the actual amount purchased. The insured, in effect, becomes co-insurer for the uncovered amount. For example, if the insured chooses to insure 50 percent of the value, and the co-insurance percentage is 80 percent, the insurer will pay, as determined by a formula, 50 percent over 80 percent or five-eighths of the claim. One effective strategy to deal with co-insurance provisions is to purchase insurance for more than the co-insurance percentage multiplied by the property value. The reason is that the property value is the value at the time of the loss, unless an agreed-value endorsement, as described next, applies.

6.2.4 Agreed-value endorsement

Some insurance companies may allow the insured to insure the property on an agreed-value basis. This is done through an appraisal and an attached agreed-value endorsement. This agreement provides that the amount of insurance purchased is equal to the value of the property. Agreed-value provisions help avoid disputes as to the value of the property at the time of loss.

6.2.5 Inflation guard coverage

Another option is the automatic-increase endorsement that can be added to a policy. It provides for automatic increases in the amount of insurance to keep pace with inflation. Inflation guard coverage can be added to apply to buildings, contents, or both. The current minimum annual percentage is 4 percent, although higher percentages are available in 2-percent increments, such as 6 percent, 8 percent, and so forth. The annual percentage increases the policy amount and applies pro-rata on a daily basis. As an example, a $100,000 policy on a building with a 10-percent inflation guard would pay $101,640 if a total loss occurs sixty days into the policy. This is computed by taking 60/365 of 10 percent, which computes to 1.64 percent. This inflation guard amount is then multiplied by the insurance amount, computing an inflation guard amount of $1,640. When added to the initial insurance of $100,000, this produces the loss payment amount of $101,640.

6.3 Deductibles

Most property insurance policies have deductibles. Deductible amounts may vary widely; however, a common deductible is $250 per occurrence. Generally, the amount of the premium decreases as the amount of the deductible increases.

6.4 Insurable Interest

Insurable interest is important in property insurance. To have an enforceable contract, insurable interest requires that the insured have some kind of interest in the insured property. Requiring that the insured have a stake in the insured property avoids both wagering and the risk of failure to protect the property from harm. Insurable interest will usually be found to exist if the insured stands to suffer a financial loss from damage to the property. There is no middle ground; either an insurable interest exists or it does not. However, the amount depends upon the value of the insurable interest to the insured.

Insurable interest must exist at the time of loss. An insured may have an insurable interest when the policy is purchased but not have one when a loss occurs. Under the insurable-interest theory, one who has sold, lost, or transferred property no longer will suffer loss upon damage to the property, and the insurable interest is extinguished.

6.5 Increase in Risk

Insurance companies provide insurance by shifting the risk from the insured to the insurer. Premiums and policy provisions are based on assuming certain kinds and levels of risk. Any factor that increases that level of risk represents a potentially unacceptable risk to the insurer for the premium being paid.

Homeowners insurance assumes that the insured home is owner-occupied, at least for a certain percentage of the time. Premiums for owner-occupied versus vacant homes are quite different. If a homeowner insured by a homeowners policy later left the property vacant, the inherent increase in risk may be unacceptable to the insurer and the insurer may not be legally bound to cover the insured for the increased risk.

7. LIABILITY INSURANCE

Liability insurance is unlike other types of insurance in that it provides a direct benefit not to the insured but to a third party. Liability insurance pays on behalf of the insured for claims for damages, which the insured is legally obligated to pay to a third party, for bodily injury, property damage, personal injury, and other legal liabilities that may arise from the operations of the insured's business.

Many types of liability insurance are available, including

- General liability.
- Product liability.
- Professional liability.
- Malpractice liability.
- Errors and omissions liability.
- Excess liability.
- Director's/officer's liability.

7.1 Occurrence Policies

Traditionally, coverage to third parties under a liability policy has been made on an occurrence basis. This means that the claim is paid by the insurance company that insured the business when the accident or injury occurred. Thus, if a person is injured on the insured's premises but does not file a claim until four years later, the parties would look to the coverage provided at the time of the injury.

The occurrence policy has caused problems because situations such as that just described brought questions as to who was the insurer at the time of the injury, what were the policy limits, and whether the insurer is still in business. This is one reason that "claims-made" policies have become somewhat popular in recent years, especially for professional malpractice policies.

7.2 Claims-Made Policies

A claims-made policy responds when the claim is made or reported, unless, as explained below, the policy includes a retroactive date. The insurer that covers the company when the claim is made is liable (regardless of when the injury actually occurred). An insurance company could thus potentially have to provide coverage for an insured for claims that arose many years before that insurer first covered the insured.

Claims-made policies are controversial. A change in insurers by a business could result in a gap during which it is unclear whether coverage exists. If a claims-made policy is retroactive for five years, it will not pay for claims made for injuries occurring more than five years before the effective date of the policy. This approach may result in a coverage gap, and the insured may have to bear the consequences.

A policy provision known as "extended report date" or "tail" coverage can reduce or eliminate the gap created by switching claims-made liability insurance policies. A tail provision allows the insured to ask for extended coverage for claims that arise after the cancellation (except for nonpayment of premium) of the policy, extending coverage under the policy for one extra reporting period. The tail period may range from sixty days to an unlimited period of time, depending on the policy provision. A predetermined premium will be charged for the tail.

Gaps in coverage occur when

— The expiring policy is a claims-made policy and the replacement policy is a claims-made policy with a retroactive date later than the retroactive date of the expiring policy.

> *Example:* Under expiring claims-made policy A, retroactive to January 1, 20X1, Jane is covered for claims made during calendar year 20X1. Replacement claims-made policy B covers Jane for claims during calendar year 20X2 provided the occurrence was after September 1, 20X1. If, in 20X2, a claim is made against Jane for an occurrence in August of 20X1, she is not covered. Thus, Jane must buy tail coverage for her expiring policy to cover occurrences between January 1, 20X1, and August 31, 20X1.

— The expiring policy is a claims-made policy and the replacement policy is an occurrence policy.

> *Example:* Under expiring claims-made policy A, Jane is covered for claims made during calendar year 20X1. Replacement occurrence policy B covers Jane for claims based on occurrences in calendar year 20X2. Once policy A expires, Jane is without coverage for 20X2 claims based on 20X1 occurrences. Thus, Jane must buy tail coverage for her expiring policy to protect herself against such claims.

If the expiring policy is an occurrence policy or if the replacement policy is a claims-made policy with the same retroactive date as the expiring policy, no gap in coverage occurs.

7.3 General Liability Policies

Most general liability policies are known as commercial general liability. Formerly, these policies were known as comprehensive general liability.

The coverage contents of the two policies are roughly the same. The general liability policy covers

— Bodily injury to persons or damage to property from the business premises and operations.

— Injury or property damage arising from the use of a product or service provided by the business.

— Coverage for risks of businesses engaged in high-risk operations, such as risk of explosion, collapse, or underground hazards.

— Injuries or claims arising from personal injury, where personal injury means injury, other than "bodily injury" arising out of one or more of the following offenses:

- False arrest, detention, or imprisonment
- Malicious prosecution
- Wrongful entry into, or eviction from, a room, dwelling, or premises that the person occupies
- Oral or written publication of material that slanders or libels a person or an organization or disparages a person's or organization's goods, products, or services
- Oral or written publication of material that violates a person's right to privacy

— Medical payments for injuries incurred on the business premises.

— Coverage for fire damage to the occupied portion of a landlord's building.

Automobile liability and workers' compensation must be separately insured because they are not included in a general liability policy. There are a few other coverages for special situations, such as injuries arising from a company-hosted event with liquor served or from a company-sponsored entertainment on a boat. Newly acquired organizations also are generally automatically covered by the general liability policy.

As with all other insurance, liability has coverage limits: the occurrence limit and the aggregate limit. The aggregate limit, which is the aggregate amount the insurer will pay for the coverage provided during the policy period, is often double the occurrence limit. The occurrence limit is usually set by the insured and the insurer, and is based on the level of risk and other needs of the insured.

The aggregate limit is reduced by each occurrence that requires a coverage payment. Thus, if an insured has an occurrence limit of \$500,000, its aggregate limit could be \$1 million. If the insured then had three claims of \$300,000 each, the aggregate would be reduced to \$100,000. If a liability claim from a later occurrence exceeds the remaining $100,000, the insured would be covered only up to $100,000 and would have to turn to an excess or umbrella liability policy to cover the balance of the claim. Some insurance companies, however, offer an aggregate greater than twice the occurrence amount.

Although professional liability policies are often considered and included in general liability policies, they are actually separate types of policies and are almost exclusively written on a claims-made basis. Examples of professional liability coverage include medical malpractice, malpractice insurance for architects and engineers, errors and omissions insurance for insurance agents, professional liability insurance for accountants, and professional liability insurance for attorneys.

7.4 Excess-Liability Policies

Excess-liability policies cover an insured for exposures that exceed the primary liability limits. Excess liability is sometimes sold in a specialty insurance market. For this reason businesses should investigate potential excess insurers before purchasing from them.

Excess policies tend to track the primary policy in coverage conditions, definitions, and exclusions. Excess insurers like to insure policyholders with high primary-insurance limits. Therefore, the cost of excess insurance tends to be lower when the insured has high primary-policy limits.

Excess liability "layers" insurance coverages. There is no coverage until the prior layer has been exhausted. Many companies purchase more than one level of excess coverage. This approach should be strongly considered, given the increasingly high verdicts that juries are awarding.

Excess-liability policies cover high limits of liability protection with very broad coverage provisions. The excess-liability policy provides excess coverage for general liability, automobile liability, and employer's liability and usually will cover many exclusions and gaps in the primary liability policy.

Excess-liability insurers generally require assurance that the insured maintains a certain level of primary general liability, auto liability, and employer's liability coverage. Here again, certain limits on primary coverage are required. Finally, most excess-liability policies have a self-insurance provision that operates like a deductible. This amount is frequently $10,000 or more. This amount usually applies to losses not covered under the primary coverage.

Although the typical excess-liability policy provides very broad coverage, there are a number of standard exclusions. These exclusions should be examined by the insured who is purchasing a given policy to determine whether or not they are acceptable. It is not unusual for companies to purchase multimillion-dollar excess-liability policies.

8. EMPLOYEE BONDING

Employee bonding covers losses due to dishonesty and fraud committed by employees. Fidelity bonds cover losses up to the policy limits.

8.1. Fidelity Bonds

There are two types of fidelity bonds: individual and blanket.

8.1.1 Individual bonds

Individual or name-position bonds cover only the individuals specified in the bond. Collection under this type of bond is dependent on proving that the named individual committed the dishonest act. The insured must inform the company if the persons named in the bond leave employment. The insured must also be able to determine, in advance, which individuals are in situations in which dishonesty is possible.

8.1.2 Blanket bonds

A blanket bond covers all employees, with the premium based upon the number of employees who have access to money or property. A commercial blanket bond pays a flat amount specified in the policy. For example, if a bond has a face amount of $50,000 and three employees acting together steal $100,000, the maximum the insured can recover is $50,000.

8.1.3 Bonding coverage

Bonds cover only employees, or those who work regularly for the employer and are paid a wage or salary. Nonemployees who handle money or sign checks can be covered under special riders. The amount of insurance to purchase depends on the total budget, built-in accounting controls, and security procedures of the insured. There is no standard or set amount.

8.1.4 Exclusions

Fidelity bonds commonly have two exclusions or limitations. First, there must be proof of a real loss and a reasonable certainty that the money or property was stolen by an employee, not a member of the general public or other nonemployee.

A second restriction often imposes limits on the ability of the employer to retain an employee once a theft has been discovered. If such an employee is allowed to continue employment with the business, coverage ceases immediately. If an employer keeps an employee on duty because of a promise to pay back or for some other reason, coverage will end for that individual only.

8.2 Combination Crime Policies

The combination crime policy combines fidelity bond coverage with other coverage. Fidelity bond coverage is the basic coverage in such a policy. In addition, however, these policies cover loss through burglary, robbery, and the disappearance or destruction of money and securities. Coverage is provided for these losses both inside and outside the premises.

This policy, in essence, covers all losses described in the policy, whereas the fidelity bond covers acts of employees. The amount of coverage is purchased on the basis of potential loss inside and outside, the amounts of cash and property at risk, and the number of employees to be covered by the fidelity bond. As with fidelity bonds, deductibles are not usually required, although the insured may arrange one if desired.

9. SOCIAL SECURITY

Social Security, or Old Age, Survivors, Disability, and Health Insurance (OASDHI), is the only federally funded social insurance plan. OASDHI was established as one of the basic parts of the Social Security Act, first passed in 1935. Companion programs under the act include Medicaid, Aid to Families with Dependent Children (AFDC), Unemployment Insurance, and Supplemental Security Income (SSI).

Social Security provides benefits upon retirement, for disability and survivors of insured individuals, medical care and catastrophic health care coverage for the aged through Medicare and Medicaid, and public assistance through Supplemental Security Income for the needy and disabled. (Social Security is covered in detail in another chapter of this manual as is unemployment insurance.)

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Trusts

TRUSTS

1. TRUST FORMATION

A trust is a legal arrangement whereby one person (the trustee) owns property but holds and manages it for the benefit of someone else (the beneficiary).

1.1 General Concept

A trust can be a valuable tool for arranging for the disposition of an individual's wealth. A trust is legally defined as "a fiduciary relationship with respect to property, subjecting a person by whom the property is held to equitable duties to deal with the property for the benefit of another person, which arises as a result of a manifestation of an intention to create it."

The Internal Revenue Code contains no specific definition of trust, but Treasury Regulations Section 301.7701-4(a) provides: "in general, the term *trust* as used in the Internal Revenue Code refers to an arrangement created by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts."

Typically, the creation of a trust involves three parties:

— The *grantor,* sometimes referred to as the settlor or donor, creates and funds the trust and establishes the fiduciary relationship.

— The *trustee,* a fiduciary, holds legal title to the property for the benefit of another. The trustee may be an individual or corporation.

— The *beneficiary* or beneficiaries are entitled to all the income and principal of the trust.

Usually the trust comes into being by an agreement between the grantor and the trustee. The agreement is usually referred to as the trust instrument or trust indenture. The trust property is usually called the *corpus* or *principal* of the trust. Even though there are at least three parties to a trust, they are not necessarily different legal entities. For example, the grantor of a trust also may be a trustee; a beneficiary may be one of the trustees; and the grantor may also be a beneficiary. In many states at least two different legal parties are necessary for a valid trust.

1.2 Reasons for Trust Creation

Trusts are set up to satisfy the needs and wishes of the grantor to provide for others, conserve property, and so forth. Beneficiaries' needs may or may not be involved. Grantors of trusts may also be primary beneficiaries and establish trusts in order to (1) obtain professional investment management and relieve themselves of the burden of managing their property or (2) avoid probate by putting their assets into a trust and managing their own property during their lifetime through the trust (see section 3.7).

A trust can be created for the benefit of family members or others, and may provide any of the following:

- Assurance that income will continue after the death of the grantor by providing professional management of assets.
- Tax advantages by transferring income-producing property to someone in a lower income tax bracket (except for children under the age of fourteen).
- Independent income to a beneficiary to permit pursuit of a career that may not be particularly remunerative.
- Elimination of guardianship for minor's assets.
- Protection for minors, spendthrifts, and disabled persons.
- A spouse's lifetime beneficial use of income-producing property without subjecting the property to estate tax at the spouse's death.

2. TYPES OF PERSONAL TRUSTS

2.1 Testamentary Trusts

A testamentary trust is created in the grantor's last will and testament. Since it is the will that creates the testamentary trust, the trust does not come into existence until the death of the testator and is not effective until the estate has been probated. The probate assets of the decedent's estate are normally used to fund the trust. However, other assets such as life insurance proceeds or death benefits from a qualified retirement plan can be made payable to the testamentary trust. A testamentary trust can be changed by revoking or amending the will that establishes it as long as the testator is alive and competent.

2.2 Inter Vivos Trusts

An inter vivos trust, sometimes referred to as a *living trust,* is created during the lifetime of the grantor. It can provide that the grantor be the income beneficiary or it can pass property to other beneficiaries either at the time the trust is set up or upon the death of the primary beneficiary. An inter vivos trust can be either revocable or irrevocable. An inter vivos trust usually becomes irrevocable upon the grantor's death.

2.2.1 Revocable trusts

A revocable trust grants an individual or a group of people the right to change or terminate the trust. Most frequently this right is given solely to the grantor of the trust, which gives the grantor the flexibility of change during his or her lifetime. Since the grantor has retained the right to change the trust, a gift is not considered to have been completed for gift tax purposes. The assets of the revocable trust will be included in the grantor's taxable estate, because it is treated as if the grantor never parted with them. Most states presume a trust to be revocable if the trust instrument is silent as to revocability. Other states presume the trust to be irrevocable unless declared expressly to be revocable. It is therefore important to declare in the trust instrument itself whether or not it is revocable.

2.2.2 Irrevocable trusts

An inter vivos trust that cannot be changed is called an irrevocable trust. Such trusts can only be altered by court action or in certain circumstances whereby all the persons beneficially interested in the trust agree in writing to the change. Obtaining written consent from infant and charitable beneficiaries is problematic. When the grantor funds an irrevocable trust, a taxable gift often results because the grantor is giving up all control over the trust property and cannot alter the terms of the trust once he or she signs the trust instrument.

An irrevocable trust can be used to save estate taxes. If the grantor gives up all rights in and all control over the trust assets, such assets and the income earned thereon may not be included in the grantor's taxable estate. If the trust contains a provision allowing the trustee to lend money to the estate or to buy assets from the estate, the trust may be used to help pay estate taxes without being included in the taxable estate. An irrevocable trust can also be used to save on income taxes by transferring income to a beneficiary who is in a lower tax bracket.

It is important to remember that the tax basis of the assets transferred to the trust is normally the same as the grantor's tax basis. When the grantor dies there is no step-up in basis. See section 2.5.1 of the chapter on Estate Planning.

2.2.3 Reversionary trusts

A reversionary trust is basically a trust, for a term of years or a period measured by one's life, in which the property is used for a specific beneficiary and then—upon the expiration of the time period or at the beneficiary's death—reverts to the grantor or the grantor's spouse. The Clifford trust, based on the famous case *Helvering v. Clifford,* 309 U.S. 331 (1940), established a minimum duration of ten years before the assets are returned to the grantor to shift the tax on the trust income to a beneficiary. (The Clifford rule is a federal tax concept and is not to be confused with state law, which allows such reversionary trusts without time limits.) An alternative to the popular Clifford trust is the spousal remainder trust, in which the income is shifted to a beneficiary for fewer than ten years, with the remainder irrevocably transferred to the grantor's spouse thereafter. Under the Tax Reform Act of 1986 certain reversionary trusts will be considered grantor trusts and therefore will not accomplish any of the tax savings that were available before passage of that law (see section 5.1.1 for a discussion of the income tax rules on reversionary trusts). See Appendix 1, "Assignment of Assets," and Appendix 2, "Client Letter on Funding," on the *Accountant's Business Manual Toolkit CD-ROM.*

3. SPECIFIC USES OF TRUSTS

3.1 Minors

Since minors cannot legally manage their own property, a trust is a valuable instrument providing for such management. Extending the trust for a period of time after the minor reaches majority allows the child to develop mature judgment before having to manage his or her own assets. In most states, when a minor reaches majority (which can be as young as eighteen), any property held for the minor in a custodian account under the Uniform Gift to Minors Act is automatically available to that person. Certain states extend the age to twenty-one, if language extending the age is in the account title at the time of the gift.

By transferring the property to a trustee for the benefit of the minor, the trust instrument could specify ages such as twenty-five and thirty for payout of a portion of the property to the beneficiary's control. Prior to the Tax Reform Act of 1986, trusts were often established for minors in order to obtain the benefits of the minors' lower income tax brackets. Under current law, if the beneficiary is under age fourteen, income tax due will be based on the parent's tax bracket, a result of the rule taxing unearned income of a child younger than fourteen in excess of $1,500 (effective in 2003) at the top tax rate of the parent.

3.2 Children and Grandchildren

Even if a child is not a minor, a trust can help a child by providing for his or her financial security for a period of years. The child has the freedom to pursue a career knowing that he or she has been made financially secure by the creation of the trust. A trust may also, depending upon state law, protect the child in case of an unsuccessful marriage in which the child's spouse makes claim for alimony, support, and division of property. A trust can be used to support a mentally retarded or otherwise incapacitated child.

If the grantor is concerned that the beneficiary will borrow against his or her interest in the principal or income of the trust, a special spendthrift provision that denies the beneficiary a right to sell or pledge his or her interest can be inserted in the trust instrument.

The validity of spendthrift trusts is premised on the grantor's right to determine how the property is used and on the grantor's right to protect the beneficiary from his or her own inability to manage money. Spendthrift provisions are not recognized in some states. Specific state law should be reviewed.

Spendthrift trusts are important for asset protection. In our highly litigious society the grantor must consider the beneficiary's potential exposure to creditors. In addition to the conventional spendthrift provision, a so-called termination provision ending a beneficiary's interest in favor of another, if the beneficiary becomes insolvent, should be considered.

3.3 Spouse

In the event of the death of the grantor, the surviving spouse may need a steady, dependable income to meet the living expenses of a family. The trust can be used not only to provide such income but also to protect the principal from being invaded. The responsibilities of investment and property management can be given to a professional, relieving the spouse of management responsibilities. Property put into trust from which a surviving spouse derives income only cannot be invaded by the spouse except as provided. In addition, this property will generally be free from marital rights of another should the spouse remarry. In most states, the property in the trust can pass directly to the deceased spouse's children or continue in trust for children without going through probate.

3.4 Life Insurance

Insurance is used to fill a variety of specific needs, such as the need

— To accumulate capital for retirement.

— To provide a fund for support of a relative.

— To provide a fund for the education of children.
— To provide liquidity in an estate.
— To prevent estate shrinkage by providing ready cash to pay debts, taxes, and expenses of estate settlement.

Life insurance proceeds are subject to estate tax if the insured owns the policy or possesses any of the indicia of ownership. (See the Estate Planning chapter for discussion of the tax treatment of life insurance.)

There is a potential gift tax if the insured, the owner, and the beneficiary are three different parties.

Example. Mary owns a $1 million insurance policy on the life of her husband, Peter, and names their child as beneficiary. When Peter dies, Mary is deemed to make a gift of $1 million to her child. (Rev. Rul. 81–166, 1981-1 C.B. 477) To avoid this problem, the child or an irrevocable trust should be the owner and beneficiary of the policy.

3.4.1 Revocable unfunded life insurance trusts

The simplest type of insurance trust is called a *revocable unfunded insurance trust.* The life insurance policy stays in the name of the insured, but the insured designates that the proceeds of the policy are to be paid to a trust that the grantor/insured created. The insured will continue paying the premiums on the insurance policy and at death the insurance will be includable in his or her taxable estate. This type of trust is set up primarily for the management of the insurance proceeds. It is flexible in that the insured can always amend the trust during his or her lifetime. Under certain circumstances, the life insurance proceeds in an irrevocable trust can be excluded from estate taxes (see sections 3.4.2 and 3.4.3).

Example. If a wife already owns the insurance on her husband's life, she can transfer the policy to a trust and become the beneficiary of the trust. Upon the death of her husband, the trust can become irrevocable. If the wife remarries, the insurance proceeds are protected from passing to a second husband upon the death of the wife.

3.4.2 Irrevocable unfunded life insurance trusts

This trust is one in which the insurance policies are assigned to an irrevocable trust for the beneficiaries. The trust instrument must state how the proceeds will be used on behalf of the trust beneficiaries. The premiums are usually paid by the grantor of the trust, who may or may not be the insured. If the insured has transferred the insurance to an irrevocable trust more than three years before death, the insurance proceeds will not be included in grantor's gross estate and may not be included in the spouse's estate upon subsequent death. The disadvantage of this type of arrangement is that the trust is irrevocable, and, therefore, the trust cannot be changed, although the grantor/insured can always stop payment of premiums and the policy will lapse.

The dollars given to the trust to pay the annual premiums are considered gifts. If the gift does not qualify for annual exclusion (see section 6.1) because the gift is one of a future interest, the grantor will be using up part of his or her unified tax credit (see Estate Planning chapter). Crummey powers (see section 6.3 herein) are usually provided to the beneficiaries in the trust instrument to enable the annual gift to qualify as a gift of present interest, therefore qualifying for annual exclusion. The lapse of a Crummey power is deemed a release of a power of appointment. It is treated as a gift to the extent it exceeds $5,000 or 5 percent of the trust principal (IRC Section 2514(e)).

3.4.3 Irrevocable funded life insurance trusts

In a funded insurance trust not only is the policy transferred into a trust but the grantor also transfers other assets such as securities or cash to the trustee. The trustee holds, manages, and invests the other assets and uses the income to pay the premium payments. If the income is used to pay premiums on the grantor's life or a spouse's life (except with respect to policies irrevocably payable for charitable purposes), that income is taxable to the grantor.

3.4.4 Current problems with life insurance trusts

Exceptionally low interest rates and the poor performance of the stock market have created a potential problem with universal life insurance policies (see section 5.3 "Universal Life Insurance," of the Insurance chapter) with irrevocable life insurance trusts. It is possible that the insurance policy may lapse or be adversely affected because the premium projections for these policies at the time of purchase are now invalid. The policy may now be underperforming because the securities that generate income to pay the policy premiums are not producing the income needed.

3.5 Business Use

A trust can be used for business purposes as an employees' trust created for the employees of a corporation (see the chapter on Employee Retirement and Deferred Compensation Plans, section 3.1). Normally the creator of the trust is the employer and the beneficiaries are certain employees of the corporation. The trustee may be an individual, bank, trust company, or committee of employees. The trust property usually consists of employer contributions, which are used to fund the trust. Basically trusts are set up for business purposes to provide employees with funds when they become incapacitated before reaching normal retirement age or to provide funds for them after they have reached retirement age. The use of such a trust may both help reduce employee turnover and attract new employees. In addition, a voting trust may be adopted to require shareholders of a business corporation to vote as a bloc rather than as individual shareholders.

3.6 Charitable Trusts

Instead of leaving property outright to a charitable organization, the grantor may wish to retain some interest in the property and still receive income or estate tax benefits. This may be possible by creation of a charitable trust that meets stringent IRS guidelines.

Three approved trust forms may be used for qualifying charitable gifts of a *remainder interest:*

— Charitable remainder annuity trust

— Charitable remainder unitrust

— Pooled income fund

Definitions of these trusts can be found in "Types of Charitable Transfers" in the chapter on Estate Planning. A contribution of a remainder interest in the trust to a charity is allowed as a charitable deduction for income, gift, and estate tax purposes only if the trust vehicle by which it is made meets stringent standards.

A donor may transfer property to a trust creating an income interest in the property in favor of a charitable organization for a period of years or for the life or lives of an individual or individuals, with the remainder interest either retained by the donor or given to a noncharitable beneficiary. This is called a charitable lead trust. There are two kinds of charitable lead trusts—inter vivos and testamentary.

The charitable contribution with respect to a charitable lead trust is equal to the actuarial value of the charitable annuity. However, in order to claim a deduction for the inter vivos contribution to the trust, the trust's income during the annuity period must be taxable to the donor, which is generally accomplished by providing for reversion of the trust corpus to the donor at the conclusion of the annuity period. (If the trust were funded with tax-exempt bonds, the donor's tax with respect to this income would be zero.)

The current low interest rates make the charitable lead trust a desired vehicle for those who wish to transfer assets to a younger generation at a low transfer tax cost while accomplishing charitable goals. For example, John transfers $1 million to a twenty-year charitable lead trust with a 7 percent charitable annuity when the Section 7520 rate is 4.2 percent. At the end of 20 years the corpus is to be paid to John's son. The amount of the gift tax is $65,304. John may avoid paying any tax on that gift by using his "applicable exclusion amount." Note that a gift of a future interest does not qualify for the annual exclusion.

3.7 Trusts for the Benefit of the Grantor (Living Trusts)

Grantors can place all or part of their assets in a revocable living (inter vivos) trust and can name themselves or anyone else as trustee. A revocable living trust for the benefit of the grantor may be used for, among others, the following purposes:

— To assure that the grantor's plans and affairs will be kept private and avoid the expense of probate (which can run as much as 5 to 6 percent of the gross estate).

— To be able to change one's plan by merely amending the trust during one's lifetime.

— To guarantee a continuation of cash flow on investments in the estate owner's portfolio that will not be interrupted by death.

— To allow designation of persons to manage the assets after death.

— To allow designation of persons and entities who may not be qualified to serve as executors in certain states or jurisdictions.

— To give a designated person an easy way to handle the grantor's affairs if the grantor becomes incapacitated.

— To provide for a smooth transition in continuing a family business.

— To avoid guardianships.

— To avoid creditors and, in certain states (Connecticut, Indiana, Illinois, Ohio, and Massachusetts), evade a spouse's elective share or the percentage of the estate on which the spouse has a claim.

— To reduce the possibility of court challenges to the estate distribution by disgruntled heirs.

— To select a more favorable legal status for the administration of the trust (see below).

— To segregate community property from separate property to maintain the separate status of each.

For income tax purposes, this type of trust is ignored. The grantor continues to treat all income, losses, and deductions as his or her own, with the same character as if the trust did not exist. As long as the grantor is the sole trustee or a co-trustee, and/or the trustee furnishes the name, address, and tax identification number of the grantor to the payees of income, no separate tax identification or tax return is required. The grantor continues to use his or her existing Social Security number.

Estate owners concerned about the preservation of assets and the management of financial affairs in the event of physical or mental incapacity can establish a *standby trust* (also known as a successor or custodian trust). This is a lifetime trust; the grantor has complete control of the trust assets, although the responsibility for asset safekeeping and recordkeeping is shifted to the (usually corporate) successor trustee. Upon the grantor's physical or mental incapacitation, the successor trustee takes over the management of the trust. If the grantor becomes mentally incompetent, the power to revoke the trust becomes ineffective.

A revocable living trust can be administered in a state other than the state in which the estate owner lived at the time of death. The trust can avoid such state laws such as those in Florida, which require that the personal representative (executor) must be related to the decedent or domiciled in the state of Florida. An estate owner resident in Florida who wants a fiduciary who is not a member of the family or domiciled in Florida to administer his or her property after death can avoid this problem by using and funding a living trust.

The estate owner who lives and works in one state but owns vacation or other property elsewhere can incur additional probate costs. Probate of the will takes place in the state of the estate owner's residence; however, separate probate procedures are necessary in other states where real estate is owned in the estate owner's name. Placing such property in a living trust can avoid these legal costs. The major purpose of a living trust, in fact, is to avoid the probate process. Since the title to the property is already in the trust, no passing of title is required following the estate owner's death. Avoidance of probate is an enormous benefit and can save significant costs and time.

A pour-over will should always be executed at the time the living trust is executed. The will is needed in case there are assets that are not in the trust's name that the decedent desires to be put into the trust. The will "pours" such assets to the trust. In addition, a pour-over will usually disposes of tangible personal property which more often than not is not put into trust.

If the revocable living trust is unfunded, whatever probate property passing to the trust after the grantor's death will incur probate costs before the property can ultimately end up in the trust. By funding the trust during one's lifetime, problems, costs, and delays involved in probating a person's estate can be avoided or reduced.

In most states, the grantor can be the sole trustee of his or her own trust. The grantor will therefore handle the writing of checks and purchase and sales orders as usual except that property will be in the name of the trustee. In those states that do not recognize a trust where the trustee and beneficiary are the same, a co-trustee, such as the grantor's spouse or a friend, attorney, accountant, or bank should be selected.

Gifts from revocable trusts, which normally qualify for a $12,000 annual exclusion (for further discussion of the amount, see section 6.1, below), may be included in the grantor's estate if the distribution to the donee was made directly by the trust within three years of the grantor's death under the contemplation-of-death rules (IRC Sec. 2035). To avoid this problem, the withdrawal should be made by the grantor, followed by a gift to the donee (Private Letter Rulings Nos. 9010004, 9010005, 9015001, and 9016002).

For estates of decedents dying after August 5, 1997, the Taxpayer Relief Act of 1997 provides that a transfer from a revocable trust is treated as a transfer made directly by the decedent. This means that the transfers from a revocable trust within three years of the grantor's death can qualify for the annual exclusion and there is no longer a need to filter such gifts through the grantor's personal checking account.

The Taxpayer Relief Act of 1997 permits an election by a revocable trust established by the decedent dying after August 5, 1997, to be treated as part of the estate for income and generation-skipping transfer tax purposes. If no estate tax return is required, the election is effective for two years. If an estate tax return is filed, the election is effective until six months after the estate tax return is finally determined. The election will allow the following special income tax provisions afforded only to estates to be available to revocable trusts.

- Estates are allowed the charitable set-aside deduction.
- Active participation requirement under passive loss waived for the estate in first two years.
- Only estates can qualify for amortization of reforestation expenditures.

3.8 Medicaid Trusts

Individuals who feared that long-term care in a nursing home would drastically deplete their assets could artificially impoverish themselves and shelter assets for their spouses and heirs by using irrevocable trusts carefully structured to comply with the federal law then in effect. The effect of the trust was to reduce income and assets of the grantor of the trust below the caps set by federal and state laws, so that Medicaid would pay the grantor's nursing home expenses.

Public Law 104-191, signed by the President on August 21, 1996, effective January 1, 1997, states that it is a crime if someone "knowingly and willfully disposes of assets (including by any transfer in trust) in order for an individual to become eligible for Medicaid assistance, if disposing of assets results in the imposition of a period of ineligibility for such assistance." That subsection, wherein the client was the target of the penalty provision, was stricken and replaced, effective August 5, 1997, by a subsection now targeting professionals, which prohibits someone who "for a fee knowingly and willfully counsels or assists an individual to dispose of assets (including any transfer in trust) in order for the individual to become eligible for medical assistance" (42 U.S.C. Section 1320a-7b(a)(6)(1997)).

The constitutionality of this amendment was challenged in December 1997, in *New York State Bar Association v. Reno* (999 F. Supp. 710 (N.D.N.Y. 1998)). In the government's response to the suit and in a letter to Congress in March 1998, United States Attorney General Janet Reno, in effect, agreed that the counseling provision was unconstitutional as written and indicated that the Justice Department would not defend challenges to the counseling provision nor would it bring any prosecutions under that section, and offered to assist Congress in drafting a revision. The Court issued a preliminary injunction against the government on April 8, 1998.

Despite the letter and preliminary injunction, the law was not repealed or modified.

The Court granted a summary judgment to the plaintiffs and entered a permanent injunction against the enforcement of the counseling provision.

While the government filed a notice of appeal to the Second Circuit Court of Appeals, after missing the deadline for filing its brief on appeal, the government stipulated to the dismissal of the appeal.

This has led at least one treatise to conclude that the District Court's ruling should be effective nationwide because the government made representations that the law would not be enforced and because the injunction is against the government (Regan, Morgan, and English, *Tax Estate & Financial Planning for the Elderly,* Matthew Bender (June, 2001), section 10.12(3)(c)).

Advance planning in the area of *Medicaid trusts and nursing home care* is required. The purchase of long-term care insurance should be considered, so that the nursing home resident's assets can be protected, but this must be done when the individual can obtain such insurance.

3.9 Special-Needs Trust

A special-needs trust, sometimes referred to as a supplement trust, is used to supplement a loved one's government benefits to improve the beneficiary's quality of life (e.g. physical therapy, medications, transportation, education, entertainment, vacation companionship, television or computer, etc.). Typically, a parent, grandparent or other relative establishes a special-needs trust for a disabled child or adult relative, who receives government assistance.

The trust was developed to manage resources for a third party while preserving the individual's eligibility for public benefits. The family leaves whatever resources it deems appropriate to the trust, while the trust is managed by a trustee on behalf of the person with the disability. On the death of the beneficiary the balance of the trust is usually distributed to other members of the family. If the trust is not administered properly, the beneficiary may lose the government benefits.

The special-needs trust could also be established using the beneficiary's own assets, a settlement or a bequest from another person. When the beneficiary dies or recovers from the disability, the balance of the trust fund is usually paid to the governmental agency which provided the benefits.

3.10 Land Trusts

Land trusts originated in Illinois and are now used in many states. This kind of trust is unique in that the trustee holds full legal title to the real estate, but the beneficiaries manage the property plus have full power to direct the trustee. The trustee executes deeds, mortgages, or otherwise deals with the property at the written direction of the beneficiaries. The beneficiaries collect rent, make improvements, and operate the property but do not hold or deal with legal title. A land trust provides faster and less expensive methods for conveying, financing, and holding interest in real estate. The arrangement is created by two instruments. The deed to the land trustee, as grantee, conveys the property to the land trustee. Contemporaneously with the deed, a land trust agreement is executed. Land trusts can provide the following benefits:

- Probate can be avoided by providing for disposition of beneficial interests upon the death of a beneficiary.

- The beneficiary's interest is changed from an interest in real estate to an interest in personal property.
- Nonresidents of the state where the real estate is located can avoid ancillary probate at the time of death.
- The identity of the beneficiary (the purchaser) is not disclosed, since only the deed into the land trustee is recorded.
- Since the interest of a beneficiary is personal property, marital rights of dower and courtesy may not apply.
- Where mortgage financing is used in connection with a land trust, personal liability of the beneficiary can be avoided.
- Judgments against an individual beneficiary or beneficiaries do not affect legal title.

Care should be taken in preparing a conveyance to a land trust. It is recommended that an attorney familiar with the laws of the state where the property is located prepare the deed and at least review the trust.

4. TRUST ADMINISTRATION

4.1 Trustee

A trustee can be either an individual or a properly licensed state or federal institution. Usually individual trustees are family members, friends, or advisers; institutional trustees are trust companies or trust departments of commercial banks. The trustees act in a fiduciary capacity and have the highest standard of care imposed by law to hold property for the benefit of the beneficiaries. Naming a trustee is a very serious decision because the trustee is responsible not only to the income beneficiaries (those who are entitled to the income from the trust property), but also to the remaindermen who are entitled to the principal (corpus) of the trust. No one should choose a trustee lightly, and a named trustee should never lightly agree to serve. The trustees are responsible to the beneficiaries and must have integrity, responsibility, experience, availability, and willingness to serve. The trustees are also responsible to the grantors in following the instructions of the trust instrument.

Will the trustee have any conflict of interest that would cloud administration of the trust? Will conflicts arise because the trustee is related or partial to any beneficiary? The best procedure may be to select an individual trustee and a corporate trustee to act together. A corporate trustee, usually impartial, specializes in handling trusts and has the necessary experience. The corporate trustee never dies as an individual does, so the corporate trustee will always be there. However, there should be some mechanism for removing and replacing any institutional or other unrelated discretion-holding fiduciary. The trust may be well served by selecting an individual co-trustee who has a relationship to the beneficiaries, whether as a family member or as an adviser who knows the needs of the family. The individual should understand what was intended by the setting up of the trust instrument. It is important that the trust instrument also provides for adequate successor trustees so that it will not be necessary to go to court to find a successor trustee. Selecting successor trustees should be undertaken with the same care exercised in choosing the original trustees. A competent attorney must draft all trust instruments to ensure their proper legal effect.

4.1.1 Duties

Primary responsibilities of a trustee are to manage, preserve, and distribute trust property. These responsibilities are similar to those of an executor or guardian, except that the executor or guardian is more closely and frequently supervised by a court, where a trustee is typically answerable to a court only after a suit is filed. Even though trustees can delegate certain duties to accountants, attorneys, real estate agents, and tax consultants, they cannot delegate their overall duty to administer the trust. When they accept the trust, trustees undertake to carry out the terms of the trust and thus assume all responsibility for the acts or omissions of the persons they employ. Although state law may impose

(Text continued on page 17)

certain duties and restrictions on a trustee, most duties are derived from the trust instrument, whether it is an inter vivos trust indenture or is created under a will setting up a testamentary trust. Some states require a statement in the trust instrument saying that the trustee may have duties in addition to those set forth in the trust instrument (see Florida Statute 737.115).

A trustee must refrain from dealing with the trust property personally and from commingling such trust property with his or her own; in addition, the trustee must exercise any discretionary duties with impartiality. The trustee has a duty to make the trust property productive and should not let the trust fund remain unavailable for investment for an unreasonable length of time. If there are two or more trustees, each is liable for his or her own breaches of trust and not for those of co-trustees unless he or she allowed the co-trustees to commit a breach of trust by failure to exercise reasonable care. The trustee normally has a duty to render accountings. A provision in a trust dispensing with the duty to account is of questionable efficacy.

Some of the other duties of a trustee in the administration of a trust are to

— Exercise reasonable care and skill ("prudent-man" standard) in acting as a trustee.

— If the state whose law controls the trust has adopted the Prudent Investors Act, comply with "prudent investor" standards, unless the trust instrument provides otherwise. Thirty-six state have adopted this standard. See section 4.1.3 below.

— Comply with the terms of the trust.

— Be fair and impartial in dealings with the beneficiaries.

— Make the trust corpus productive within the terms of the trust.

4.1.2 Powers

The powers of the trustee are derived from statutes, common law, and the trust instrument itself. In many instances the statutory powers granted a trustee by governing state law are sufficient to manage the trust. Nevertheless, since trustees may be required to deal with third parties who are unfamiliar with the laws of the state, it is desirable to itemize their powers in the trust instrument. If a trust will be required to deal with real estate in a state other than the state in which the trust is located, the trustee should, at a minimum, be given all statutory powers granted trustees in the foreign state with respect to the real estate in that state.

If the grantor retains administrative power over trust property, the trust income, even if the trust is irrevocable, may be includable in the grantor's taxable income and the corpus may be part of the grantor's taxable estate (see sections 5.1.5 and 7.1).

4.1.3 Prudent investing

The trustee has a duty to treat the beneficiaries fairly and impartially. This often requires reconciling the interests of income and remainder beneficiaries. Historically, the trustee has attempted to accomplish this by investing in the proper mix of stocks and fixed income investments. Stocks tended to appreciate more than fixed income investments, which produced more income. Thus stock investments tended to favor the remainder beneficiaries, whereas investing in fixed income securities favored the income beneficiary. The trustee was required to fix the right mix of investments to treat both types of beneficiaries fairly and impartially, perhaps paying less attention than warranted to market imperatives.

Under the prudent man rule of the Restatement (Second), of Trusts Section 227 (1959), a trustee was allowed "to make such investments and only such investments as a prudent man would make of his own property having in view the preservation of the estate and the amount and regularity of the income to be derived." Over time, the prudent man rule was interpreted in such a manner that each individual investment within a portfolio had to stand on its own merit alone and without regard to the overall portfolio. From that viewpoint, entire categories of investments became viewed as too imprudent or speculative for fiduciary investment.

At the same time the list of permissible investments was narrowing, broad new types of investment products and strategies were developing. It became generally recognized that the prudent man rule, as it had come to be interpreted, was too restrictive and in need of revision. Evolving ("modern") investment theories postulated that a wider range of investment vehicles were suitable for fiduciary investment if the trust portfolio was viewed as a whole rather than viewing each investment in isolation. Some states, such as California and Delaware, changed their statutes to reflect this criticism of the prudent man rule.

Against this background of increasing criticism and changes in state laws, the Restatement (Third) of Trusts: Prudent Investor Rule was published in 1992. This was followed shortly thereafter by the Uniform Prudent Investor Act of 1994 (UPIA). The UPIA states that it makes five fundamental alterations for prudent investing, all of which are to be found in the Restatement of Trusts (Third):

1. The standard of prudence is applied to any investment as part of the total portfolio, rather than to individual investments. In the trust setting the term *portfolio* embraces all the trust's assets.

2. The tradeoff in all investing between risk and return is identified as the fiduciary's central consideration.
3. All categoric restrictions on types of investments have been abrogated; the trustee can invest in anything that plays an appropriate role in achieving the risk/return objectives of the trust and that meets the other requirements of prudent investing.
4. The long familiar requirement that fiduciaries diversify their investments has been integrated into the definition of prudent investing.
5. The much criticized former rule of trust law forbidding the trustee to delegate investment and management functions has been reversed. Delegation is now permitted, subject to safeguards.

Section 2 of the Uniform Prudent Investor Act, adopted in at least 36 states and patterned loosely after Section 227 of the Restatement and an Illinois statute, sets forth the standard of care for investing:

> SECTION 2. STANDARD OF CARE; PORTFOLIO STRATEGY; RISK AND RETURN OBJECTIVES.
>
> (a) A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill and caution.
> (b) A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust.
> (c) Among circumstances that a trustee shall consider in investing and managing trust assets are such of the following as are relevant to the trust or its beneficiaries:
> (1) general economic conditions;
> (2) the possible effect of inflation or deflation;
> (3) the expected tax consequences of investment decisions or strategies;
> (4) the role that each investment or course of action plays within the overall portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property;
> (5) the expected total return from income and the appreciation of capital;
> (6) other resources of the beneficiaries;
> (7) needs for liquidity, regularity of income, and preservation or appreciation of capital; and
> (8) an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.
> (d) A trustee shall make a reasonable effort to verify facts relevant to the investment and management of trust assets.

(e) A trustee may invest in any kind of property or type of investment consistent with the standards of this [Act].
(f) A trustee who has special skills or expertise, or is named trustee in reliance upon the trustee's representation that the trustee has special skills or expertise, has a duty to use those special skills or expertise.

The Uniform Prudent Investor Act thus adopts "modern" investment theory emphasizing the concept of total return.

The Restatement of 1992, the Uniform Prudent Investor Act of 1994, and "modern" investment theory were in conflict with the older rules of the Uniform Principal and Income Act. If a trustee acting under the new Prudent Investor Act and modern theory invested entirely in stocks in a period of rising markets and low interest rates, there would be no income to distribute to the income beneficiary. The Uniform Principal and Income Act of 1997, adopted in at least 29 states, addressed the problem. According to the 1997 Act, one of the two purposes of the 1997 Revision was to "provide a means for implementing the transition to an investment regime based on principles embodied in the Uniform Prudent Investor Act, especially the principle of investing for total return rather than a certain level of 'income' as traditionally perceived in terms of interest, dividends and rent."

Under the 1997 Uniform Principal and Income Act, if a trustee prudently invests trust assets for total return and the result is such that trust income under traditional concepts is too large or too small to be fair and impartial to the beneficiaries, Section 104 gives the trustee the power to adjust the amounts of accounting income and principal to achieve a fair result. Three conditions must be met before a trustee can exercise the power to adjust or reapportion income and principal: (1) the trustee must manage the trust as a prudent investor, (2) the trust instrument must require all income to be distributed at regular intervals, and (3) the trustee must determine, upon administering the trust upon its terms and after deciding whether to exercise any discretionary powers under the trust, the trust cannot be administered impartially (or administered partially if the trust requires a beneficiary to be favored).

Section 104(b) requires the trustee to consider certain factors in deciding to adjust. Section 104(c) places limitations on the power to adjust when tax benefits would be lost. Section 104(e) allows a trustee to release the power to adjust.

The power to adjust is illustrated in the following three examples from the commentary to the Uniform Principal and Income Act (1997):

Example 1. T is the successor trustee of a trust that provides income to A for life, remainder to B. T has received from the prior trustee a portfolio of financial assets invested 20 percent in stocks and 80 percent in bonds. Following the prudent investor rule, T determines that a strategy of investing the portfolio 50 percent in stocks and 50 percent in bonds has risk and return objectives that are reasonably suited to the trust, but T also determines that adopting this approach will cause the trust to receive a small amount of dividend and interest income. After considering the factors in Section 104(b), T may transfer cash from principal to income to the extent T considers it necessary to increase the amount distributed to the income beneficiary.

Example 2. T is the trustee of a trust that requires the income to be paid to the settlor's son C for life, remainder to C's daughter D. In a period of very high inflation, T purchases bonds that pay double-digit interest and determines that a portion of the interest, which is allocated to income under Section 406 of this Act, is a return of capital. In consideration of the loss of value of principal due to inflation and other factors that T considers relevant, T may transfer part of the interest to principal.

Example 3. T is the trustee of a trust that requires the income to be paid to the settlor's sister E for life, remainder to Charity F. E is a retired schoolteacher who is single and has no children. E's income from her Social Security, pension, and savings exceeds the amount required to provide for her accustomed standard of living. The terms of the trust permit T to invade principal to provide for E's health and to support her in her accustomed manner of living, but do not otherwise indicate that T should favor E or F. Applying the prudent investor rule, T determines that the trust assets should be invested entirely in growth stocks that produce very little dividend income. Even though it is not necessary to invade principal to maintain E's accustomed standard of living, she is entitled to receive from the trust the degree of beneficial enjoyment normally accorded a person who is the sole income beneficiary of a trust, and T may transfer cash from principal to income to provide her with that degree of enjoyment.

Trusts created after the adoption of Section 104 may prohibit the exercise of a power to adjust by specifically referring to the section (refer to local statutory numbering). Trusts created before the enactment of the section will not normally be deemed to prohibit the exercise of the power to adjust.

Giving the trustee a power to adjust the amounts of accounting income and principal had troublesome tax implications. Under IRC Section 643, if a fiduciary recharacterized income to principal for trust accounting purposes, the recharacterization would not be recognized for tax purposes. The income beneficiary would have to report income retained by the trust and added to principal. If a trustee allocates principal to income and distributes principal to the income beneficiary, it is difficult to determine whether the principal so distributed contained any of the trust's capital gains because money is fungible.

To answer these and other questions the IRS issued proposed regulations in February 2001. The final regulations were issued December 30, 2003. They are dealt with more specifically in section 5 below. Part of the IRS's explanation for the issuance of the regulations states:

> "The IRS and the Treasury Department recognize that state statutes are in the process of changing traditional concepts of income and principal in response to investment strategies that seek total positive return on trust assets. These statutes are designed to ensure that, when a trust invests in assets that may generate little traditional income (including dividends, interest, and rents), the income and remainder beneficiaries are allocated reasonable amounts of the total return of the trust (including both traditional income and capital appreciation of trust assets) so that both classes of beneficiaries are treated impartially. Some statutes permit the trustee to pay to the person entitled to the income a unitrust amount based on a fixed percentage of the fair market value of the trust assets. Other statutes permit the trustee the discretion to make adjustments between income and principal to treat the beneficiaries impartially. Under the proposed regulations, a trust's definition of income in conformance with applicable state statutes will be respected for federal tax purposes when the state statutes provide for a reasonable apportionment of the total return of the trust."

As mentioned above, state statutes were in the process of changing traditional concepts of income and principal in response to modern investment theories that emphasize total positive return of the trust. Within six months of the issuance of the temporary regulations, several states had already enacted legislation and legislation was pending in other states. In general, states have taken one of three approaches: (1) to allow the power to adjust contained in the Uniform Principal and Income Act, (2) to allow conversion of an income and principal trust to a unitrust (approved by the IRS regulations but not contained in the Uniform Principal and Income Act), or (3) to allow both of the foregoing. California has authorized the power to adjust. Delaware does not but does allow conversion to a unitrust. New York and Florida allow both. New York specifies a 4 percent unitrust. Florida and Delaware allow unitrusts between 3 percent and 5 percent. Some states have smoothing provisions that allow the unitrust calculations to be based on several years.

Some states have ordering provisions, which dictate how the distributions to a beneficiary are to be characterized. For example, distributions to an income beneficiary might be characterized first as ordinary income to the extent thereof, then as tax exempt income, then as short-term gains, then as long-term gains, and finally to return of principal. Other states leave the ordering to the discretion of the trustee. With these and with many other of the issues discussed in this section, the law is changing very rapidly and state law controls. Check the most current laws specific to your state.

4.1.4 Liability

Trustees are liable to the beneficiaries for any actual losses resulting from breach of fiduciary duty and may be surcharged by forcing them to personally make good any such losses from their own assets. Such breaches may entitle a beneficiary to force removal of a trustee. The standards imposed on a trustee are strict—some feel too strict. The grantor may wish to rectify this by inserting in the trust instrument an exoneration clause (sometimes called an exculpatory clause), stating that the trustee will not be liable except for losses caused by willful neglect or bad faith. Even though these clauses afford some protection, they are normally construed against the trustee.

4.1.5 Compensation

Trustees' compensation is usually established either in the trust instrument or by operation of applicable state law. Many states provide statutory guidelines for the compensation of trustees, which are usually based on a percentage-of-value and income approach but have sliding scales. In the absence of a state statute or an agreement between the trustee and the grantor or beneficiaries, the trustee is entitled to reasonable compensation. Reasonable compensation (and hence the fee to which the trustee is entitled) is a question of fact and of law, measured at least in part by the value of such services as established in the community. Most institutional trustees regularly promulgate and disseminate fee schedules. This helps establish the amount of fees customarily charged in the community. An adjustment in compensation may be appropriate if the trustee has delegated significant duties, such as the delegation of investment authority. Fees and trustee's performance are a concern of beneficiaries, especially in bad markets.

4.2 Beneficiary

In most circumstances the beneficiary will have no control of the trust other than possibly the right to request a change of the trustee if the trustee does not perform satisfactorily or for such other cause (or without cause), all only as the instrument may authorize. Note that if all beneficiaries consent and are in existence courts will generally agree to a trust termination if there is no ultimate purpose of any kind requiring the continuation of the trust. If the grantor's purpose in establishing the trust has not been fully accomplished, the trust cannot be terminated even though all beneficiaries desire that it should be terminated.

4.3 Duration

Many grantors wish to continue their trust in perpetuity, which frequently conflicts with the so-called rule against perpetuities. The common-law rule against perpetuities required a trust to terminate within 21 years after the death of certain specified lives in being at the time of creation of the trust. The period began at the time the trust became effective, which would be the moment of death in the case of testamentary trusts and the moment of execution of the trust instrument in the case of inter vivos trusts. Many states have adopted the Uniform Statutory Rule Against Perpetuities, which extends the permissible duration to 90 years. Some states have gone even further. Florida has substituted 360 years in place of 90 years. Delaware completely eliminated the rule for trusts not holding real property. Because of the lack of uniformity in the rule among the various states, the scrivener should consider the inclusion of a "savings" clause in the trust, bringing the applicable maximum duration into conformity with whatever state's law might be applicable. Even though trusts of extremely long duration are now permissible, the scrivener should be careful to take into account the generation-skipping consequences of such trusts.

Under the common law, there was no limit on the duration of a trust that has a charitable purpose. This rule has been codified by many states. Caution should be exercised because, in time, a specific charity may cease to exist or the reason for a charity's being may cease to exist. Many other statutory exceptions exist for other types of trusts, such as pension and profit sharing trusts, and other types of employee benefit plans.

4.4 Dynasty Trusts

A "dynasty trust" involves an irrevocable trust that seeks to take advantage of the two loopholes in the "generation skipping tax" system. It is funded with the amount which the Code exempts from generation skipping tax (in the calendar year 2006, $2,000,000 per grantor; thus a married couple might be able to utilize $4,000,000), and the fact that the estate tax is not imposed on property in which a decedent possesses only a life estate (see the chapter on estate planning, Section 6).

The dynasty trust is designed to last beyond the lifetimes of the children and grandchildren of the grantor, conceptually into perpetuity (subject to the rule against perpetuities of the governing jurisdiction, discussed below). It restricts ownership of trust assets by not vesting ownership of the trust assets in any individual beneficiary. Instead, beneficiaries are permitted the use and enjoyment of the trust property, as well as the income and possibly the principal thereof as determined by the exercise of discretion by the trustees named, or designated, in the trust.

In some states, trusts are exempt from state income taxes, allowing the assets to grow state tax free for years. Alaska, Florida, Nevada, South Dakota, Texas, Washington and Wyoming do not impose income tax on assets within trusts. Delaware and New Hampshire do not tax trusts as long as a beneficiary lives out of state. New York will not tax trusts if the grantor lives out of state.

In addition to the benefit of tax savings, a dynasty trust is designed to serve as an asset protection vehicle in connection with claims of creditors for all its beneficiaries and protection of assets from matrimonial claims against those beneficiaries. Experts agree asset-protection trusts set up in the U.S. haven't been adequately tested in court, and it's unclear how well they will hold up. The following states allow "asset protection trusts:" Alaska, Colorado, Delaware, Missouri, Nevada, Oklahoma, Rhode Island, South Dakota and Utah.

As a partial reaction to the generation-skipping tax system and to permit the preparation of dynasty trusts, the following is a list of the states that have abolished their rule against perpetuities: Alaska, Arizona, Colorado, Delaware, District of Columbia, Idaho, Illinois, Maine, Maryland, Missouri, Nebraska, Nevada, New Hampshire, New Jersey, Ohio, Rhode Island, South Dakota, Virginia, Washington and Wisconsin. In addition to these states, Florida allows a dynasty trust to last for 360 years, and Washington allows a dynasty trust to last for 150 years. Wyoming and Utah permit dynasty trusts to last 1,000 years. New Hampshire is now one of the few states that allow so-called perpetual purpose trusts, created by individuals for specific purposes, such as maintaining a home, business or art collection in the family, rather than benefit an actual person. Another interesting aspect of the use of dynasty trusts is that the grantor need not reside in one of these states to take advantage of their favorable perpetuities laws.

Once the dynasty trust is properly drafted and funded, its adherents laud the additional variations of the benefits of leveraging, asset valuation discounts, and use of special powers of appointments.

However, one wonders just how attractive an irrevocable trust plan will be during a period of uncertainty in long-range tax planning, which may be affected by the Tax Act of 2001. The act (1) purports to eliminate the estate tax and the generation-skipping tax in 2010; (2) turns one of the key goals of estate planning from saving excise taxes to reducing capital gains taxes; and (3) in the short term (until 2005), pegs the generation-skipping exempt amount to the unified credit exemption equivalent amount, instead of being larger than the unified credit exemption equivalent amount.

5. INCOME TAXATION

5.1 Grantor

A grantor who transfers property to a trust and retains certain powers over or interests in the trust is treated as the owner of the trust for federal income tax purposes under the grantor trust provisions of Internal Revenue Code Sections 671 to 678. As a result, the income and deductions attributable to that trust are included directly in the grantor's taxable income.

5.1.1 Reversionary interest

Under the Tax Reform Act of 1986, the income of a trust is generally taxed to its grantor if the grantor retains (or gives a spouse living with the grantor at the time of the gift) a power or a reversionary interest of more than 5 percent of the value of the transferred property. An exception occurs when the trust may revert only after the death of an income beneficiary before age twenty-one who is a lineal descendant of the grantor. Clifford trusts and spousal remainder trusts will therefore be taxed as grantor trusts. For a trust created pursuant to certain binding property settlement agreements entered into before March 1, 1986, a grantor is treated as an owner of that portion of a trust in which he or she has a reversionary interest in corpus or income if the interest will or may reasonably be expected to result in possession or enjoyment within ten years of the transfer to the trust.

5.1.2 Adverse and related parties

An *adverse party* is one who has a substantial beneficial interest in a trust that would be adversely affected by the exercise or lack of exercise of a power possessed with regard to the trust. A *nonadverse party* is one who does not come within the definition of an adverse party. A related or subordinate party is a nonadverse party who is either a close relative (spouse living with the grantor; father, mother, issue, brother, or sister), an employee of the grantor, a corporation or employee of a corporation in which the holdings of the grantor or the trust are significant, or a subordinate employee of a corporation of which the grantor is an executive. A party who is close to the grantor is considered subservient to the wishes of the grantor.

5.1.3 Beneficial enjoyment

A grantor is treated as the owner of any portion of a trust with respect to which the grantor or a nonadverse party, without the consent of an adverse party, has the power to control the beneficial enjoyment of the related corpus or income. Thus the trust income will be taxed to the grantor in any of the following circumstances:

— If the income may be distributed currently to the grantor or the grantor's spouse, whether or not it is so distributed.

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— If the income may be held or accumulated for future distributions to the grantor or the grantor's spouse, whether or not it is so held or accumulated.

— If the income may be applied to the payment of premiums on insurance covering the life of the grantor or the grantor's spouse, whether or not it is so applied.

— If the income is actually applied or distributed for the support or maintenance of a beneficiary whom the grantor is legally obligated to support or maintain.

5.1.4 Reservation of administrative powers

Under IRC Section 675 a grantor is treated as the owner of a portion of a trust with respect to which

— The grantor or a nonadverse party has the power to deal for less than adequate and full consideration.

— The grantor or a nonadverse party has the power that enables the grantor to borrow trust income or corpus without adequate interest or without adequate security.

— The grantor has borrowed income or corpus of the trust and has not repaid the amount before the beginning of the taxable year, unless the loan provides for adequate interest and security and is made by an independent trustee.

— The grantor has retained the power exercisable in a nonfiduciary capacity (a) to vote stock of a corporation in which the holdings of the trust and the grantor are significant from a viewpoint of voting control, (b) to control the investments of the trust in such corporations, or (c) to reacquire trust corpus by substituting other property of equivalent value.

5.1.5 Powers that can be retained

Grantors who do not retain a beneficial interest in a trust can retain the following powers under IRC Section 674 without being subject to income tax:

— The power to apply the income for support of a dependent to the extent that the power is not actually so used.

— The power to allocate income or corpus among charitable beneficiaries.

— The power to distribute corpus (a) to beneficiaries within a fixed class of beneficiaries subject to a reasonably definite standard or (b) to income beneficiaries when the corpus distribution is an advancement of that beneficiary's proportionate share of the trust.

— The power to withhold income temporarily from a beneficiary within a fixed class of beneficiaries where the withheld income must be distributed to that beneficiary or his or her estate or the beneficiary has the general power of appointment over the property.

— The power to withhold income during the disability of a beneficiary within a fixed class of beneficiaries.

— The power to allocate items between income and corpus.

— The power held by an independent trustee of distributing income and corpus among a fixed class of beneficiaries.

— The power to allocate income or corpus to beneficiaries within a fixed class of beneficiaries subject to a reasonably definite external standard.

Income will not be taxable to grantors merely because an independent person neither related to nor subservient to them can distribute, apportion, or accumulate income to or for a beneficiary or class of beneficiaries and pay out corpus to or for a beneficiary or class of beneficiaries. A group of trustees is independent so long as not more than half the trustees are related or subordinate parties who are subservient to the wishes of the grantor.

5.1.6 Creating a defective grantor trust

The fact that the grantor is taxed as the owner for income tax purposes does not necessarily mean the trust would be included in the grantor's estate as long as the trust is properly drafted. The estate tax rules (see section 7.1 of this chapter) are not as broad as the grantor trust income tax rules. For examples of powers that would cause trust income to be taxed to the grantor but that would not cause the trust assets to be taxed in the grantor's estate, see section 7.1 below.

There are reasons to create a "defective" trust, according to which the grantor of the trust would be taxed as the owner of the trust for income tax purposes under Internal Revenue Code Sections 671 to 678, yet the assets of the trust would not be included in the grantor's estate.

Defective grantor trusts can be effective funding vehicles after the trust is established, where the ulterior motive is to "make additional gifts" of the income tax payments on the income earned by the trust without actually making the gifts. The grantor's estate is reduced by the tax payments at no gift tax cost because the grantor is obligated to pay this tax and therefore not making a gift to the trust beneficiaries.

> *Example.* In calendar year 2005 Mrs. Jones owns $1,000,000 of corporate bonds paying $60,000 a year in interest. By transferring the bonds to a defective trust, assuming there was no gift tax because of the unified credit, Mrs. Jones continues to pay income tax of $16,800 on the income earned by the trust. Thus, after five years, Mrs. Jones effectively reduced her estate by $84,000. The trust fund builds to a greater amount, since no income tax needs to be paid out of it.
>
> If she left the property by will, the $43,200 a year after-tax interest would accumulate in her estate and would be subject to estate tax.

The IRS has ruled in Rev. Rul. 2004-64, 2004-27 I.R.B. 7, that the grantor who pays income tax on the income generated by a defective grantor trust is not treated as making a gift to the trust beneficiaries. However, for trusts created after October 3, 2004, if the trust instrument or applicable local law requires the trustee to reimburse the grantor for the income taxes payable by the grantor, the entire trust assets are includible in the grantor's gross estate.

Another technique is to buy appreciated assets from the defective trust, since any transactions between the trust and the grantor are not taxed. The grantor by buying appreciated assets from the trust and holding them until death avoids capital gains tax.

> *Example.* In calendar year 2005 Mary Smith transfers $1,000,000 of stock to a defective grantor trust taking full advantage of her unified credit. Over time, the stock appreciates to $2,000,000. If the trust were to sell the assets to a third party, it would incur at least a $1 million capital gain and owe at least $150,000 in tax.
>
> If Mary bought the stock for $2,000,000 from the trust there would be no tax (see Rev. Rul. 85-13, 1985-1 C.B. 184), and if she died holding the stock, her beneficiaries would get a stepped-up basis for the stock. The $1 million of appreciation on the stock would have been removed from Mary's estate.

5.2 Beneficiary

5.2.1 Distributable net income (DNI)

Normally beneficiaries are taxed on the amounts that are required to be distributed or the amounts actually distributed currently to them, except that distributions are included in the gross income of the beneficiary only to the extent of the distributable net income (DNI) of the trust. DNI, an ingenious concept introduced in the 1954 Internal Revenue Code, is the most important aspect of fiduciary income taxation. It serves as the overall limitation on the amount of the distribution deduction available to the trust as well as a limitation on the amount taxable to beneficiaries. The underlying theory of fiduciary income taxation is that total taxable income must be taxed. Thus, whatever a trust gets as a distribution deduction must be reported by the beneficiary. In general, the character of the income in the hands of the beneficiary is the same as it was in the hands of the trust. Thus, an amount received or receivable by a beneficiary, which amount is deemed to consist of tax-exempt income, will not be taxed to the beneficiary.

For example, a trust that is required to distribute all of its income (a simple trust) to one beneficiary, earned $9,000 in taxable interest and $1,000 in tax-exempt interest, and incurred no expenses. The following is the computation of DNI and taxable income to the beneficiary from the trust:

Taxable income—fiduciary income tax return (Form 1041)	
Tax-exempt interest (Section 641(b))	-0-
Taxable interest (Section 641(b))	$ 9,000
Exemption (Section 642(b))	(300)
Taxable income before distribution deduction	$ 8,700

DNI (Section 643)	
Taxable income before distribution deduction	$ 8,700
Add: Exemption (Section 643(a)(2))	300
Exempt income (Section 643(a)(5))	1,000
DNI	$10,000

Although DNI is $10,000, the *deductible DNI* is $9,000 ($10,000–$1,000). The last sentence of Section 651(b) prevents a deduction for any portion of the DNI that consists of tax-exempt income. (This computation is made on Schedule C of Form 1041.)

Taxable income before distribution deduction (per above)		$ 8,700
Distribution deduction:		
Income required to be distributed currently (Section 651(a))	$10,000	
Limited to deductible DNI (Section 651(b) (see above))		(9,000)
Taxable income		(300)

Reportable by beneficiary		
Income required to be distributed currently (Section 652(a))		$10,000
Limited to DNI		$10,000
Character of amounts reportable under Section 652(a) (same as character of DNI) (Section 652(b))	Taxable	Exempt
Tax treatment to beneficiary	$ 9,000	$ 1,000

This computation is reprinted from *Income Taxation of Estates and Trusts,* CPE Course Handbook (New York: American Institute of Certified Public Accountants, Inc., 1987), p. H4-5.

If the trust agreement authorizes the trustee to make discretionary distribution of income, the trust is classified as a "complex trust." IRC Sec. 663(b) allows trustees of complex trusts to elect to treat distributions during the first 65 days of the trust year as if they have been made on the last day of the immediately preceding tax year. If the trustee does not make the election, the distributed income is deducted by the trust and taxed to the beneficiary in the year the actual distribution is made. Since most trusts are now in a higher tax bracket than the beneficiaries, this election allows the trustee an opportunity after year end to equalize the marginal tax rates of the trust and the beneficiary.

Traditionally, capital gains have been taxed to the trust and added to trust principal. They were not usually included in DNI. Changes in state laws have given trustees the power to reallocate principal to income. These changes stressed IRS definitions of accounting income and DNI. Effective January 2, 2004, final regulations under IRC Section 643 issued by the IRS on December 30, 2003, sought to resolve some of the problems wrought by the Uniform Prudent Investor Act and the Uniform Principal and Income Act. The new regulations revise the definition of income under IRC Section 643(b) and of DNI under IRC Section 643(a). Other changes to the regulations ensure that the exercise of the new powers to invest for total return and recategorize income and principal will not disqualify trusts from favorable tax treatment to which they were already entitled under the marital deduction, gift tax, generation-skipping, and other provisions of the tax law.

The definition of income is changed under IRC Section 643(b)-1. Although the old language remains, additional language is added that states, "However, an allocation of amounts between income and principal pursuant to applicable local law will be respected if local law provides for a reasonable apportionment between the income and remainder beneficiaries of the total return of the trust for the year, including ordinary and tax-exempt income, capital gains, and appreciation." In other words, a trustee acting as a prudent investor for total return and where permitted by state law may recategorize trust principal as income, or the reverse, for the purpose of treating the beneficiaries fairly and impartially. Making such a recategorization would change the amount of accounting income to be distributed to the income beneficiary. Section 1.643(b)-1 says such redetermination of the amount of income will be recognized for federal tax purposes. The section is effective for taxable years ending after January 1, 2004.

IRC Section 643(a)(3) provides the rules for inclusion of capital gains in DNI. If a trustee, acting as a prudent investor, reallocates accounting principal to income in order to treat the income beneficiary fairly and impartially, it is still not readily apparent whether capital gains are being carried out to the beneficiary with the payment of principal because money is fungible; once cash received from capital gains is added to a trust's principal cash, it is impossible to determine if subsequent distributions of principal cash contained those capital gains. The regulations provide that if the trustee allocates capital gains to the distribution (and the trustee need not do so) in accordance with the trust and state law, the allocation of such gain will be honored for tax purposes provided the exercise is done in a reasonable and consistent manner and is evidenced on the trust's books, records, and tax returns. There appears to be no method to make an election to make such allocation other than by evidencing it on the trust's tax return.

Among others, the following examples appear in IRC Section 1.643(e):

> *Example 1.* Under the terms of Trust's governing instrument, all income is to be paid to A for life. Trustee is given discretionary powers to invade principal for A's benefit and to deem discretionary distributions to be made from capital gains realized during the year. During Trust's first taxable year, Trust has $5,000 of dividend income and $10,000 of capital gain from the sale of securities. Pursuant to the terms of the governing instrument and applicable local law, Trustee allocates the $10,000 capital gain to principal. During the year, Trustee distributes to A $5,000, representing A's right to trust income. In addition, Trustee distributes to A $12,000, pursuant to the discretionary power to distribute principal. Trustee does not exercise the discretionary power to deem the discretionary distributions of principal as being paid from capital gains realized during the year. Therefore, the capital gains realized during the year are not included in distributable net income and the $10,000 of capital gain is taxed to the trust. In future years, Trustee must treat all discretionary distributions as not being made from any realized capital gains.

Example 2. The facts are the same as in Example 1, except that Trustee intends to follow a regular practice of treating discretionary distributions of principal as being paid first from any net capital gains realized by Trust during the year. Trustee evidences this treatment by including the $10,000 capital gain in distributable net income on Trust's federal income tax return so that it is taxed to A. This treatment of the capital gains is a reasonable exercise of Trustee's discretion. In future years Trustee must treat all discretionary distributions as being made first from any realized capital gains.

5.2.2 The throwback rules

When the trust distributed previously accumulated income to a beneficiary, the tax on that distribution was determined by special averaging rules. Under those rules (called the accumulation distribution or throwback rules), the income was taxed at the average of the top tax rates for the beneficiary during three of the preceding five years, excluding the highest and lowest years. With the tax rates for trusts introduced by the 1986 Tax Reform Act (see section 5.3), the trust's tax bracket will probably be higher than that of the beneficiary who is charged with the throwback income, resulting in a higher tax paid by the trust than that required of the beneficiary. Although the tax paid by the trust is credited to the beneficiary, it cannot result in a net credit or refund to him or her. The throwback rule does not apply to accumulation of income during the minority of a beneficiary. Income accumulated by a domestic trust prior to the beneficiary's attaining the age of twenty-one, or years a beneficiary was not in existence, is not subject to the throwback rules. This exception, however, does not apply in the case of distributions from multiple (more than two) trusts.

The Taxpayer Relief Act eliminated the "throwback rules" for most domestic trusts for distributions in tax years beginning after August 5, 1997. The throwback rule continues for foreign trusts, domestic trusts that once were foreign, and certain domestic trusts created before March 1, 1984, that would have been treated as "multiple trusts."

5.3 Trust

5.3.1 Deductions

Normally, trusts are allowed to deduct itemized deductions only to the extent that they exceed 2 percent of adjusted gross income (IRC Section 67(a)). For purposes of this limitation on itemized deductions, adjusted gross income of a trust is computed in the same manner as in the case of individuals. However, the deduction for costs which are paid or incurred in connection with administration of a trust would not have been incurred if the property were not held in such a trust, are fully deductible without regard to the 2 percent threshold. (IRC Section 67(e)(1)).

Fully deductible costs not subject to 2 percent floor include fees paid to trustees, expenses associated with judicial accountings and the costs of preparing and filing fiduciary income tax returns. However, there is a split in the circuits regarding fees for investment advice and whether they are subject to the 2 percent floor. The IRS takes the position that investment advisory fees are incurred by individual investors outside of the trust administration and fees fail to satisfy the requirement they would not have been incurred if the assets were not held in trust. The Sixth Circuit has found that a trust's fees for investment advice are not subject to the 2 percent floor (O'Neill v. Commissioner, 994 F. 2d 302 (6th Cir. 1993) Nonacq. 1994-2C.B.1). The Federal Circuit (Mellon Bank, N.A. v U.S., 265 F. 3d 1275 (Fed. Cir. 2001) *aff'g* 2001-2 U.S.T.C. ¶50,621 Second Circuit (Rudkin Testamentary Trust v. Commissioner, F. 3d 149 (CA-2,2006) and Fourth Circuit, (Scott v. U.S., No. 02-1464 (4th Cir. 5/1/03) have all held they are.

5.3.2 Taxable income

Two or more trusts are treated as one trust for federal income tax purposes if these trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries and the principal purpose of the trusts is the avoidance of federal income tax.

A trust is taxed on income if it does not distribute it to a beneficiary. Under earlier law trusts paid tax on their accumulated income at the same rates as a married individual filing a separate return.

Income tax rates for trusts and estates for taxable years beginning in 2007 are as follows:

If taxable income is	The tax is
Not over $2,150	15 percent of taxable income
Over $2,150 but not over $5,000	$322.50 plus 25 percent of the excess over $2,150
Over $5,000 but not over $7,650	$1,035.00 plus 28 percent of the excess over $5,000
Over $7,650 but not over $10,450	$1,777.00 plus 33 percent of the excess over $7,650
Over $10,450	$2,701.00 plus 35 percent of the excess over $10,450

If the trust has net long term gains after May 5, 2003 and qualified dividends, the maximum rate for these items is 15 percent. However, qualified dividends or capital gains from disposition of property held for investment can be excluded from the above rates to the extent these items are included in investment income for investment interest expense purposes.

Before passage of the Tax Reform Act of 1986, the accumulation distribution rules permitted the deferral of taxation without any interest accruing on deferred taxes. Trust income tax was very fertile ground for aggressive tax planning. Now, however, the tax bracket of the trust will be higher than that of any of the beneficiaries, so there will be no tax advantage to accumulating income and paying it out at a later date.

Trusts must now pay quarterly estimated federal taxes in the same manner as individuals. If the estimated payments made by a trust exceed the trust's tax liability, the trustee may elect to treat the excess as an estimated payment made by a beneficiary. The election is made on a fiduciary return that must be filed within sixty-five days after the close of the taxable year. The excess payment is considered as paid on the last day of the calendar year, so the beneficiary can take credit for this payment on the January 15 estimated payment following the calendar year.

For income tax returns filed after August 5, 1997, the Taxpayer Relief Act of 1997 requires that income tax returns of beneficiaries of a trust or an estate be filed in a manner consistent with the information furnished by the fiduciary, or that a statement identifying the inconsistency be filed.

(Text continued on page 35)

6. GIFT TAXATION

6.1 Annual Exclusion

A gift of a current income interest in a trust (that is, where the trust income is to be paid out to a beneficiary at least annually) is a gift of a "present interest" for gift tax purposes and is thus eligible for the gift tax annual exclusion in 2006 of $12,000 (indexed annually for inflation after 1998 in one-thousand-dollar multiples) or $24,000 with spousal consent, per beneficiary. (The annual exclusion amount is indexed each year for inflation under IRC Section 2503(b)(2).)

If a trust contains a direction or authorization to accumulate the trust income, the interest of the beneficiary is a "future interest" that is not eligible for the $12,000 (or index increased) annual exclusion.

In most cases it will be desirable to limit the size of a present interest gifted to the amount of the annual exclusion because the excess will at least erode the available unified credit of the grantor, or even result in a fairly heavy tax if the credit has already been exhausted. However, a series of excludable annual gifts can result in substantial gift tax savings.

The value of the remainder interest in a trust is a future interest and therefore the annual exclusion does not apply. However, the gift of a remainder interest in the trust to a donee who is the income beneficiary of the trust is a gift of present interest that qualifies for the exclusion in those states whose laws provide for merger of interest and termination of the trust. A gift to a minor will not be considered a future interest if the property and its income may be expended for the benefit of the minor prior to his or her attaining age twenty-one and may be distributed to that individual at that time or to his or her estate in the event of his or her prior death (see section 6.2).

6.2 Gifts for the Benefit of a Minor (IRC Section 2503(c))

Trusts for the benefit of a minor are really a statutory creation, Section 2503(c) having been added to the Internal Revenue Code in 1954. It was originally intended as an exception to the rule denying the annual gift tax exclusion to gifts of future interests. Since the trustee of such a trust is given discretionary power to withhold or distribute trust income and capital, there exists a true "future interest." For such transfers made before January 1, 2010, the annual exclusion, though, is allowed for gifts to such a trust if the trust is irrevocable and meets the three primary requirements of IRC Section 2503(c):

— The trust instrument must authorize the unlimited use of the trust property and income "for the benefit of the donee before his attaining the age of twenty-one (21) years." This requirement is satisfied by giving the trustee absolute discretion to make distributions to or for the benefit of the minor. Implicit in this requirement also is the necessity that only one child may be the beneficiary (the donee); there must be a separate trust or valid separate share for each child intended to be benefited. Further, the child must be born; a transfer in trust for an unborn child does not qualify.

— The trust property must pass into the child's ownership at age twenty-one. Revenue Ruling 74-43, 1974-1 CB 285, holds that this requirement is satisfied so long as the beneficiary has the right to demand, within a "limited" time after attaining age twenty-one, that the trust assets be delivered to him or her, even if the trust further provides that if no demand is made the trust may then continue by its own terms beyond age twenty-one.

— If the minor dies before age twenty-one, the trust assets must pass to his or her estate or to the donee's appointee pursuant to a general power of appointment. The term *estate* in this section of the code is a specific defined term so that child's "heirs," "descendants," "next of kin," and so forth are not his or her "estate"; a mere remainder to such persons will not qualify the trust.

For such transfers made after December 31, 2009, and except as may be provided in regulations, a transfer to a trust will be treated as a taxable gift, unless the trust is treated as wholly owned by the donor, or the donor's spouse, under the grantor provisions of the Code IRC Section 2511(c), added by Pub.L. 107-16, Economic Growth and Tax Relief Reconciliation Act of 2001, (The 2001 Act) Section 511(e). (Of course, all of the changes to the estate and gift scheme are also sunsetted for transfers made after December 31, 2010. The 2001 Act, Section 901.)

The trust instrument should designate successor beneficiaries, such as siblings, nieces, nephews, and the like in the event the beneficiary fails to do so by defaulting in exercise of a general power of appointment. This is permissible and should always be included in the trust instrument. The fact that the local law prevents a minor from exercising his power of appointment does not disqualify the trust.

6.3 Demand (Crummey) Trusts

Many parents are not content to pass substantial wealth to their children through a minority trust under IRC Section 2503(c) because such a trust passes the wealth to children at age twenty-one. These parents prefer to pass the wealth to their children at a more advanced age such as thirty or thirty-five. A gift of money to a trust to be distributed to the children at age thirty or thirty-five creates a future interest in the children. Without the benefit of the minority exception, such a gift does not qualify for the annual gift tax exclusion. If the trust could be found to create a present interest, however, the annual exclusion would apply.

A trust creating a present interest in a beneficiary who is not to receive any distributions for several years is commonly referred to as a Crummey trust after the case of *Crummey v. Comm.*, 397 F.2d 82 (9th Cir. 1968), in which the use of such a trust was upheld. A Crummey trust creates a demand power, commonly referred to as a Crummey power, in the beneficiary to withdraw trust assets from the trust when those assets are gifted to the trust. This power, which is designed not to be exercised, creates a present interest in the power holder and qualifies gifts to the trust for the annual exclusion. Thus, the grantor can contribute up to $12,000 ($24,000 with spousal consent) for transfers made before January 1, 2010, to the trust annually without paying gift tax on the contribution.

When establishing a Crummey trust, the following factors should be kept in mind:

— The power should be limited to occasions when additional gifts are made to the trust. Only then is there need of a present interest deduction.

— The power should be limited to the lesser of the amount of the gift or the amount eligible for the exclusion. For example, if a husband and wife make a $25,000 gift to the trust, the demand right should be limited to $24,000. There is no benefit gained by making the entire $25,000 subject to demand since the additional $1,000 does not qualify for the annual exemption.

— The power holder must know of his right and must have time within which to exercise his right (Rev. Rul. 81-7, 1981-1 C.B. 474). The amount of time within which the power holder must exercise his or her right must be "reasonable." Thirty days has been determined to be reasonable; ten days may not be reasonable. Thus, the grantor should provide notice to the beneficiary any time a gift is made to the trust. If the beneficiary is a minor or other legally incompetent person, such notice should be given to his or her natural or legal guardian.

— Failure of beneficiary to exercise his right of withdrawal is deemed a release of a power of appointment. It is treated as a gift to the extent it exceeds $5,000 or 5 percent of the trust principal (IRC Section 2514(e)).

For such gifts made after December 31, 2009, and except as may be provided in regulations, a transfer to a trust will be treated as a taxable gift, unless the trust is treated as wholly owned by the donor, or the donor's spouse, under the grantor provisions of the Code IRC Section 2511(c), added by Pub.L. 107-16, the 2001 Act, Section 511(e). (Of course, all of the changes to the estate and gift scheme are also sunsetted for transfers made after December 31, 2010 (the 2001 Act, Section 901).)

7. ESTATE TAXATION

7.1 Grantor (Decedent)

Trust property will be taxed in the grantor's estate if the grantor alone, or in conjunction with another, retains the power to alter, amend, or revoke the trust or to designate who is to enjoy the trust income or corpus. Retention of the right to the trust income or the use of trust property is sufficient to include the assets of the trust in the grantor's estate.

In addition, the grantor's estate is taxed if the transfer to the trust is not intended to take effect until the grantor's death. This applies where

— Possession or enjoyment of the property could be obtained by surviving the grantor.

— The grantor has retained a possibility of regaining the property (reversionary interest), having it return to the estate, or having a power of appointment over it.

— The value of this reversionary interest immediately before the grantor's death exceeded 5 percent of the value of the entire property.

It is not necessary that the power to alter the terms of the trust be one that may be operative in favor of the grantor. Even if the grantor completely severs any personal economic benefit but keeps the right to designate who is to enjoy the interest or principal, the power has the same effect as if the principal itself were subject to recapture by the grantor for personal benefit. The rules for determining whether income of a trust is taxable to a grantor and whether the corpus is includable in the grantor's estate for estate tax purposes are thus not the same. The following are examples of techniques that can be used to cause a trust to be a grantor trust without causing the trust assets to be included in the grantor's taxable estate:

— Use trust income to pay premiums on the grantor's life insurance (Section 677(a)(3)). (See section 3.4.3, herein.)

— Designate the grantor's spouse a permissible distributee of trust income, thereby violating Sections 677(a)(1) and 677(a)(2). (See section 5.1.3, herein.) The distributions made to the grantor's spouse should not be used to discharge a grantor's legal obligation to support his or her spouse, or else the trust would be included under Section 2036.

— Grant a third person (even an independent trustee) the power to add beneficiaries designated as recipients of trust income or principal. This power will violate Sections 674(a) and 674(c). It is important that the grantor should not be the person actually retaining the power to add beneficiaries to the trust, because, under Section 2036 or 2038, it would cause the trust to be included in the grantor's estate.

If the grantor of an inter vivos trust reserves the right to replace a corporate trustee after removing the original corporate trustee without cause, an unlimited discretionary power to distribute trust income and principal to the grantor's adult children held by the corporate trustee would then be attributable to the grantor for estate tax purposes.

7.2 Beneficiary

Sometimes a trust instrument grants powers to a beneficiary. Whether these powers are considered a general power of appointment or a limited power of appointment will determine whether the possession of these powers would cause a beneficiary to be subject to estate tax.

Only powers defined as "general powers of appointment" result in taxability. Basically for tax purposes, a general power of apointment is one that can be exercised by a person in favor of himself or herself, his or her estate, or creditors.

A power to consume, invade, or appropriate income or corpus for the donee's benefit does not always necessarily constitute a general power of appointment. If the power is limited by ascertainable standards such as for health, education, support, or maintenance of the donee, it is not a general power. In short, the holder's duty regarding use of the power must be reasonably restricted in terms of his or her needs for health, education, or support or any combination thereof. However, a trustee's powers to invade for "general happiness" (Est. of John Russell Little, 87 TC No. 34 (1986)), or to invade for any special "need"

(IRS Letter Ruling (TAM) 8601003 (9/20/85)) are not considered ascertainable standards. A power of appointment encompasses only a power granted to the donee by a third party. It does not include any right or power retained by the creator of the power to transfer property. The power of appointment confers upon someone other than the creator the right to make some disposition of the property interest.

Since October 21, 1942, general powers of appointment have had the following effects upon the holder of the power:

— If the power is held at death (even though not exercised) the property subject to the power will be included in the holder's gross estate.

— If the holder had exercised it in his or her own favor prior to death, the power would no longer exist and therefore would not be subject to tax; however, the property controlled by the holder of the power would be included in the gross estate of the holder of the power and taxed. It is possible for the holder to make a qualified disclaimer of the power. A qualified disclaimer has the same effect as if the person to whom the power was granted had never had the power. A disclaimer can be used only if the individual learned of the power conferred upon him or her and refused to accept it at the outset, typically within nine months of the date of the irrevocability of the power. If the individual actually assumes the power and later lets it go, the effect is a release, not a disclaimer, and will result in a taxable gift.

7.3 Grantor Retained Income Trust

A grantor retained income trust (GRIT) has become a popular method of saving on both estate and gift taxes. Under a GRIT, which is irrevocable, the grantor receives income from the trust (either a fixed-payment Grantor Retained Annuity Trust (GRAT) or a fixed percentage of the fair market value of the trust property) for a term of years, after which time the assets are distributed to the remainder beneficiaries.

If the grantor survives the term of years, the benefits gained by using a GRIT are twofold. First, upon the termination of the income interest, with the grantor still living, the trust assets, including all appreciation in value subsequent to the date of transfer to the trust, pass to the beneficiaries free of estate taxes. Second, since the beneficiaries obtain only a remainder interest (that is, they receive only what is left after the term of years expires, in this case the assets but not the income produced by them), the initial value of the assets placed in the trust is reduced by the value of the preceding term of years and thus discounted below the market value of the assets for gift tax purposes. Thus, the value of the remainder interest to the beneficiary (valued at the time the trust is funded) is far less than the value of the same assets if directly transferred to the beneficiary free of any intervening income interest. The longer the term created by the trust, the greater the discount on the value of the assets. The discount rate is equal to 120 percent of the mid-term applicable federal rate (AFR) rounded to the nearest two-tenths of a point. The AFR is based on the yields of Treasury securities and is published monthly by the Internal Revenue Service.

> *Example.* Grantor places $100,000 in trust and retains a fixed amount of income produced by the trust for ten years, after which time, the trust assets pass to his son. Assuming a discount rate of 4.4 percent, the remainder interest is valued under Treasury Gift and Estate Tax Valuation Table B at only $39,800.

If the grantor does not survive the term of years, however, the trust assets are included in the grantor's taxable estate. To mitigate the consequences of the death of the grantor before the term has expired, many practitioners recommend that a series of grantor retained income trusts be created. For example, instead of setting up a single trust for a term of ten years, a grantor can set up a series of trusts, one for five years, another for eight years, and another for ten years, each funded with different assets. Thus, if the grantor survives only six years after the trusts are created, only the assets of the eight- and ten-year trusts will be included in his or her taxable estate.

If the grantor is insurable, consideration should be given to taking out life insurance on the grantor's life to cover the loss of the estate tax savings if the grantor dies during the term of the GRIT. The insurance should not be owned by the grantor, so the proceeds would not be included in the grantor's estate. (See the chapter on Estate Planning for more details about keeping insurance proceeds out of the insured's taxable estate.)

Other items that should be considered when establishing a GRIT include the following:

— No step-up in basis is permitted for GRIT property if the grantor survives the period of the trust. Use of higher-basis assets could reduce the income tax consequences to the beneficiary if the GRIT property is sold after the trust is terminated.

— There is a disadvantage to gift-splitting with a spouse if the grantor dies before the expiration of the trust. If the value of the trust's assets at the time of death is included in the grantor's taxable estate, the grantor's unified credit used to offset the gift tax on the grantor's half of the gift is still available. However, if the grantor's spouse elected to treat half of the gift as if made by him or her, the unified credit used for that portion of the gift would be wasted.

See the Estate Planning chapter for a detailed discussion of changes in GRITs under the Revenue Reconciliation Act of 1990.

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Estate Planning

ESTATE PLANNING

1. FUNDAMENTAL ESTATE PLANNING CONCEPTS

Estate planning is a process of providing for the financial needs of an individual during his or her lifetime and of transferring the remaining property with a minimum amount of taxes and administration expenses at death. Estate planning is therefore concerned with maximizing the estate by minimizing income, gift, and estate taxes while taking into consideration the estate owner's goals and the family's need for future income and capital.

While tax planning is only one of the purposes and goals of estate planners (see subsections 1.1 to 1.6, below), it must be noted at the outset that the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) has brought dramatically new reforms to the estate, gift, and generation-skipping tax rules and practice, has increased the available exemptions and will repeal, in 2010, the estate and generation-skipping tax schemes.

Estate planners must now evaluate all estate plans in light of:

— The estate, gift, and generation-skipping rules currently in effect

— The increased exemptions and lowered rates between 2005 and 2009 (together with which changes are effective in which years)

— The possibility of repeal of the estate and generation-skipping (but not gift) taxes in 2010

We have updated this chapter to advise you of those statutory changes and to point out how and why individual practical changes might apply to which areas of estate planning.

1.1 Family

The estate planner must know who the family members are and who the intended beneficiaries are, as well as their needs and ability to manage money. The domicile of the client must be established so that the estate can avoid multiple state tax and administration problems. Consideration should also be given to how the surviving spouse will manage with regard to personal support and the support of dependent children and grandchildren during the period of administration. It is important that the surviving spouse have sufficient cash and other liquid assets, which—along with insurance-policy proceeds—should cover living costs for the family until the other assets are liquidated.

Minor children or other children may require special attention. A determination must be made as to whether any of the children or grandchildren are adopted and to see whether they have the same rights as children born from the marriage. An incompetent child may require custodial care, and the estate owner may wish to provide that child with adequate financial provisions for life to ensure the child's security and remove a possible financial burden from the siblings.

Guardianships for minor children may have to be established if both parents are deceased. Elderly parents may have to be provided with special trusts upon the death of a child who was supporting them.

Sometimes representing a husband and wife jointly in estate planning can be a problem. The estate planner may be in an untenable position when one spouse wants to make a confidential change that affects the other spouse. It is important to obtain a written retainer agreement in which both spouses state whether secrets of one spouse may be kept from the other spouse.

Estate planning for same sex or other unmarried couples requires focusing on special issues. State intestacy laws may not be adequate for these clients because the laws were not designed to meet the needs of unmarried couples. Since there is no deferral of estate taxes for unmarried couples, liquidity on the first death must be given special consideration.

1.2 Estate Value

The estate planner must review all assets to determine proper ownership of these assets, with a determination of who is going to receive specific property. Unique features of the assets must be understood. The assets must be valued; this is normally a very simple task, but determining the value of a going business or an interest in a partnership, limited liability company, or a closely held corporation can be very complicated.

1.3 Planning Objectives

The estate planner must understand the financial requirements for the estate owner's beneficiaries and should also be aware of the aspirations of the estate owner. The estate planner should know the answers to the following questions:

— What are the estate owner's hopes for his or her children and grandchildren, and what opportunities should be available to them (college, trade school, or their own business)?

— What is the estate owner's judgment of the requirements of the surviving spouse or partner and children and grandchildren and of their capacity to manage financial affairs?

— What are the estate owner's thoughts concerning how much income would be required for the surviving spouse or partner and their children or children from prior marriages?
— What is the philosophy of the estate owner regarding how much ready cash should be made available to his or her children and grandchildren?
— What amount of liquid funds would be needed to pay off liabilities of the estate?
— How much is needed to educate the children and grandchildren?
— What are the estate owner's charitable intentions and commitments?
— What assets does the estate owner feel should be disposed of at his or her death and what assets should be passed on in kind to heirs?
— What medical problems do the estate owner and his or her family have that will affect cash flow?

1.4 Maximizing the Estate

One of the objects of estate planning is to maximize the estate, which can be accomplished by minimizing the estate tax. Even so, the estate planner should not make recommendations to minimize the tax if the long-term effect would be detrimental to the future size of the estate. The estate planner must have a thorough understanding of how the estate tax works and of which assets of the estate owner would be includable in the taxable estate. In addition, estate planners should be aware of the following factors:

— In recent years, inflation and "bracket creep" have subjected more individuals to the onerous impact of estate taxation.
— Lifetime gifts may help reduce future estate tax.
— Business interests may have to be transferred during the lifetime of the estate owner to avoid future appreciation's being subject to estate tax.
— Insurance on the estate owner's life may have to be transferred to an irrevocable trust or to the children to keep the insurance out of the estate owner's and the spouse's taxable estate.

1.5 Other Facts

The first step in devising an estate plan is to gather the facts. The estate planner must collect accurate and detailed information for an accurate and complete picture of the estate owner's assets. (See the *Accountant's Business Manual Toolkit CD-ROM,* which contains the appendix to this chapter, for questionnaires that can be useful in obtaining the information.) With these facts available it will be possible to project the probable growth of the estate, determine how tax liabilities against it may be minimized, and estimate how much income is to be expected either on retirement or to the family after death.

1.6 Cash Flow Analysis

A complete analysis must be made of the estate owner's current income, including tax-exempt income, and future income such as Social Security and other retirement benefits. The cash flow analysis should also include both living expenses and expenses for the surviving spouse, children, and dependent grandchildren after the estate owner's death.

1.7 Estate Planning Team

The skill of more than one individual is required to obtain and analyze the estate owner's information properly and to prepare all documents necessary to implement the estate plan. Formulation of the plan requires some discussion with other members of the estate planning team, which often includes the estate owner's CPA, lawyer, life underwriter, investment counselor, and bank trust officer. The team of planners should have a strong financial background and an existing professional relationship with the estate owner and his or her family.

1.7.1 CPA

Unlike other members of the estate planning team, the certified public accountant sees his or her client on a regular, recurring basis. Because of this frequent (sometimes annual) contact with the estate owner, the CPA should be familiar with the estate owner's affairs and can help in gathering information as well as determining the value of assets. In addition, the CPA can be particularly useful in valuing closely held businesses. The CPA can also prepare the estate tax and income tax projections using sophisticated computer techniques that allow for multiple "as if" propositions.

1.7.2 Attorney

The attorney's primary responsibility is to review the ownership of assets, add his or her views to the CPA's regarding the tax laws, interpret probate laws, and prepare the necessary legal documents that can implement the plan such as the will, buy-sell agreements, and trust agreements. The attorney must make sure the client's wishes are expressed by the documents and will be followed after death. The attorney will be aware of proposed testamentary dispositions that might violate state laws, such as the rule against perpetuities, and can assure that the documents are properly executed.

1.7.3 Life insurance underwriter

The life insurance underwriter will review the estate owner's insurance and recommend changes that may be required to meet the needs of the estate owner. Insurance may be needed to fund buy-sell agreements as well as to pay estate taxes and administrative expenses. The life insurance underwriter can also advise the other members of the team and the estate owner as to available funding vehicles.

1.7.4 Investment counselor

The investment counselor will review the estate owner's investments and make recommendations with regard to current and future holdings. This adviser may help establish the standards to be used in investing trust or other estate assets.

1.7.5 Trust officer

It is a good idea to have a trust officer involved in the original planning if the estate owner is going to use a bank as executor or trustee. The trust officer can recommend ways to minimize administration costs and preserve capital in investments. If the estate plan calls for the estate owner to set up a living trust, a bank will probably be called in to administer the trust after the estate owner becomes incapacitated or dies.

2. THE CONVENTIONAL WILL

2.1 Definition and Purpose

A will is an instrument that enables an individual to dispose of his or her property upon his or her death. In addition, the will appoints a fiduciary and makes provisions for the administration of the estate. Wills can be revoked at any time during the estate owner's lifetime and there can be special instructions for funeral arrangements and upkeep of cemetery plots.

Certain property does not pass under a will. This property is often referred to as *will substitutes*. The following is a partial list of will-substitute property:

— Property held in trust

— Life insurance payable to a named beneficiary

— Transfer on death (TOD) and pay on death (POD) accounts

— Joint property with right of survivorship (or tenants by the entireties)

— Homestead property (in some cases)

— Bank accounts in trust for another individual (totten trusts)

— Qualified retirement plans payable to a spouse or named beneficiary

The divorce does not mean that the ex-spouse is no longer a beneficiary; therefore, it is important that the estate owner has eliminated his or her former spouse from the above documents, unless required by the divorce agreement to maintain the ex-spouse as beneficiary.

Since the property listed above does not pass under a will, determination must be made as to what is controlled by the will. This property is often called the *probate estate* and can be quite different from the taxable estate.

2.2 Who Should Make a Will

Every person of sound mind who is not a minor has a right to make a will disposing of real and personal property. There are certain restrictions that most state laws place on your right to dispose of your property by will. For example, most states allow a surviving spouse to elect to receive a certain portion of a married person's property; or that certain properties be set off for a surviving spouse and minor children apart from the estate; or that children born after a will has been executed be entitled to a share of the estate unless they have been mentioned or provided for in appropriate ways; or that gifts to charities be limited in estates where the decedent is survived by a parent or children.

2.3 Intestacy

Each of the 50 states has laws that prescribe in great detail what happens to a citizen's property if there is no will or will substitute. These laws are generally referred to as *statutes of descent and distribution* or as *statutes of intestate succession*; thus, if a person dies without a will, the state takes over and makes a will for the person. As a consequence, the estate may go to the "wrong" person, or to the right person but in the wrong form. Property not disposed of by a will goes to the heirs outright even though they may not be capable of handling it and would be better served if it were in trust. If such persons are minor beneficiaries, court-appointed guardians will be required to manage their inheritance during minority. The administrator of the estate, designated by statute, may be a person the testator would not have chosen to handle the estate. Upon the death of the surviving parent, a guardian of the person of the minor children will also be appointed; the person selected by the court will not necessarily be the one best suited for the job or the one the deceased parent would have selected.

2.4 Required Formalities

Each state has its own specific set of formalities required to make a will valid. The number of required witnesses to the will differs from state to state. A witnessed will is accepted in all jurisdictions, the unwitnessed will only in some. It is therefore wise to avoid using the unwitnessed will, particularly if the individual is likely to leave assets in more than one jurisdiction, since the use of this type of will would increase the possibility of some of the dispositive provisions failing.

Although there are some variations in state statutes with respect to preparing a witnessed will, these requirements are essentially applicable to all common law jurisdictions:

— The will should be declared in an instrument in writing.

— The testator should sign the instrument; if that is not possible, another person should sign for the testator, in the testator's presence and at the testator's request.

— This signature of the testator or person requested to sign must be following the text of the will immediately and without leaving any intervening space.

— None of the witnesses should be beneficiaries, executors, or trustees under the will.

— The testator should expressly ask the attesting witnesses to attest "the execution of the will."

— The testator and the witnesses should all sign in each other's presence.

It is very important that local law be checked to make sure that the will has been executed according to the law.

2.5 Changes

2.5.1 Codicil

A codicil is a change to the will; it is treated as part of the will and must be executed the same way. A codicil is generally an amendment to the will rather than a replacement for it; hence the will's provisions remain effective except to the extent changed by the codicil. Today, with the use of word processing equipment, many attorneys are preparing new wills rather than amending old ones through the use of codicils. If there is a codicil, the will and codicil must both be admitted to probate.

2.5.2 Revocation

A will can be revoked by an intentional positive physical act, such as cancellation, obliteration, or destruction; by a written revocation, using the same number of witnesses and ceremony required for a will to be valid (see above); or by operation of law. In some states, a divorce may automatically invalidate a provision in favor of a spouse. Revocation by operation of law is difficult to guard against. If an original will (as opposed to a copy) cannot be offered for probate, a presumption may arise that the testator destroyed the will for the purpose of revoking it.

2.5.3 Restatement after revocation

If the will has been revoked by law contrary to the testator's wishes, or if the testator has revoked the will and wishes to restore it, the will can sometimes be revived by republishing it or by reexecuting it just as it was originally executed.

Many states adhere to a rule that the destruction or revocation of a second will when the first will is still intact automatically revives the first will; they assume an intention to revive the first will from the fact that the testator did not destroy it when the second was made.

3. WILL COMPONENTS

The will is one of the most important documents a person can make and, therefore, it is important that it be drawn by an attorney with a thorough understanding of the estate owner's wishes and present and future obligations.

3.1 Estate Owner's Domicile

It is important to establish the estate owner's domicile. Typically, this is very easy; however, with many people spending their winters in Arizona or Florida and still owning or renting real estate in Northern states, the question of domicile cannot be taken too seriously. A determination has to be made as to which is the estate owner's principal home. This may require a review of where the estate owner files tax returns, registers cars, and votes, and whether the person has filed a homestead tax exemption in the state believed to be his or her domicile. It is important to note that even though a person establishes a domicile in one state, any real property located in another state is subject to that state's inheritance or estate tax. Real property passing under a will is probated in the state where it is situated, not the state of the decedent's domicile.

The determination of a person's domicile is important, because under state law a person's domicile determines the

— Execution requirements for a valid will (see section 2.4 of this chapter).

— Amount of the decedent's estate that passes to family members if there is no will (intestacy) (see section 2.3 of this chapter).

— Amount of state inheritance or estate taxes. (But non-domiciliary real property is subject to such taxes in the non-domiciliary state.)

— Rights of a surviving spouse as to an elective share (percentage of the estate on which the spouse has a claim).

3.2 Marital Deduction Provision

Property left to the surviving spouse, either outright or in an "A" trust, also known as a marital trust, can qualify for the unlimited marital deduction (see section 4.2.3). If the intention is to minimize taxes in the successor's estate, a formula clause may be used to limit the amount passing to the surviving spouse; the rest of the property can then be left in a "B" trust (credit shelter trust or bypass trust) for the surviving spouse's benefit or for the benefit of the entire family. This strategy allows the property passing to the B trust to be "sheltered" by the deceased spouse's applicable exclusion which is $1,500,000 for deaths in 2004 and 2005; $2,000,000 for deaths in 2006, 2007, and 2008; and $3,500,000 for deaths in 2009, before the proposed repeal of the estate tax for deaths after December 31, 2009. These changes are set forth in a chart in section 4.3.3.

These increases in estate tax exemptions require modification of marital planning. It may no longer be prudent for an estate plan that places the full amount in a B trust. This may deprive the surviving spouse of sufficient access to the funds and may violate state laws that allow surviving spouses to inherit a minimum portion of the other's estate.

3.2.1 Pecuniary formula

One method of limiting the amount going to the surviving spouse to the amount necessary to cancel out the federal estate tax, is using a pecuniary formula. This formula gives the spouse the smallest dollar amount that would "zero out" the estate. This bequest can be given outright or in trust. The advantage of using this formula is that a fixed-dollar value is going to the surviving spouse. There are, however, two major disadvantages associated with this formula:

— The surviving spouse does not share in any appreciation or depreciation of the estate during the period of administration.

— Gain is realized by the estate when the bequest of a fixed amount is satisfied by assets that have appreciated in value at the time of distribution (Revenue Ruling 60-87, CB 1960-1, 286; Revenue Ruling 56-270, CB 1956-1, 325).

3.2.2 Fractional formula

The fractional-formula clause gives the surviving spouse a share or percentage of the estate. Under this formula, the surviving spouse shares in any appreciation or depreciation of the estate from date of death to date of distribution. The surviving spouse thus may suffer if there is a severe shrinkage. Additionally, no capital gains are generated when the estate distributes property in kind as long as the distribution does not have the effect of an exchange among the residuary beneficiaries.

The use of the pecuniary instead of the fractional formula or vice versa is sometimes determined by the drafter's personal preferences. The fact that either one, drawn properly, will generate the needed marital deduction does not mean that one method is not preferable to the other in certain circumstances.

3.2.3 Pecuniary credit shelter formula

In a very large estate, where the amount of the credit sheltered trust will be insignificant, it would simplify the administration if the credit sheltered trust first received the fixed-dollar amount and the surviving spouse or marital trust received the residue of the estate. In this formula, the credit sheltered trust is given an amount equal to the largest amount without incurring a federal estate tax.

The advantage of using this formula is the avoidance of capital gain taxes with the marital portion if the bulk of the estate appreciates in value. Only funding of the credit shelter trust with appreciated assets would be subject to capital gains tax.

3.2.4 Equalization formula

If either or both husband's and wife's estates are over the applicable exclusion amount (see chart in section 4.3.3) and both the estate owner and his or her spouse are of an advanced age, the estate planner should consider a formula in which the amount left to the surviving spouse would be an amount that would equalize both estates. Equalizing the two estates, and subjecting the estate of the first spouse to die to estate tax upon death, may be more cost effective than subjecting the combined estates to estate tax (at higher rates) on the death of the surviving spouse.

3.3 Tax Apportionment

In most states, if there is no specific clause in the will as to who pays the estate taxes, each recipient of property from the estate must pay his or her applicable share regardless of whether or not they were designated to receive property in the will. It is very common in many wills to avoid state law and make the residuary beneficiaries pay all the taxes and waive any right of reimbursement from assets that pass outside the will. Thus, everyone but the residuary beneficiaries would receive their inheritance free of estate tax.

Many estate planners are often surprised by the large amount of assets that pass outside of the will. These may include the following:

— Jointly owned property that passes directly to the surviving owner, such as a residence or bank accounts

— Life insurance that is included by the IRS as part of the estate for federal tax purposes

— Pension benefits, such as IRA and 401(K) plans

— Property that passes pursuant to a living trust

— Property subject to a general power of appointment

If the preceding property is received by the same beneficiaries in the same proportions as those of the residue of the estate, there is no problem. If there is a difference, however, it may not be appropriate to put the entire tax burden on the beneficiaries of the residue of the probate estate. In many cases, the assets go to someone other than the residuary beneficiary.

The planner should be cautious when including in the residuary provisions of a will or trust both beneficiaries whose bequests generate an estate tax deduction (whether charitable or marital) and beneficiaries whose bequests do not generate such a deduction.

Example. T's will provides for $5,000,000 in preresiduary bequests for which no estate tax deduction is allowable and leaves one-third of the residuary to each of his two daughters and the remaining one-third to charity. The will provides that taxes shall be paid from the residue of the estate. State law provides that bequests that do not generate estate taxes do not share in the estate tax burden unless the will provides otherwise.

If the charity is charged with one-third of the estate taxes, its net share will be less, the charitable deduction will be less, and the estate taxes will be greater. All three residuary beneficiaries will, however, receive the same amount. If the charitable bequest is not charged with any estate taxes, the estate tax will be less but the charity will receive more than the other two residuary beneficiaries.

The proper outcome depends upon whether, when T directed that taxes be paid from the residue, he intended that all residuary beneficiaries bear the tax equally or whether he intended to merely state that preresiduary bequests would bear no tax but that as among residuary beneficiaries the state law of apportionment would apply. Did T intend that his daughters and the charity receive equal amounts, or did he intend that the charity receive significantly more than his daughters even though they were all to receive one-third of the residue (before taxes)? To resolve this ambiguity, T should carefully draft his will to answer such questions.

With regard to QTIP trusts included in the estate of the surviving spouse, if the will of the surviving spouse has a tax clause in which it is stated that the residuary estate pays for all taxes, whether or not the property passes under the will, this can cause a problem if the beneficiaries of the residuary estate and the beneficiaries of the QTIP are not the same. In those cases, the tax clause should not require the residuary estate to pay the estate tax on the value of the property included in the QTIP trust that is taxable in the surviving spouse's estate.

3.4 Common Disaster

A husband and wife may die in a common disaster or in such circumstances that it is impossible to determine the order of death. State law would normally dictate that for the purposes of administering the husband's estate he is deemed to have survived. For the purposes of administering the wife's estate she is deemed to have survived. One-half of joint property would pass through each estate. No property would pass from one spouse to the other by virtue of right of survivorship, intestate succession, or under a will or will substitute where the bequest is conditioned upon surviving the testator.

If a couple dies in a common disaster and one of the spouses has an estate in excess of the applicable exclusion amount and the other's estate is less than the applicable exclusion amount, the family will underutilize the unified credit. If the wealthier spouse's will creates a credit shelter trust for the applicable exclusion amount and leaves the remainder of the estate to the poorer spouse, the poorer spouse will receive nothing because under state law he or she would be deemed to have predeceased the wealthier spouse. The unified credit would again be underutilized.

State simultaneous death statutes allow testators to shift the statutory presumption of order of death. The statutes apply to all testators and beneficiaries, not just spouses, though spouses are most likely to die in a common disaster. In the case of the spouses with disproportionate estates, both wills should state that in the event of a simultaneous death the poorer spouse is deemed to have survived. This would allow both estates to fully utilize the applicable exclusion amount to the extent that the assets are sufficient to do so. Do not overlook the issue of simultaneous death and its effect on other matters such as the devolution of homestead property, which is beyond the scope of this treatment.

3.5 Identification of Beneficiaries

It is very important that the correct name and location of the individual beneficiaries and/or charitable organizations be obtained for the will; charitable organizations are often known by names other than their legal ones. Specific identification of all the beneficiaries should be made to avoid any problems with people with similar names.

3.6 Guardianship of Minor Children

A will should detail the guardianship arrangements for minor children by specifying who will care for the children in the event of the parents' death and who will manage the children's finances. These responsibilities need not be vested in the same person.

In some instances, a will may have a clause arranging to compensate guardians "above and beyond the cost of caring for the child." All wills should have a clause appointing a second-choice guardian if the first-choice guardian either dies or cannot act as guardian.

A will can authorize funds for an addition to the existing home of the guardian, so the minor can have his or her own bedroom.

Under most state laws, natural parents have a paramount right to the guardianship of their children, though that right is not absolute. The custodial parent may designate in the will someone other than the natural parent. The will can express a custodial parent's stance on an ex-spouse's suitability as a parent; however, the state court ultimately makes the final guardianship decision.

3.7 Dispositive Provisions

Determination should be made of who will receive the property if the beneficiary dies before the estate owner (should it go to the children of the beneficiary or should the bequest lapse and then pass on to the residuary beneficiaries?). In many states, adopted children are treated as natural children. The will should state if adopted children are to be treated the same as natural children.

The will should give the executor the right to hold tangible personal assets that may pass to minors or to sell them for the benefit of the minor.

It usually makes sense to appoint a trustee of property left to minors rather than leaving it outright to a minor. In most states, property left to a minor is subject to the jurisdiction of the surrogate or probate court and annual accountings (which may be accessible public records) may have to be filed. By using a trust set up in the will, the expense of the administration of a minor's property through the courts can be avoided. In addition, instead of having the minor obtain the property at eighteen, the will can state a later age at which the minor will obtain the property.

3.8 Powers

Usually, broad fiduciary powers are necessary and advisable to permit flexible administration. Many states have given the fiduciary broad powers in dealing with the assets of the estate. However, since we are never sure what state the estate owner may be domiciled in at the time of death, it is a good idea to give broad powers in the will even though state law may give such powers.

3.8.1 Real estate

In many states, if the will does not authorize a power to sell real estate, the executor must go to court and obtain permission in order to sell real property. This will be an added expense to the administration of the estate.

3.8.2 Investments

Determination must be made whether the executor should have the power to retain a closely held corporation's stock and partnerships or be required to sell them. Normally, if there is no specific contrary power in the will, the executor should have the power to retain closely held stock or businesses rather than be forced to sell them. In addition, giving the executor broad powers of investment is normally a good idea, since no one knows what assets will be the best investment in the future. However, a testator can suggest in the will the type of investment in which the executor should invest. Specific powers should also be given to allowing the executor to retain unproductive property for a reasonable time.

3.8.3 Self-dealing

Sometimes the executor and attorney or investment adviser are the same person, and often there can be a substantial saving in expenses if the executor performs other duties for the estate. This should be discussed in detail with the estate owner. In many states, an attorney or CPA cannot function as such and be an executor. In addition, if the CPA is the executor and his or her accounting firm is performing independent audits, that person will no longer be considered an independent accountant and therefore may have to give up either the executorship or the accounting work.

4. FEDERAL ESTATE TAX

The unified federal estate and gift tax is a tax on the privilege of transferring property during one's lifetime and at death. Thus the gift tax and the estate tax are really part of the unified transfer tax.

4.1 The Gross Estate

The gross estate, the starting point in estimating estate tax, includes the value of any property (probate and nonprobate) the estate owner had an interest in at death, as well as property in which the estate owner retained an interest, power, or control at the time of demise. Internal Revenue Code (IRC) Sections 2031 and 2033 are the basic gross estate provisions. These sections are very broad and all-inclusive. The gross estate also includes gift taxes paid by the decedent or the estate for all gifts made by the decedent or his or her spouse within three years before the decedent's death. The term *value* means fair market value at date of death, with the exceptions of the alternate valuation date (see section 4.1.9, below) and special-use valuation (see section 4.1.2, below).

4.1.1 Tangible personal property

The ownership of tangible personal property is one of the most troublesome areas in estate planning. Unlike securities, most personal property has no legal written title. In some cases, it is impossible to know who owns the furniture in a house. In some states there is presumption that the furniture in a house rented or owned by a husband belongs to him when in fact it may belong to his wife. Disposal of tangible personal property is normally not documented by a written conveyance signed by the donor. A personal property insurance floater can help in determination of which property is owned by the estate owner. Copies of bills or checks showing payment by one spouse may be necessary in order to identify ownership of the property, which in community property states is usually owned equally if acquired over time from community funds.

If any articles of personal property have an artistic or intrinsic value of $3,000 (e.g., jewelry, furs, silverware, paintings, antiques, coins or stamps), an appraisal by an expert would be required. The same is true of collections whose combined value exceeds $10,000.

4.1.2 Real estate

It is important that the attorney examine copies of deeds to real estate. The attorney also may be required to give his or her opinion in regard to a state's homestead rules affecting the ownership of the real estate. In jointly owned real estate, it is important to determine the effects that will result from the death of one spouse (see section 4.1.6, below).

One goal of estate planning is the avoidance of ancillary proceedings, required when estate owners own property in a state that is not their legal domicile. Such proceedings take place in the state in which the property is situated and entail the additional expense of having a person appointed to handle the proceedings there. To avoid ancillary proceedings, planning consideration should be given to holding the real estate in joint name, or in a living trust, partnership, S corporation or limited liability company. As a general rule, an interest in a partnership, S corporation or limited liability company (which entity may, itself, own realty in various states) is considered intangible property with its tax situs in the state of the decedent's residence and thus does not subject the estate owner to ancillary proceedings. It is important that the deed to the entity property is in the name of the entity and not in the name of the entity owner, or else an ancillary proceeding would be required.

Real estate can usually be valued by an expert appraiser. The general rule is to value the property on the basis of its highest and best use even if it is not being so utilized. For example, land presently used for farming that could be converted into either a residential subdivision or an industrial park has greater value than if it could only be used as farmland. The Internal Revenue Service would value the land at this higher and better use even though the property would continue to be used as farmland. This valuation method has caused hardship for those who wanted to continue the property in a family business; an executor may therefore elect, under Section 2032A, to value qualified property on its actual use as either farm or special business property. For the special-use valuation to apply, the estate owner must be a citizen or resident of the United States at the time of his or her death and the real property must be located in the United States and actively used as a farm or in a closely held business. The special-use valuation cannot reduce the estate owner's gross estate more than $900,000 in 2006 (this figure is the result of being indexed for inflation after 1998) below the value under the regular valuation method. In addition, the value of the farm or closely held business (both real and personal) must be at least 50 percent of the estate owner's gross estate, and at least 25 percent of the value of the gross estate must be qualified real property. Special-use valuation is particularly important to farmers and ranchers; advisers must have specific knowledge of all the rules and regulations of this method when advising such people.

If the land is subject to a qualified conservation easement, the Taxpayer Relief Act of 1997 allows an election to exclude from a taxable estate up to 40 percent of the value of the land subject to the easement. The maximum exclusion is as follows:

Year of Death	
2001	$400,000
2002 and later	500,000

There is no step-up in basis to the extent the value of the property subject to the exclusion is excluded from the gross estate.

The only changes made by EGTRRA to the area of qualified conservation easements is that the requirement that the land be located within a certain distance from metropolitan areas, national parks, wilderness areas, or urban national forests is eliminated; and the language regarding the value of the property to be taken into account is clarified to be the value of the property as of the date of the contribution referred to in the definition of *qualified conservation easement*. Both provisions are effective for estates of decedents dying after December 31, 2000.

4.1.3 Stocks and bonds

Marketable securities are valued at the mean between the highest and lowest quoted selling price on the valuation date. If there is no market activity on the valuation date but there are sales within a reasonable period before and after that date, a weighted average of the mean between the highest and lowest quoted selling prices on the nearest dates before and after the valuation date is used (Treas. Reg. Sec. 20.2031-2(b)). The average is weighted inversely by the number of trading days separating the valuation date and the selling date. For example, assume that no sale arose on the valuation date. Five business days before the valuation date and three days after the valuation date the most recent sales occurred. Five days before the valuation date the mean was $100 and three days after the valuation date the average was $96; the value therefore would be computed as follows:

$$\frac{(3 \times \$100) + (5 \times \$96)}{8} = \$97.50 \text{ per share}$$

Ownership of a large block of stock may be governed by the blockage rule (Treas. Reg. Sec. 20.2031-2(e)) under which a discount is taken on market value. If it can be shown that the block of stock is so large in relation to the actual sales on the existing market, then the shares cannot be liquidated within a reasonable time without depressing the market. Therefore, the price at which the block could be sold outside the market (through an underwriter) is a more accurate indication of value rather than market quotations. Mutual funds are valued at their redemption price (bid) value.

The valuation of a closely held business corporation creates special problems since there is no established fair market value for the stock shares. In Rev. Rul. 59-60, 1959-1 C.B. 237, as modified by Rev. Rul. 65-193, 1965-2 C.B. 370 and as amplified by Rev. Rul. 77-287, 1977-2 C.B. 319, Rev. Rul. 80-213, 1980-2 C.B. 101 and Rev. Rul. 83-120, 1983-2 C.B. 170, the Internal Revenue Service has established guidelines for valuing closely held businesses. For stocks, the guidelines spell out relevant factors such as net worth of the company, prospective earning power, dividend-paying capacity, goodwill, or other intangible value. These guidelines are nevertheless not all-inclusive since no one closely held corporation is exactly the same as another. To avoid problems with the Internal Revenue Service in valuing closely held corporations, consider the use of restrictive agreements or mandatory buy-sell agreements. In addition to the tax reasons for a buy-sell agreement, there are many nontax reasons for a buy-sell agreement, such as control passing to a particular person or persons. Any value based on an option to buy will not fix the value of the shares; there must be an obligation to sell. The fair market value of closely held corporation bonds depends on the soundness of the security, the interest yield, maturity date, and other relevant factors.

Rev. Proc. 2003-68, 2003-34 I.R.B. 398 was issued to provide guidance for valuation of stock options by providing a methodology for valuation. Rev. Proc. 2003-68 takes into account the volatility of the underlying stock, the exercise price of the option, the stock price at the time of valuation and the term of the option at the date of valuation. The valuation for certain options under Rev. Proc. 98-34, 1998-1 C.B. 983 is still available, even after Rev. Proc. 2003-68.

4.1.4 Mortgages, notes, and cash

Cash, United States currency, and bank deposits are valued at their face value. Notes, whether secured or unsecured, and mortgages are valued at the amount of the unpaid principal plus interest accrued to date of death unless the executor can establish a lower value or worthlessness. Note that a below-market interest rate can result in a lower value.

4.1.5 Insurance

Life insurance is purchased for many reasons, including the creation of a liquid estate, to protect from costs that will be sustained through death taxes and probate costs, to fund buy-sell agreements, and to utilize the tax shelter of inside build-up in a whole-life form of insurance. Normally, death proceeds of insurance are received income-tax-free. If someone other than the insured owns the policy for more than three years (see below) and the proceeds are payable to that person, they may be received free of estate tax even though the insured pays the premiums.

If the insured owns the policy on his or her life, the proceeds are subject to estate tax. If at death the estate owner owns a policy on someone else's life, that asset is included in the estate. Regs. Sec. 20.2031-8 explains how to value such policies. Insurance that has been transferred by the insured within three years of the insured's death is includable in the insured's estate under the contemplation-of-death rules (IRC Sec. 2035).

Following the 1981 tax reform measure, which provided for an unlimited marital deduction, survivorship life insurance (also known as second-to-die insurance) has become a popular vehicle for estate tax savings. A survivorship policy pays benefits on the death of a surviving spouse. Because the date of payment is determined by the longer of two lives, the premiums for survivorship insurance are significantly less than premiums for similar coverage payable on the death of one spouse.

If a survivorship policy is owned by the children or by an irrevocable trust (see the chapter on Trusts), the proceeds can be exempt from estate and income taxes. A couple can acquire survivorship insurance with proceeds roughly equaling the amount of the expected estate tax liability on their estate. The children or the trust then have a source of funds with which to pay estate taxes when both parents are deceased. Such funds are especially useful when estate taxes are owed on a closely held business or other nonliquid assets the children wish to preserve.

4.1.6 Jointly owned property

About half of the states allow property to be owned jointly by a husband and wife as a "tenancy by the entirety." On the death of one spouse the property becomes legally owned by the surviving spouse by right of survivorship, and only half the property is included in the estate tax return of the deceased spouse. That half would qualify for the marital deduction. Property can also be owned jointly by persons, married or not, as joint tenants with right of survivorship. In such cases, the property passes without probate to the survivor on death. This type of ownership should be clearly indicated by the deed or other instrument by which the conveyance is made. The usual method for conveyances to unmarried persons is to make the conveyance to "John Smith and Roger Smith as joint tenants with full right of survivorship, and not as tenants in common." In some states if the property is conveyed to a husband and wife, the conveyance automatically creates a tenancy by the entireties unless otherwise indicated. If the property is owned by two unmarried individuals as a joint tenancy, the proportion to be included in a deceased tenant's owner's gross estate is based on the percentage of his or her contribution to the total cost. This percentage is applied against the fair market value of the entire property on the day of the decedent's death. Note that the value of the entire property in cases involving unmarried persons will be included in the gross estate unless the amount contributed by the survivor is proved. In determining the amount of the survivor's contribution, any part of a contribution that was originally received from the decedent by gift cannot be included. If the property is held by spouses as joint tenants with right of survivorship, half the property is included in the decedent's gross estate.

Massachusetts has now made it possible for gay couples to marry and own property as tenants by the entirety. The effect that this will have on the laws of other states and the federal estate tax rules is unclear at this writing.

If property is held by tenants in common, each party owns an undivided interest in the property and there is no right of survivorship. Each party may sell his or her own portion without the consent of the other parties. A decedent's half interest in property as a tenant in common passes under his or her will just like any other property that the person owns and is thus includable in the gross estate. It is very important for the estate planner to look at copies of the deeds that set up joint property. Most estate owners will not have the detailed information describing how the property is held. In addition, it is important for the attorney to make a determination under state law of whether the property is held as tenants in common or as joint tenants. Some states require the words *tenants in common* to create a tenancy in common, while other states require that if property is given to two people and the words *right of survivorship* do not appear on the deed, they are automatically considered tenants in common.

4.1.7 Community property

The concept of community property is a creature of statute and exists in Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. Community property exists only between husband and wife and there are variations among the community property laws of the nine states. If the property is considered community property, normally half is included in the estate of the deceased spouse. Familiarity with the specific community property rules of each state is important in determining what is considered community property. Not all property acquired while residing in the state may be consided community property. In addition, if the estate owner moves from a community property state to a noncommunity property state, part of his or her property may still be subject to the community property rules. In community property states a married person may own separate property, usually property acquired before marriage. In addition, property acquired by gift, bequest, devise, or descent would also be considered separate property.

4.1.8 Other property

Other property may include a partnership interest, which would have to be valued much like an interest in a closely held corporation; other obligations due the decedent; tangible personal property; income accrued to date of death; unpaid compensation for work performed prior to death; employee death benefits contracted for by the decedent; claims, rights, patents, and copyrights; royalties; leaseholds; and judgments. Property in which the estate owner had certain legal or beneficial interests, or property subject to a general power of appointment possessed by the estate owner that he or she chose not to transfer during life, is includable in the estate. The estate may also include joint and survivor annuities, refund annuities and other payments received under similar contracts or agreements to the extent that the estate owner contributed to the purchase price, as well as payments to be made pursuant to qualified retirement plans and individual retirement accounts.

4.1.9 Alternate valuation date

The executor can value the gross estate at alternate valuation date values. The alternate election is on an all-or-nothing basis: all assets are valued at either date of death or the alternate valuation date. In general, the alternate valuation date is six months after date of death except for property distributed, sold, exchanged, or otherwise disposed of before the six-month interval, which is valued as of the disposition date.

The alternate valuation date can be used *only* when the gross estate value is less on that date than the date of death *and* results in a reduction of estate tax.

4.2 Allowable Estate Deductions

Once the value of all property included in the estate owner's gross estate has been determined, the next step is to compute and itemize allowable deductions against the gross estate.

4.2.1 Funeral and administration expenses

Funeral expenses are limited to those amounts actually expended by the executor. They include the undertaker's charges, burial costs, cemetery plot costs, and cost of headstones. Also included as a funeral expense is the cost of transportation incurred by the person who takes the decedent's body to the place of burial. Administration expenses include attorney's, executor's, accountant's, and appraiser's fees; court costs; publication fees; and other expenses necessary for estate administration. The executor has an election to deduct administrative expenses from the gross estate (Form 706) or from the estate's income tax return (Form 1041); see section 9.3, below. A particular expense can be divided between the estate and income tax returns in any proportion the executor chooses. Following the Tax Reform Act of 1986, the estate tax rates are generally higher than the fiduciary income tax rates; thus it is generally beneficial to deduct these expenses on the estate tax return when there is no marital deduction available and the estate is taxable.

4.2.2 Debts, mortgages, and liens

Debts secured by mortgages and liens are deductible separately but only if the encumbered property is included in the gross estate. Expenses of the decedent's last illness would also be included in this category. The debt or claims against the estate must be enforceable against the estate, so if the statute of limitations has expired and these debts cannot be enforced against the estate, they cannot be taken as a deduction. (This could occur when creditors fail to file claims against the estate within the period prescribed by applicable state law for perfecting claims.)

4.2.3 Marital deduction

To the surviving spouse, the marital deduction is perhaps the most important of the deductions from the gross estate. The marital deduction is allowed to citizens or residents of the United States but only with respect to property the value of which is included in the gross estate.

Under the marital deduction provisions of the Economic Recovery Tax Act of 1981, the marital deduction is unlimited. Thus a decedent can leave a spouse the total estate without any estate tax at all. However, any property received by the surviving spouse that is still owned by the surviving spouse at the time of his or her subsequent death may be subject to a substantial estate tax at that time.

For example, assume that a husband has an estate of $2,000,000 and a wife has an estate of $2,000,000. If the husband dies in 2006 and leaves his entire estate outright to his wife there would be no federal estate tax on his death, but on her subsequent death in 2008 the wife would have a taxable estate of $4,000,000 and gross federal estate tax of $1,680,800 less unified credit of $780,800, or $900,000 (see illustrations A and B that follow). Note that EGTRRA calls for gradual increases in the applicable exclusion amount through 2009 (see section 4.3.3, herein), before a single year repeal of the tax for the year 2010.

Setting up a credit shelter trust must generally be taken even in community property states to avoid inclusion of the entire $4,000,000 in calendar 2006; ($4,000,000 in calendar 2007, and 2008; and $7,000,000 in calendar 2009) in the estate of the surviving spouse. In other words, if the first to die leaves all to the surviving spouse, there will be only one $2,000,000 (or $3,500,000) applicable exclusion amount even if all the assets are owned fifty/fifty under the community property law. Thus, a credit shelter trust is still needed to provide for the surviving spouse's needs and to take advantage of both applicable exclusion amounts.

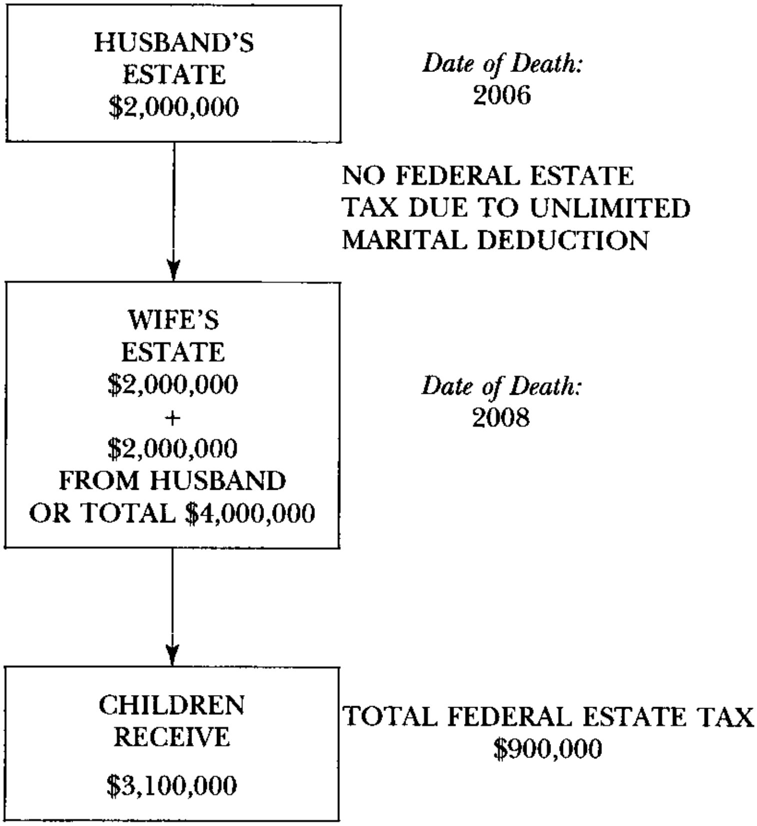
The unlimited marital deduction may not apply to wills signed before September 12, 1981 (see section 3.2.4, herein). Note that to be allowed, the marital deduction must pass to a surviving spouse, creating problems concerning whether such person is actually a surviving spouse or not.

4.2.3.1 Maximum marital deduction

Although the unlimited marital deduction generally applies to decedents dying after 1981, a transition rule keeps the marital-deduction

Illustration A.

OUTRIGHT DISTRIBUTION (ENTIRE ESTATE LEFT TO WIFE)

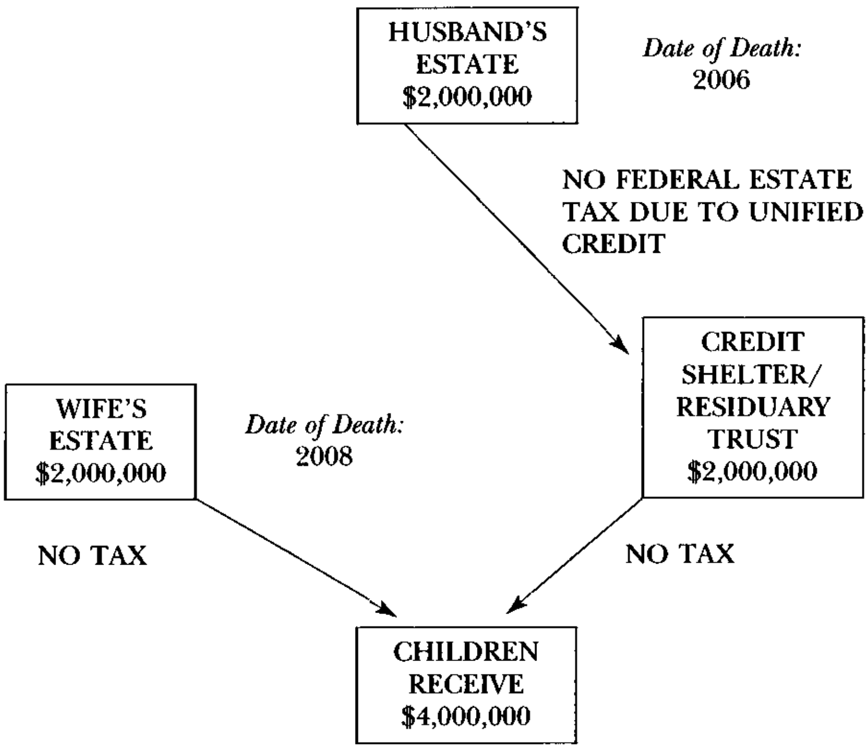


limitation in effect on half the adjusted gross estate when a formula bequest is made by certain decedents dying after 1981. The transition rule provides that if the decedent's will or trust created on or before September 12, 1981, contains a formula expressly providing that the spouse receive a maximum amount of property qualifying for the marital deduction allowable for federal estate tax purposes, the amount that can be left to the spouse under this clause will be determined in accordance with the law in effect on December 31, 1981. The transition rule will not apply if the clause is amended after September 12, 1981, and the amendment refers to "unlimited marital deduction" or if state laws have been amended to interpret such clauses as constituting a valid unlimited marital deduction.

Notwithstanding the transition rule, the IRS has held on several occasions that where the clause refers to the law or statute in effect at

Illustration B.

USE OF NONMARITAL TRUST (CREDIT SHELTER TRUST)



the date of death, the transition rule is not applicable and the unlimited marital deduction is applicable (IRS Letter Ruling 8510023).

4.2.3.2 Qualified terminal interest property (QTIP)

A *terminal interest* is one that ceases after a period of time or upon the occurrence of a contingency. Under prior law, a terminal interest passing to the surviving spouse generally would not qualify for the marital deduction. In 1982, Congress changed the rules so that property transferred through a "qualified terminal interest property trust" (or QTIP trust) qualifies for the marital deduction if an irrevocable election is made to include this property in the transferee spouse's estate upon death. The executor can make a partial election as long as the surviving spouse receives an income interest in a specific portion (a fractional or percentage interest only) of the property so that the elective part will reflect its proportionate share of the increment or decline in the whole of the property. The election must be made on a timely filed

Estate Tax Return (Form 706). The election is made by simply listing the terminable interest property on Schedule M and deducting its value. No special box is checked.

Under Reg. 20-2056(b)-7(b), if a partial election is made, the trust can be divided into separate trusts. The severance of the trust must occur no later than termination of the period of the estate administration and, although the severed trusts must be based on fair market value on the date of division, the trusts do not have to be funded with a pro rata portion of each asset.

Congress's solution, the QTIP, enables property to qualify for the marital deduction while not allowing the transferee any control over the ultimate disposition of the property. Thus, the donor spouse retains control over the ultimate disposition of the property placed in the QTIP. However, the QTIP requires that all the property income must be paid to the surviving spouse and the principal must solely benefit the spouse during his or her lifetime. There is no ability to split the income between beneficiaries other than the spouse.

Undistributed income of the QTIP trust at the time of the surviving spouse's death can pass with principal to the remainder beneficiaries, rather than to the estate of the surviving spouse (Treas. Reg. Sec. 20.2056(b)–7(d)(4)).

Note that since the property is included in the estate of the surviving spouse, in cases where the survivor is much younger than the estate owner, the value of this property with appreciation ultimately can far exceed the amount of property value at the time of the decedent's death. At the death of the surviving spouse, the QTIP property will receive a step-up in basis under IRC Section 1014 to its fair market value at the time of the spouse's death.

Certain income interests not in trust will also qualify as QTIP interests eligible for the marital deduction. Where homestead law grants a surviving spouse a life estate with the remainder to the decedent's issue, the executor can elect QTIP treatment for the value of the homestead. It will thus qualify for the marital deduction on the death of the first spouse to die. It will then be included in the taxable estate of the second spouse to die at its value at the second death. On the first death the executor can also make a "reverse QTIP election" electing on Schedule R to treat the first decedent as the transferor of the homestead for GST tax purposes to allocate the first decedent's GST tax exemption to the property. Upon the death of the second spouse to die the homestead will be included in that spouse's estate for estate tax purposes but that spouse will not be deemed to be the transferor of the property for GST tax purposes. See section 6 below for a more thorough discussion of generation-skipping taxes.

4.2.4 Charitable deduction

For estate tax purposes, there is no limit on the amount that may go to a qualified charitable organization. An individual could therefore leave his or her entire estate to a charity. State law, however, may limit an amount a person can leave to a charity if he or she is survived by a spouse and/or children. In addition to an outright bequest to a charity in order to obtain a charitable deduction, it is possible to split the charitable bequest to either an income interest or a remainder interest. The bequest can thus be enjoyed by a private beneficiary either before or after it is enjoyed by an institutional charitable beneficiary (see section 8.3.2, herein).

4.3 Computation of Estate Tax

4.3.1 Taxable estate

Having reduced the gross estate by allowable deductions, we arrive at the taxable estate. The taxable estate is increased by the amount of all adjusted taxable gifts made by the decedent after 1976 to determine the tentative tax base. For gifts made after August 5, 1997, the Internal Revenue Service cannot revalue the gifts if the three-year statute of limitations has expired and the gifts are "adequately disclosed" on a gift tax return. This is important because taxable gifts are added back to the estate when calculating estate tax. If the gifts were undervalued and were not completely disclosed on the gift tax return, the Internal Revenue Service can increase the value, and demand more estate tax (see section 5.5 herein).

The following is a schematic of the structure of the unified transfer tax:

	Gross Estate	(Secs. 2031–2044)
Minus:	Administration Expenses	(Sec. 2053)
Minus:	Funeral Expenses	(Sec. 2053)
Minus:	Debts	(Sec. 2053)
Minus:	State Death Taxes*	(Sec. 2053)
Minus:	Losses During Administration	(Sec. 2054)
Equals	Adjusted Gross Estate	(Sec. 2056(c)(2)(A))
Minus:	Charitable Deduction	(Sec. 2055)
Minus:	Marital Deduction	(Sec. 2056)
Equals	Taxable Estate	(Sec. 2051)
Add:	Adjusted Taxable Gifts	(Sec. 2001(c))
Equals	Taxable Base	

*Death after 12/31/04

Compute:	Unified Transfer Tax on Taxable Base	(Sec. 2019(c))
Minus:	Credits	
	Unified Credit	(Sec. 2010)
	Credit for State Taxes	(Sec. 2011) Repealed in 2005
	Gift Tax Credit for Pre-1977 Gifts	(Sec. 2012)
	Credit for Tax on Prior Transfers	(Sec. 2013)
	Credit for Foreign Death Taxes	(Sec. 2014)
Equals	Tax Payable	

4.3.2 Tentative estate tax

The next step is to compute the estate tax on a tentative tax basis. The following table shows the computation as it appears in the instructions for table A of Form 706 for 2007:

Unified Transfer Tax Rate Schedule

If the amount is: Over	But not over	Tentative tax is: Tax	+ Percent	On excess over
$ 0	$ 10,000	$ 0	18%	$ 0
10,000	20,000	1,800	20	10,000
20,000	40,000	3,800	22	20,000
40,000	60,000	8,200	24	40,000
60,000	80,000	13,000	26	60,000
80,000	100,000	18,200	28	80,000
100,000	150,000	23,800	30	100,000
150,000	250,000	38,800	32	150,000
250,000	500,000	70,800	34	250,000
500,000	750,000	155,800	37	500,000
750,000	1,000,000	248,300	39	750,000
1,000,000	1,250,000	345,800	41	1,000,000
1,250,000	1,500,000	448,300	43	1,250,000
1,500,000	2,000,000	555,800	45	1,500,000
2,000,000		780,800	46	2,000,000

The maximum estate and gift tax rate will be phased down for calendar years after 2005 and before 2010. The IRS will be issuing new estate and gift tax tables for each of those years. The new table will be the same as the above table, except as noted below.

The maximum rate for any calendar year after 2005 and before 2010 will be:

— 46% in 2006

— 45% in 2007, 2008, and 2009

4.3.3 Unified credit

In 1997 a unified credit of $192,800 was allowed against the unified transfer tax imposed on the taxable base. The unified credit was equivalent to an exemption of $600,000 from the taxable base (*i.e.*, the unified transfer tax on $600,000 is $192,800). The above credit is available for lifetime gifts made and for estates of decedents dying after 1976.

The Taxpayer Relief Act of 1997 increased the unified credit beginning in 1998 through the year 2006. The maximum amount that can be protected from tax by the unified credit, previously referred to as an "exemption equivalent" but now called the "applicable exclusion amount," increased from $600,000 to $1,000,000 in the year 2006.

However, EGTRRA increased the phase-in of the higher "applicable exclusion amounts." (The gift tax applicable exclusion amount will remain at $1,000,000. See section 5, below.)

The phase-in is as follows:

Year of Death	*Unified Credit*	*Applicable Exclusion Amount*
2004 and 2005	555,800	1,500,000
2006, 2007, and 2008	780,800	2,000,000
2009	1,455,800	3,500,000
2010	N/A (estate tax repealed)	
2011*	345,800	1,000,000

*(If Congress fails to re-enact or extend the 2001 changes)

Taxable gifts before 1988 are counted toward cumulative transfers in determining the rate adjustment for transfers made after 1987, but the tax rate on gifts before 1988 remains unchanged. Thus, if a person made $7 million in gifts before 1988 and $5 million in transfers after 1987, $2 million of transfers (that is, the excess of $12 million total transfer over $10 million) are subject to the adjustment. If a person made a total of $22 million in gifts before 1988, no transfers after that date are subject to the rate adjustment.

4.3.4 Credit for state death taxes

For decedents dying before January 1, 2005, the state death tax credit is given for taxes paid on property included in the decedent's gross estate. The credit equals the lesser of the total of the taxes actually paid to any state or the District of Columbia, or the amount determined by the use of table C in the instructions for Form 706 (reproduced here in Table 1, below), which also appears in Section 2011 of the Internal Revenue Code.

Many states require as a minimum estate or inheritance tax the greater of the tax computed under the state law or the credit allowed on the federal estate tax return for state death taxes. Some states, such as Florida, have no separate estate or inheritance tax but do require payment of the credit for the estate death taxes to be paid (sponge taxes).

Table 1. Credit for State Death Taxes

*Adjusted taxable estate exceeding** *(1)*	*Adjusted taxable estate* not exceeding column (1)* *(2)*	*Credit on amount in column (1)* *(3)*	*Rate of credit on excess over amount in column (1)* *(4)*
$ 40,000	$ 90,000	$ —	0.8%
90,000	140,000	400	1.6
140,000	240,000	1,200	2.4
240,000	440,000	3,600	3.2
440,000	640,000	10,000	4.0
640,000	840,000	18,000	4.8
840,000	1,040,000	27,600	5.6
1,040,000	1,540,000	38,800	6.4
1,540,000	2,040,000	70,800	7.2
2,040,000	2,540,000	106,800	8.0
2,540,000	3,040,000	146,800	8.8
3,040,000	3,540,000	190,800	9.6
3,540,000	4,040,000	238,800	10.4
4,040,000	5,040,000	290,800	11.2
5,040,000	6,040,000	402,800	12.0
6,040,000	7,040,000	522,800	12.8
7,040,000	8,040,000	650,800	13.6
8,040,000	9,040,000	786,800	14.4
9,040,000	10,040,000	930,800	15.2
10,040,000	—	1,082,800	16.0

*Tentative taxable estate less $60,000

Table 2. Credit for Federal Estate Tax Previously Paid

Period of time exceeding	*Not exceeding*	*Percent allowable*
—	2 years	100
2 years	4 years	80
4 years	6 years	60
6 years	8 years	40
8 years	10 years	20
10 years	—	none

EGTRRA phases out the state death tax credit by 2005. The Act reduces the state death tax credit by 25 percent (of the Table 1 amount) in calendar 2002, 50 percent (of the Table 1 amount) in 2003, and 75 percent (of the table amount) in 2004, before repealing it entirely in 2005.

The state death tax credit will be replaced with an unlimited state death tax deduction with respect to estates of decedents dying after December 31, 2004. This deduction will be allowed only for taxes that are paid and claimed before:

- Four years after the estate tax return is filed or
- If later, the latest of:
  - 60 days after a decision of the Tax Court determining the estate tax liability becomes final
  - The expiration of the period in which to file a claim for refund or 60 days after a decision of a court in which an estate tax refund suit has become final
  - The expiration of the period within which estate taxes are to be paid under Section 6166

It is expected that this provision in EGTRRA will have serious adverse effects on the expected revenue receipts of the various states because most states impose a state death tax equal only to the federal credit.

States imposing such "soak up" taxes may wish to adopt other sources of state revenue to replace their current state death tax or adopt their own forms of state inheritance or estate taxes. Some states, such as Pennsylvania and New Jersey, have already changed their estate tax laws to prevent loss of revenue as a result of the federal changes. This will create disparity among state tax systems and may actually become a significant factor in the decision of some clients regarding their residence.

Commentators have already noted that due to the statutory language of the New York State Estate Tax, estates of New Yorkers will pay a greater amount of total estate taxes than their counterparts in other states, unless there is a change in either the State of New York or federal estate tax laws.

Furthermore, if more states adopt broader state estate taxes, estate planning may be needed to provide clauses to apportion these state estate taxes, or provide for their payment, even if the federal estate tax is repealed.

Readers are urged to look for changes to their state death tax statutes as a response to this provision.

4.3.5 Credit for federal estate tax previously paid

Sometimes a decedent's estate may contain property that was previously taxed in the estate of another decedent who was a transferor of the property. When this is the case and the property was included in the transferor's taxable estate within ten years before or two years after the current decedent's death, IRC Section 2013 allows a credit for a federal estate tax previously paid (see Table 2, above).

The credit is limited to the lesser of the federal estate tax attributed to the transferred property in the transferor's estate, or the federal estate tax attributable to the transferred property in the transferee's estate. There is no requirement that the transferred property be identified in the estate of the transferee, or that it be in existence on the date of the transferee's death.

4.4 Special Deferred Payment Rules

The estate planner should be familiar with the special rules that apply to an interest in a closely held business. IRC Section 6166 provides for an automatic 14-year deferred payment arrangement for the estate tax attributable to an interest in a closely held business. To qualify, the interest must exceed 35 percent of the adjusted gross estate. The adjusted gross estate is simply the gross estate minus deductions claimed under IRC Sections 2053 and 2054. Those deductions are for debts, administration and funeral expenses, mortgages, and casualty losses. The charitable and marital deductions do not enter into the computation of the adjusted gross estate. The deferred payout privilege applies to qualifying stock in a closely held corporation, partnership interest, or even a sole proprietorship.

Under Section 6166, payment of the estate tax attributable to the closely held business interest is entirely deferred for four years. The balance is then payable in ten equal annual installments. Simple interest of only 4 percent (2 percent for estates of decedents dying after 1997) per annum is payable on the tax attributable to the first million dollars of a closely held business included in the gross estate. For calendar years after 1998, the $1 million amount is adjusted for inflation in multiples of $10,000 based on increases in the CPI. For death in 2004 the amount is $1,140,000. For estates of decedents dying after 1997, the interest rate on any excess value is reduced to 45 percent of the rate charged for underpayment of taxes. For estates of decedents dying before 1998, the interest rate is at the usual Treasury rates. Interest only must be paid during the first four years of the deferral. There are provisions for acceleration of the payment when the business is disposed of during the deferral period.

There is no deduction for income or estate tax purposes for the interest paid on the installment payments for decedents who die after 1997. Estates of decedents dying before 1998 may elect to have the 2-percent interest rate apply to the portion that was previously eligible for the 4-percent rate. The election must be made before January 1, 1999 and is effective for installments due after the election but not before 1998. If the one-time election is made to use the lower interest rate, the estate will not be able to deduct the interest for installments due after the date of the election.

EGTRRA expands the availability of the installment payment provisions by providing that the estate of a decedent with an interest in a qualifying lending and finance business is eligible for installment payment of estate tax if all installment payments (including principal and interest) are made over no more than five years. The act accomplishes this by providing that an executor may elect, for purposes of the estate tax installment provisions, to treat any asset used in a qualifying lending and finance business, as defined in new IRC Section 6166(b)(10)(A)(i), as an asset which is used in carrying on a trade or business. This portion of the act is effective for estates of decedents dying after December 31, 2001.

5. GIFT TAX

Lifetime gifts generate tax benefits. Specifically, if the gift qualifies for the annual exclusion, not only will there be no gift tax, but on the death of the estate owner, the property will be excluded from the estate. Estate owners who make taxable gifts remove from their estates the appreciation from the time of the gift to the date of death, significantly reducing the tax cost to the estate. Furthermore, if gifts of income-producing property are made to donees (most effective for those over the age of 13), there may be a saving of income taxes by deflecting the income from the higher marginal income tax rate of the donor to the lower rates of the donee. Lifetime gifts are reported annually to the Treasury on Form 709, the gift (and generation-skipping transfer) tax return. They are later included in the estate tax return, Form 706, as part of the taxable base. The actual payment of the gift tax effectively reduces the taxable base by the amount of gift tax paid, and even if the gift tax has not been paid before the decedent's demise it will be deductible as a debt of a decedent. Form 709 is required to be filed when a donor makes a gift to an individual in excess of the allowable annual exclusion amount (see section 5.1, below) or when a donor and the donor's spouse split gifts.

EGTRRA does not repeal the gift tax. Moreover, it retains the gift tax even with respect to gifts made after December 31, 2009. The committee report is silent on the reason for this, but it seems likely that Congress was concerned that the unlimited right to make gifts without a gift tax would lead to the use of intrafamily gifts to shift income from family members in higher income tax brackets to those in lower income tax brackets. Others have mentioned that Congress may have been concerned that the absences of a gift tax would permit lifetime transfer of income-producing assets and wealth to nonresident alien family members who might not be subject to U.S. taxes.

The lifetime exemption for gift tax purposes is $1,000,000 for transfers after December 31, 2001, and does not increase.

The maximum rate for gift tax rates is the same as the estate tax rates (50 percent for transfers in 2002; 49 percent for transfers in 2003; 48 percent for transfers in 2004; 47 percent for transfers in 2005; 46 percent for transfers in 2006; and 45 percent for transfers in 2007, 2008, and 2009).

In 2010, when the estate and generation-skipping taxes are repealed, the maximum gift tax rate will be the top individual income tax rate in that year, presently scheduled to be 35 percent.

Under the present "sunset provisions" in EGTRRA, unless Congress re-enacts or extends these changes, the estate, gift, and generation-skipping tax laws will be restored to their current state on January 1, 2011. (See section 10.)

The increase in the gift tax lifetime exemption from $675,000 in 2001 to $1,000,000 in 2002 (and thereafter) should encourage some clients to make larger taxable gifts, in an amount sufficient to use the client's full gift tax lifetime exemption. These gifts will shift future appreciation and income to other family members without additional gift or estate taxes, and will save estate taxes if the client dies during the period when there is still a federal estate tax imposed with respect to that client's estate.

Furthermore, even if the estate tax is allowed to be repealed, there is no real disadvantage to making lifetime gifts sufficient to use one's

$1,000,000 exemption. This is particularly true because the carryover basis rules would apply basis rules similar to the gift tax rules for assets received from a decedent. Of course, assets given away during a decedent's lifetime would not generally be eligible for the new estate $1.3 million aggregate basis increase or $3 million spousal property basis increase. (See section 7.2.)

However, estate planners should be more cautious about recommending gifts that will require the actual payment of gift taxes during the phase out of the estate tax. Gifts that require a gift tax payment have been attractive because the gift tax is computed on the value of the property received by the donee without consideration of the gift tax payment that the donor will make (a "tax exclusive" computation), while the estate tax is computed on the total amount available to transfer, including both the amount that the beneficiary will receive and the amount that will be used to pay the estate tax on that transfer (a "tax inclusive" computation).

A gift requiring that a client pay a gift tax might not be as attractive if the gift can be made in a year when the rate will be lower and/or a transfer may occur without tax if the estate tax is allowed to remain repealed.

Of course, some gifts may still appear favorable if the client's age and health suggest that the client will not be alive when and if the estate tax is repealed and if the gift removes substantial amounts of income and appreciation even for a few years or if it creates significant valuation discounts that might not be available had the asset been held until death.

An advantage of taxable gifts is that recipients can add the gift tax paid on a gift to the basis of the securities sold. (See section 7.1 for the income tax basis for property transferred by gift.) The estate value is reduced by the gift tax paid. But Section 2035(b) of the Internal Revenue Code requires inclusion in the gross estate of all gift taxes paid on any gifts made within three years of death.

5.1 Annual Exclusion

There is in 2006 an annual gift tax exclusion of $12,000 (indexed annually for inflation after 1998 in multiples of $1,000) for each donee. If the donor's spouse joins in the gift by consenting to the gift on the gift tax return (Form 709) each spouse is entitled to take an annual exclusion of $12,000 for each donee (see section 5.4, below). The annual exclusion is, however, available only for a gift of a present interest (one whose enjoyment commences immediately after the gift is made). Thus, in making gifts with the use of a trust, the beneficiary's interest in the property gifted to the trust must qualify as a present interest if the estate owner wants to obtain the benefits of the annual exclusion. With regard to gifts in trust for the benefit of a minor, no part of the transfer will be considered a future interest if the terms of the transfer meet the following conditions:

— Both the property and its income may be expended by or for the benefit of the minor donee prior to his or her obtaining the age of twenty-one. To the extent not so expended, it will pass to him or her at that time.

— In the event of the donee's death prior to 21, the property and income not expended will pass to his or her estate or to a person appointed by him or her under the exercise of a general power of appointment.

For calendar year 2004, the first $114,000 of gifts to a spouse who is not a citizen of the United States, other than gifts of future interests in property, are not included in the total amount of taxable gifts.

5.2 Transfers for Educational and Medical Expenses

The voluntary payment of medical expenses and education expenses for another is exempt from gift taxation. Note that the education payment exclusion only applies to tuition paid, not to dormitory or other housing costs, meals, or books. The payment must be made directly to the medical care provider or qualifying education organization as defined in Regs. Sec. 25.2503–6(b).

Contributions to a "qualified state tuition program" (as defined in Section 529 of the Internal Revenue Code) are subject to the gift tax, but contributions are eligible for the $12,000 annual gift tax exclusion. A distribution from a qualified tuition program is not a taxable gift. The contribution is not treated as a gift of the future interest and *is not treated as a transfer excluded from taxable gifts as a tuition payment for gift tax purposes.* If the total contributions to a qualified state tuition program (to a maximum of $60,000 per child) exceed the annual exclusion limit for a year, the gift can be spread out over five years for gift tax purposes and there would be no gift tax. To do so, one must file a gift tax return for the year of the contribution, and the five-year averaging election must be made on the return.

There are no income limitations to take advantage of this program. Many of the programs are available to out-of-state donors and beneficiaries.

After the passage of EGTRRA, for tax years beginning after December 31, 2001, distributions from these qualified tuition plans will be treated as exclusions from the income of the recipient, thus making these programs even more attractive to the donors.

The Act also authorizes private educational institutions to establish such qualified tuition programs to offer prepaid educational services after calendar year 2001. Distributions from these programs will be treated as exclusions from the income of the recipient in tax years after December 31, 2003.

No interest in a qualified tuition program is included in the estate of any person for estate tax purposes, except for an amount distributed on account of the death of a beneficiary. Thus, the value of an interest in a qualified tuition program is included in the estate of the designated beneficiary, not in the estate of the contributor.

A growing number of wealthy individuals are choosing to directly pay tuition for family members. The IRS in private letter ruling 200602002 stated that the prepayment of tuition directly to a school on behalf of a grandchild enrolled in that school is an exempt payment that escapes gift and generation-skipping transfer tax. The IRS ruling gives additional assurance that prepayments for multiple years will also be acceptable.

The prepayments, the IRS ruled do not entitle the grandparent to any tuition discounts. All tuition payments would be nonrefundable—a crucial point, and once paid, would become the school's "sole property," even if the student discontinues his or her education.

Such a ruling issued to a taxpayer may not be cited as a precedent by another taxpayer, but the result confirmed in the ruling is consistent with the law and with other known expressions of IRS opinions.

5.3 Marital Deduction

As under the estate tax, there is an unlimited gift tax marital deduction for gifts to a spouse. The reasons are the same as for estate tax marital deduction (discussed in section 4.2.3, above).

5.4 Gift Splitting

Gifts made by a married person to one other than a spouse can be considered as if half has been made by the consenting spouse. Thus if the donor and spouse elect to split gifts by filing a gift tax return with the consenting spouse's signature, $24,000 (indexed annually for inflation after 1998 in multiples of $1,000) can be given to each third-party donee without exceeding the annual exclusion. If the gifts of the donor spouse are gifts of present interests worth less than $24,000 per donee and the consenting spouse makes no gifts or only gifts of present interests worth less than $12,000 per donee to donees other than those to whom the donor spouse makes gifts, then only the donor spouse is required to file a return (with the consenting spouse signing the return). If the consenting spouse also makes gifts outside the above parameters, then both spouses are required to file returns. Form 709-A, United States Short Form Gift Tax Return, is no longer available.

5.5 Adequate Disclosure of Gifts

Lifetime gifts must be adequately disclosed to support proper valuation of gifts reported on a gift tax return. Adequately disclosed gifts will preclude the Internal Revenue Service from adjusting the value of the gifts for either gift tax or estate tax purposes (see section 4.3.1, herein) after the three-year statute of limitations has expired.

For gift tax returns filed after December 3, 1999, IRS Reg. 301.6501 (c)-1 (f) will apply. This regulation establishes detailed requirements for meeting the adequate disclosure standard. If the disclosure requirements are satisfied the statute of limitations will start to run when the gift tax return is filed.

To start the running of the statute of limitations on the assessment period, the following information must be provided:

— A description of the property transferred and any consideration received

— The identity and relationship of the parties involved

— If the gift is in trust, the trust identification number and a copy of the trust

— A detailed description of the method used in determining the fair market value of the property including any relevant financial data, or a qualified appraisal

— A statement of relevant facts that would apprise the IRS of any position taken that is contrary to any proposed, temporary, or final Treasury regulations or revenue rulings in effect at the time of the gift

6. TAX ON GENERATION-SKIPPING TRANSFERS (GST)

Before EGTRRA, the generation-skipping transfer (GST) tax had been imposed at 55 percent on transfers by a trustee in accordance with authority under a trust, or on direct transfers, to a "skip person," that is, a beneficiary related by blood to the transferor or the transferor's spouse, who is more than one generation younger than the transferor (for example, a grandchild), whether by will or by lifetime gift. Any of the following transfers will be a taxable event subject to GST tax:

— Taxable distribution (any distribution of principal or income to a skip person from a generation-skipping trust)

— A taxable termination (expiration of an interest in a trust that defers property to a skip person, such as expiration of life estate)

— Direct transfer (direct skip), such as an outright transfer from a grandparent to a grandchild, where the grandparent sets up a trust for a grandchild

(Text continued on page 43)

If an event gives rise both to a taxable termination and a direct skip, it is treated as a direct transfer. Characterization as direct skip, taxable termination, or taxable distribution is relevant to the question of who must pay GST tax. The liability for the GST tax is as follows:

— If a direct skip, the transferor (or transferor's estate) is liable (IRC Sec. 2603(a)(3)).

— If a taxable termination, the trustee is liable (IRC Sec. 2603(a)(1)).

— If a taxable distribution, the distributee is liable (IRC Sec. 2603(a)(2)).

In all cases, the tax is charged to the property that is the subject of the taxable transfer, unless otherwise directed pursuant to the governing instrument by specific reference to the tax imposed (IRC Sec. 2603(b)). Transfers of up to $1 million indexed annually for inflation after 1998 and prior to 2004 ($1,120,000 in 2003) per grantor are exempt.

In the years 2004 through 2009, the generation-skipping tax exemption is the same amount as the estate tax exclusion amount (2004 and 2005—$1,500,000; 2006, 2007, and 2008—$2,000,000; 2009—$3,500,000), followed by full repeal in 2010.

Inter vivos transfers made after September 25, 1985, are subject to GST tax. The law does not apply to transfers from trusts that were irrevocable before September 26, 1985, or to transfers made pursuant to wills in existence before September 26, 1985, if the decedent died before 1987. If a decedent was incompetent on October 22, 1986, and remained incompetent until death, trusts included in the incompetent decedent's estate, or direct transfers at the time of the incompetent decedent's death, are exempt. All direct transfers to a skip person will be exempt from GST tax, if at the time of the transfer the parent of the skip person, who is the child of the transferor, is deceased. This exemption does not apply to distributions from a trust.

For a transfer made after 1997, the Taxpayer Relief Act of 1997 has expanded the deceased parent exception to include transfers to collateral heirs (for example, grandnieces and grandnephews), provided that the decedent had no living descendants at the time of the transfer. The exception is also extended to transfers in trust where the parent of the trust's beneficiary was dead at the time of transfer is subject to gift or estate tax.

EGTRRA makes several important technical changes to the generation-skipping tax rules, in particular relating to the allocation of a donor's GST exemption for lifetime transfers, and it is important to note that these changes are generally effective (retroactively) for transfers after December 31, 2000.

1. A GST exemption is automatically allocated to lifetime transfers that are not direct skips but are made to generation-skipping trusts (sometimes referred to as the "unused portion" of a GST exemption on an "indirect skip"). These terms are defined, and there are six categories of exceptions to this rule, in IRC Section 2632(c).
2. Transferors can elect not to have these automatic allocation rules apply by so noting on a timely filed gift tax return for the year in which the transfer was made or deemed to have been made, or on such later date or dates as may be prescribed by regulations.
3. The IRS may, in its discretion, grant reasonable extensions of time to make regulatory or statutory elections, especially since some of the legislation is retroactive in its effective date.
4. GST trusts will now be permitted to be severed (into trusts with a GST exclusion ratio of one and a GST exclusion ratio of zero) under certain circumstances even though the document does not authorize the severance or even if the reforming proceeding did not commence before the date an estate tax return was due.
5. Value of property for purposes of determining the GST inclusion ratio is clarified to be its value as finally determined for gift tax or estate tax, or its value at the close of an estate tax inclusion period (ETIP), if a GST exemption allocation is deemed to have been made at the close of the ETIP.
6. In recognition of the fact that the GST rules are complex, Congress added a provision to give statutory authorization that the GST exemption will be allocated when a taxpayer demonstrates substantial compliance with the rules for allocating the GST exemption return, including evidence of intent contained in the trust instrument, the instrument of transfer, and any other factors that the IRS considers relevant.
7. A transferor will be permitted to retroactively reallocate the unused portion of a lifetime transfer GST exemption if a lineal descendant of the transferor predeceases him or her.

There is only one GST tax on double skips. So, if the donor's will makes a direct bequest to his or her great-grandchild, the bequest is subject to one GST tax even though two generations are skipped. In the case of a trust that provides that income is paid to a child for life then to a grandchild for life, then remainder to great-grandchild, there is taxable termination on the child's death and again on the death of the grandchild.

The GST tax does not apply to any inter vivos transfer that is exempt from gift tax due to the $11,000 annual exclusion or because it is made for certain tuition or medical payments.

Planning Tips. Consider the following GST planning tips:

— Establish a "dynasty trust" for grandchildren with up to $1 million or indexed amount of property. This will exempt the entire trust from GST tax.

— Decide whether it is preferable on a son's or daughter's death to (1) pay estate tax on trust funds going to grandchildren, by giving the son or daughter a general power of appointment, or (2) plan to avoid the GST tax by expecting a son or daughter to survive to the repeal of the tax.

— If an inter vivos trust for grandchildren has been established before September 26, 1985, do not add any property to this trust.

— The most important planning consideration is ensuring full use of the GST exemptions available to the testator and the testator's spouse.

— In lieu of deferring the funding of the long-term family trust, testators of substantial wealth should consider an immediate funding of such trust with an amount equal to their GST exemption.

7. INCOME TAX

As a result of the unlimited marital deduction for estate tax purposes and with the unified credit applicable exclusion amount from $1,000,000 to $3,500,000 by the year 2009, many estates will owe no federal estate taxes. However, careful consideration should be given to the income tax basis for the property transferred during lifetime and at death.

7.1 Income Tax Basis for Property Transferred by Gift

If the fair market value of the gifted property on the date of the gift exceeds the donor's adjusted basis in the property, the donee's (the recipient's) basis in the property will be the same as the donor's basis (Section 1015(a)). For pre-1977 gifts, the donee's basis may be increased by the amount of the gift tax paid by the donor with respect to the particular gift. The sum of the gift taxes plus the donee's basis cannot exceed the fair market value of the gifted property as of the date of the gift (Section 1015(d)(1)).

If the fair market value on the date of the gift is less than the donor's basis, the donee's basis will be determined when the gifted asset is sold, as described below:

— If the donee sells the property at a gain: the donee's basis will equal the donor's adjusted basis;

— If the donee sells the property at a loss: the donee's basis will equal the fair market value at the time of gift;

— If the donee sells the property for an amount between the donor's basis and the fair market value at the time of the gift: the donee's basis will equal the sales price; thus, no gain or loss will be recognized on the sale.

For gifts made after 1976, the donee may increase the donor's basis by only a portion of the gift taxes paid on the appreciation. Use the following formula to determine the amount of increase:

$$\frac{\text{FMV at time of gift} - \text{Donor's adjusted basis}}{\text{FMV of the gift}} \times \text{gift taxes paid}$$

For example, if a taxable gift was made in 1987 with a fair market value of $20,000 on the date of the gift, the donor's basis was $6,000 and the donor paid a $10,000 gift tax with respect to that gift, the donee's *new* adjustment basis will be (including increase):

$$\$6{,}000 \text{ plus } \frac{14}{20} \times \$10{,}000 \text{ or } \$13{,}000$$

7.2 Income Tax Basis for Property Transferred at Death—The New Specter of Carryover Basis

Until the estate tax is repealed in 2010, the basis of most property included in the gross estate of a decedent is the value of the property on its valuation date. This often results in a step-up in basis. This new basis becomes the basis in the hands of the estate or the beneficiaries of the estate when they sell the property (IRC Sec. 1014 (a)(1)). Under special holding period rules, the gain or loss on sale of that property would be considered long-term capital gain or loss even if the property is sold within one year after the decedent's death (IRC Sec. 1223 (11)). The basis adjustment does not apply to property that constitutes income in respect of a decedent.

For decedents dying after December 31, 2009, EGTRRA will eliminate this automatic step up in basis, and will require that the basis will be the lesser of the decedent's basis or the market value on the date of the decedent's death. Thus, while the step up in basis is eliminated, a step down for loss assets is preserved.

There are two exceptions to this general rule.

First, the new act grants an executor the power to step up the basis of assets formerly owned by the decedent, on an asset-by-asset basis, by a total of $1,300,000, (referred to as an "aggregate basis increase").

Second, for assets transferred to or for the benefit of the decedent's surviving spouse, an additional $3,000,000 of basis step up is available (referred to as the "spousal property basis increase"). This basis increase is allowable only for property passing to a surviving spouse outright or in a qualified terminable interest (QTIP) trust, in accordance with rules similar to the present estate tax marital deduction rules.

Both of these exceptions can therefore apply to property received by a spouse. Thus, up to $4,300,000 of basis increase can be allocated to property transferred to one's spouse.

The basis increase rules do not apply to property acquired by gift within three years of death (other than from a spouse). This restriction is meant to discourage gift giving of low basis assets to individuals who would be expected to bequeath the identical assets to the donor.

7.3 Gifts to the Decedent Within One Year of Death

Until the estate tax is repealed in 2010, an exception to the stepped-up basis rule occurs with respect to appreciated property acquired by the decedent by gift within one year of the decedent's death if such property passes to the donor or the donor's spouse. In this case, the basis of the property will equal the adjusted basis that the decedent had therein just prior to death.

7.4 Survivor's Community Property Tax Basis

The survivor's half of the community property gets a basis step-up, even though it is not included in the estate of the first to die. This is particularly significant with regard to homes owned as community property (see section 4.1.7 for a list of community property states).

8. SPECIAL ESTATE PLANNING SITUATIONS

8.1 Estate Freeze

The so-called "estate freeze" is a type of estate planning whereby the owner of a family business, generally a corporation or partnership, attempts to lower his or her taxable estate by transferring appreciating assets to other (generally younger) family members, thereby capping or freezing the value of the owner's estate derived from the value of the business as it stands at the time of the transfer while passing on potential appreciation to the transferees. The estate freeze is intended to avoid estate taxes on the appreciated value of the assets when the owner dies. Naturally, the transferor usually claims at the time of the transfers that most of the value of the business is in the interest he or she retained thereby minimizing gift taxes. However, after the transferor's death, executors frequently take the position that most of the value of the business is in the interest transferred, thus reducing estate taxes. Through use of various types of stock transfers, owners try to retain actual control of the assets transferred while minimizing estate taxes as well as gift taxes.

If it is likely that the client may die before the estate tax is repealed, these estate tax freezing techniques will remain very significant in minimizing the adverse estate tax impact of the growth in value of the client's assets.

In the event that the client survives until the estate tax repeal, these techniques would produce no tax benefit.

Nevertheless, since this "interim" period may last for at least as long as eight years, the consideration of the use of these techniques for this "interim" period will be essential in many estate plans.

8.1.1 Recapitalizations

In a common type of estate freeze, the owner retains an interest with a fixed value, such as a preferred stock with voting rights, and then transfers common stock by gift or sale to younger family members active in the business. The preferred stocks generally are created in a recapitalization and constitute most of the business's value when created. The value of the gifts of the common stock might be so slight at the time of transfer as to fall within the annual gift tax exclusion amount. After the transfer, all additional growth in the value of the business would adhere to the common stock, and transfer taxes might be completely avoided.

Congress had enacted Internal Revenue Code (IRC) Section 2036(c) to curb what it perceived as subterfuges to avoid estate and gift taxes. IRC Section 2036(c) as enacted in 1987 did not work, primarily because it did not deal directly with the valuation problems at the time of the transfer. IRC Section 2036(c) was repealed retroactively in 1990 and replaced with several new sections dealing with the valuation of preferred stock, transfers to trusts, lapsing rights, and buy-sell agreements. Those rules are found in Chapter 14, IRC Sections 2701 to 2704. They are intended to assure more realistic gift tax valuation at the time of the transfer.

8.1.2 Corporations and partnerships

Under the Chapter 14 rules, when an estate freeze occurs and there is a significant change in the structure of the family business, a value is determined for the entire business under ordinary valuation principles. Then the value of any "applicable" retained interest held by the transferor is determined as set forth in Chapter 14. In general, under Chapter 14, the value of the retained interest will be lower and the value of the transferred interest higher than in the past. The value of the retained interest (including the value of distribution rights, liquidation, put, call or conversion rights pertaining thereto) is subtracted from the value of the entire business to determine the value of the transferred shares. It is expected that the result will be higher gift taxes payable upon the transfer of the common shares.

Where applicable, these rules require that the value of the retained interest and the value of the entire corporation, partnership, or other property be determined at the time of the initial transfer. The difference between them is usually assumed to be the value of the gift and is subject to gift tax at that time. Unless certain well-defined criteria, which vary with the nature of the property transferred or retained, are met, the law requires the retained interest to be valued at zero. This in turn requires that gift or transfer taxes be paid based on the value of the entire assets of the business or the total worth of the property before the transfer.

It should be re-emphasized that the gift tax statute of limitations does not expire on an undisclosed or inadequately disclosed transfer even though a gift tax return was filed for other transfers in the same year.

In cases where there is a transfer of common stock in a corporation or any interest in a partnership to a member of the family, in which rights to income and capital are junior to other equity interests, the value of such a transfer cannot be less than the value determined by assigning to all such junior equity interests a value equal to 10 percent of the total of all equity interests plus the total amount of indebtedness to the transferor or to an applicable family member. Therefore it will be impossible for such a transfer not to incur some gift tax effect.

Basically, Chapter 14 comes into play when common shares or other interests are transferred to younger family members while preferred shares or other interests are retained by older family members. The language is technical. It speaks of an interest in a corporation or partnership being transferred to a "member of the family" (defined as the transferor's spouse, a linear descendant of the transferor or his or her spouse, or the spouse of a descendant), while an "applicable retained interest" is held by the transferor or "an applicable family member" (defined as the transferor's spouse, an ancestor of the transferor or spouse, or the spouse of such ancestor).

The new rules apply to transfers occurring after October 8, 1991. However, interests created before that date are not protected upon a subsequent transfer.

The valuation rules do not apply to a retained interest that is marketable or an interest that differs from a marketable interest only with respect to voting rights for stock and management rights and liability limits for partnerships.

8.1.3 Trusts

When a transferor retains an interest in the income from assets transferred to a trust, thus creating a grantor retained interest trust (GRIT), the value for gift tax purposes of the remainder interest transferred to a member of the family as defined in IRC Section 2702(e) is normally the value of all the assets less the amount equal to the value of the annual income interest. (See the chapter on Trusts for a discussion of the general rules of GRITS.) However, the retained income interest would not be considered a "qualified interest" and thus would not be deductible from the entire value of the original trust assets unless:

— The trust is a grantor retained annuity trust (GRAT), carrying the right to receive a fixed amount at least annually.

— The trust is a grantor retained unitrust (GRUT), carrying the right to an annual fixed percentage of the fair market value of the trust assets determined annually.

If the trust is not a GRAT or a GRUT in which the retained income interest is "qualified," the entire trust value would be considered for gift tax purposes as transferred to the family member remaindermen, and the GRIT would be treated as an outright gift.

> *Example:* A grantor transfers $500,000 to a GRIT and retains the right to income from the trust for ten years. At the end of this time, the trust terminates and its assets are distributed to the grantor's children. The gift tax value of the transfer will be $500,000 at the date of the trust's establishment.

A GRIT that is neither a GRAT nor a GRUT can remain viable in the following circumstances:

— Remaindermen are related to the grantor, but do not meet the definition of "member of family" in IRC Section 2702(e), such as nieces, nephews, and their spouses.
— The trust is funded solely with tangible property.
— The trust is funded solely with the personal residence of the grantor.

8.1.3.1 Qualified personal residence trust

Grantor retained interest trusts or GRUTs funded with personal residences are excellent estate planning vehicles that allow the homeowner to continue using the family home for the duration of the trust. At the end of the trust term, the legal title to the home passes to the trust beneficiaries—usually the grantor's children—at a discounted value for gift tax purposes, even though the home is likely to have appreciated. The grantor can rent the home after the trust terminates.

> *Example:* The value of the gift of a $600,000 home to a trust, retaining the right to its use for 15 years, is approximately $174,000. If the grantor dies during the term of the trust, the value of the property at the time of the grantor's death will be included in his or her estate.

8.1.3.2 Grantor retained annuity trust

A grantor retained annuity trust or GRAT is an irrevocable trust agreement whereby the grantor can receive a fixed amount each year during the term of the trust (Reg. Sec. 25.2702-3(b) (1)). The gift to trust remainder beneficiaries would be valued at a discount, and the appreciation of the assets would be removed from the grantor's estate. Even if the grantor dies during the term of the GRAT, less than the full value of trust property is included in the grantor's estate, provided the grantor does not retain a contingent interest in the trust.

> *Example:* F establishes a GRAT. She transfers property worth $500,000 to the trust and retains a yearly annuity of $50,000 (10 percent) for a period of ten years. The beneficiaries of the trust are her children. The value of the gift to her children is computed as follows:

Total value transferred to GRAT		$500,000
Less present value of annuity:		
Annual payments	$50,000	
Present value factor	× 6.9591	347,955
Net gift amount to children		$152,045

> If F survives for ten years, the remainder of the trust property passes to her children free of additional gift or estate tax. If F survives only a portion of the ten years, the remaining value of the annuity interest is included in F's taxable estate.

Assume that F dies five years after the creation of the GRAT. At that time, interest rates have increased by 2 percent. The value of the property in the GRAT at that time is $700,000. The value of the annuity interest at the time of F's death is $193,480 ($50,000 × 3.8696).

The ability to gain tax savings depends on the ability to maintain the principal of the GRAT. Thus, if the income level from the property is substantially less than the annuity amount, the principal of the trust may be diminished.

A disadvantage of a GRAT is that the grantor's beneficiaries will likely have less tax basis in the property, since the trust assumes the grantor's tax basis.

8.1.3.3 Grantor retained unitrust

The grantor retained unitrust or GRUT is similar to the GRAT, except the grantor has the irrevocable right to receive payment, at least annually, of a fixed percentage of the net fair market value (determined annually) of the trust assets. Trust distributions can vary each year depending upon the value of the trust.

8.1.3.4 GRATs, GRUTs, and QPRTs after EGTRRA

All three of the trust techniques described above are effective only if the donor survives a stated term, and this term must now be planned with consideration for the increased applicable exclusion amounts, and the promised repeal of the estate tax.

There may be no estate tax benefit to making a gift to a GRAT, GRUT, or QPRT for a term that runs beyond the date of the repeal of the estate.

It is suggested that any GRAT, GRUT, or QPRT created during the phase out of the estate tax either have a term that expires soon enough to give the donor a reasonable likelihood of surviving the reserved term, and yet also expires before January 1, 2010, or be predicated on a strong belief that the estate tax will not actually be repealed.

8.1.4 Buy-sell agreements

A buy-sell agreement is an effective method of freezing the value of an owner's interest in a business for tax purposes provided it meets the requirements of the Internal Revenue Service. IRC Section 2703 applies to buy-sell agreements made or substantially modified after October 8, 1990. Reg. Sec. 25.2703-1 says that a buy-sell agreement with a family member will not be effective to establish the value of a deceased owner's stock unless it meets the following three requirements:

1. The agreement is a bona fide business arrangement;

2. The agreement is not a device to transfer property to the natural objects of the transferor's bounty for less than full and adequate consideration in money or money's worth; and
3. At the time the agreement is created, the terms are comparable to ones entered into by persons in an arm's-length transaction.

The regulations state that if more than 50 percent by value of the property subject to the agreement is owned directly or indirectly by individuals who are not members of the transferor's family, the above three requirements are deemed to have been met. "Members of the transferor's family" is broadly defined in the regulations.

Agreements entered into before October 9, 1990, and not substantially modified after October 8, 1990, must meet the requirements of IRC Section 20.2031-2(h) to fix estate tax value.

Some business owners enter into buy-sell agreements primarily for non-tax reasons. For them, a buy-sell agreement continues to be sensible. For those, however, that primarily want to enter into such an agreement for the purpose of freezing the value of their business interests for estate tax purposes, the looming potential for repeal or substantial reduction of estate taxes may suggest a go-slow approach to such agreements.

8.2 Family Limited Partnerships (FLPs)

Family Limited Partnerships (FLPs), an old familiar vehicle, have been in the forefront of estate planning techniques of the 1990s due to the benefits obtained before EGTRRA. The FLP can be created to accomplish the following.

— Transfer wealth to family members without giving up control.

— Save significant estate and gift taxes by generating substantial valuation discounts with respect to gifts of interests in the partnership.

— Shift taxable income among family members to save tax.

— Avoid confiscatory compressed income rates applicable to trusts.

— Provide investment flexibility.

— Reduce investment costs.

— Afford the ability to make block purchases at lower rates.

— Provide the ability to negotiate lower investment advisory fees and commissions.

— Protect one's assets from creditors.

— Protect assets given to family members from their creditors.

An FLP is a limited partnership, subject to all the rules of limited partnerships discussed in the Partnership chapter. Parents can fund the FLP with almost any asset except for S corporation stock. The assets should be related to a trade or business, investment, or income-producing venture. Parents can name themselves general partners, each with a one-percent interest and be the original sole limited partners with the remaining 98 percent. Over time, limited partnership interests can be gifted to their children.

As long as parents remain general partners, they make all decisions regarding the management of the FLP, even if most of the limited partnership interests are gifted away.

Currently, the tax law allows gifts of limited partnership interests at discounted value for gift tax purposes to account for the fact they have limited marketability and are minority interests. Typically, discounts are in the range of 25 percent to 35 percent. These discounts allow the parents to greatly reduce their estate by making gifts of FLP limited partnership interests as opposed to outright gifts of business or investment property.

Splitting income among family members can create significant tax benefits by having portions of the total amount of the family income fall into lower tax brackets. There is no requirement that the actual income be distributed so that, for wealth accumulation purposes, FLPs are superior to irrevocable trusts set up for the children. With trusts, the taxable income must be distributed annually to the children, or it will be taxed at extremely unfavorable trust income tax rates.

Another income tax benefit associated with FLPs can result in the creation of earned income, from what would normally be portfolio or passive income, by paying a salary to a family member for services rendered. IRAs can be used to shelter part of this income.

FLPs offer a degree of protection of the FLP assets against creditors of both parents and children. This protection is established by applicable state law and should be discussed in advance with a local business lawyer. Under the laws of most states, a creditor of a partner cannot obtain outright ownership of a partnership interest. *However,* the creditor may be able to obtain a "charging order"—which gives the creditor the right to receive the cash distributions that would have gone to the debtor partner. But, if the debtor is also the general partner who controls these distributions, that creditor doesn't get too far. A creditor may have to report its share of income of the partnership income on its tax return, therefore, the creditor could be reporting the share and pay taxes without receiving any distributions. This could backfire on the creditor. The assets of the FLP are not protected from creditors of the FLP.

It is important to carefully monitor developments in this field, especially as to the position of the IRS in this rapidly evolving planning area.

After the passage of EGTRRA, estate planners should continue to consider the creation of FLPs, family LLCs, and family holding companies, because they are an effective tool to achieving both tax and non-tax goals.

In addition, it is important to acknowledge that the promise of estate tax repeal may never be realized, a client may well die before the estate tax is actually repealed, the sunset provisions may limit repeal to estates of those dying in 2010, or Congress may do something altogether unfathomable at this time.

On the other hand, if the estate tax is repealed and the carryover basis rules become significant, estates that do not have sufficient appreciation to take full advantage of all the aggregate basis increases and spousal property basis increases may find the reduced value of an interest in an FLP to be counterproductive. These clients may want to increase the value of their assets, increasing their net appreciation and creating sufficient opportunity to take full advantage of the basis increases allowed by the carryover basis rules. Such clients may therefore wish to liquidate these entities and hold separate assets rather than hold interests in an FLP, the value of which would have been subject to a discount.

The increases in the applicable exclusion amount may create a similar problem for estates that will no longer owe estate taxes. The use of an FLP to reduce a no-longer-existing estate tax liability is counterproductive when it has the effect of reducing the surviving spouse's or other family members' adjusted basis in inherited assets.

This change of focus might put executors in the awkward position of arguing for lower discounts and higher values in interests in these entities to create room for larger basis adjustments.

The IRS policy of attacking the valuation discounts of family limited partnerships and limited liability companies is creating exposure for practitioners. The IRS is engaged in a national program attaching entity-based discounts using fractional interests, in spite of several tax court decisions adverse to the IRS position. In light of the IRS aggressive posture, practitioners must be aware of their exposure to penalties under Circular 230.

8.3 Charitable Transfers

The income, estate and gift tax laws encourage charitable giving; but it is still important that the estate owner be charitable of mind before being encouraged to do so.

8.3.1 Planning considerations

Lifetime charitable gifts not only save income tax but also eliminate the property from the donor's estate; consideration of charitable giving should therefore be made during one's lifetime. The greatest tax benefits from lifetime gifts generally come from gifts of stock and real estate that have appreciated in value. Many people, however, want to retain the property until their death and then pass on the property to charity. The greatest tax benefits for a gift made at death (a "testamentary" gift) come from gifts of retirement plan benefits and U.S. savings bonds. These assets produce taxable income ("income in respect of a decedent") whereas other assets inherited do not produce taxable income to the beneficiaries.

Frankly, the increase in the estate tax applicable exclusion amount, the repeal of the estate tax, and the implementation of the carryover basis will have a negative effect on some donors' charitable giving because the tax motivation will simply be greatly reduced.

There will be certain techniques that might prove useful in specified situations.

Once the carryover basis rules are in force, leaving low-basis assets to charity will allow an executor to allocate all of the decedent's aggregate basis increase and spousal property basis increase among assets passing to the decedent's family members.

An even better tax savings will occur if the charitable bequest is made by designating the charity as the beneficiary of a qualified retirement plan or other tax-deferred retirement benefit, since no portion of the aggregate basis increase or spousal property basis increase can be allocated to such assets, because they are items of income in respect of a decedent (IRD), and, moreover, the receipt of such assets generally produces ordinary compensation income, harmless to the charity, rather than capital gains.

In addition, once the carryover basis rules are in force, individuals who give inherited property to charity will usually be making gifts of appreciated assets.

8.3.2 Types of charitable transfers

Outright donation of assets to the charity is the simplest form of charitable transfer. However, there are other methods of giving the charity an interest in property as well as giving other beneficiaries an interest in the same property.

If the estate owner wants to give the charity an income interest for a period of years and then the remainder interest to other beneficiaries, he or she may do so by using a qualified charitable lead trust. This could also be used in a situation in which there are young beneficiaries that the estate owner feels are not capable of handling the assets for ten years or so. The qualified charitable lead trust in the will gives the charity the use of the income while the young beneficiaries are maturing and then the property passes to the beneficiaries. The value of the property left to the beneficiaries that is subject to estate tax is reduced by the value of the charitable interest for the period of time stated in the will.

The estate owner who wishes to give the income from the property to his or her beneficiaries only for a stated period of time (maximum twenty years) or until their deaths and then wishes the property to pass on to a charity can do so by using a charitable remainder trust. The estate owner can claim an immediate tax deduction for a gift that a charity will not receive for many years. The income interest must be stated as a fixed-sum annuity or a fixed percentage of the value of the trust (called the unitrust). The annuity rate must be at least 5 percent of the fair market value of the trust for this to qualify as a charitable remainder trust. The Taxpayer Relief Act of 1997 provides that the annual payment to the income beneficiary cannot be more than 50 percent of the initial fair market value (annuity trust) or 50 percent of the annual value of the trust (unitrust) for transfers after June 18, 1997. In addition, the act provides that the remainder interest of the charity must be at least 10 percent of the net fair market value of the property transferred to the trust for transfers made after July 28, 1997. This is a good way of passing on the income to either a surviving spouse or children and then to a charity upon their demise or after a stated period of years. A charitable remainder trust allows one to carve out the amount of the value of the remainder going to the charity to reduce the taxable value of the income interest for estate tax purposes.

The following is a brief description of the various charitable remainder trusts arrangements:

— *Charitable remainder annuity trust (CRAT).* A trust that pays a *fixed dollar amount* (based on the value of the property contributed to the trust) each year to one or more income beneficiaries and then the remaining proceeds are distributed to one or more charitable organizations. Best suited for older beneficiaries. The principal grows for the benefit of the charity. A young beneficiary's life expectancy may cause the CRAT to fail the 10 percent requirement as stated above.

— *Charitable remainder unitrust (Standard CRUT).* A trust that pays a *fixed percentage* of the value of the trust's assets each year (redetermined annually) to one or more income beneficiaries and then the remaining proceeds are distributed to one or more charitable organizations. Ideal for younger beneficiaries where the assets will be invested in growth securities. The growth in principal is shared between annuitants and charity.

— *Charitable remainder net-income unitrust (NICRUT).* A trust that pays *the lesser of that year's net income or a fixed percentage* of the value of the trust's assets each year (redetermined annually) to one or more income beneficiaries and then the remaining proceeds are distributed to one or more charitable organizations. Ideal for growth securities and hard-to-sell assets.

— *Charitable remainder net-income with make-up unitrust (NIMCRUT).* A NIMCRUT is a NICRUT with a "make-up" provision in the trust instrument. The trust can pay in excess of the stated payout percentage to the income beneficiary in order to make up any shortfall from a prior year when the net income limitation caused the beneficiary to receive an amount that was less than the stated payout. Can be used for future retirement.

— *Flip unitrust.* A unitrust that begins as a NICRUT or a NIMCRUT but converts into a regular unitrust (a SCRUT) the year after a specified date or a "triggering event" occurs (Reg. Sec. 1.664-3(c)). Permissible triggering events include marriage, divorce, death, birth of child, and sale of an unmarketable asset such as real estate (Reg. Sec. 1.664-3(d)). Best suited for real estate and closely held securities, which will be sold in the future.

The investment planning goals of all the above charitable remainder trusts should be as follows:

— Earn enough net return to pay the annuity without using the trust principal.

— Grow the capital of the trust in order to at least have the trust's assets keep up with inflation.

— Maximize the growth of the capital of the trust for the benefit of the unitrust beneficiaries.

— Provide real value for the future charitable remainder.

— Avoid UBIT (unrelated business income tax).

A charitable remainder trust can also be used to generate income and defer capital gains tax. A grantor with highly appreciated low-yielding investments can transfer such investments to a charitable remainder trust. The trustee can sell the investments and invest in others with a higher yield. The trust does not have to pay capital gains tax and the income interest, retained by the grantor for life or for a term of years, is increased by the higher yield of the trust's investments.

Example: An individual owns marketable securities with a cost basis of $100,000 and a fair market value of $500,000. The individual is presently earning $10,000 in dividends from the stock. If the individual, who is in the 15 percent capital gains income tax bracket, sold the stock, he would have $440,000 to invest after paying capital gain taxes of $60,000 and would earn $35,200 a year if he was able to get an 8 percent return.

If, instead, he transfers the property to a charitable remainder trust, the trustees of the trust can sell the securities and reinvest proceeds without incurring any tax. Assuming the same 8 percent return, the trust can pay $40,000 a year for his life or fixed number of years (maximum twenty years), and the donor would be entitled to a charitable deduction for the actuarial value of the charity's remainder interest.

Assume the donor, who is age seventy, selects the annuity of $40,000 a year for a fixed term of twenty years. If the donor dies during this period, his children would receive the annuity payments for the balance of the term. The charitable value of the remainder is approximately $112,295, which will provide the donor with a deduction worth $34,812 at a 31 percent income tax bracket. The charitable deduction may be subject to the alternative minimum tax.

The annual distribution of charitable remainder trust amounts to the individual beneficiary or beneficiaries is taxed under a special four-tier provision of the tax code as follows:

— First, as ordinary income to the extent that the charitable remainder trust has ordinary income in the taxable year and had undistributed ordinary income from prior years

— Second, as capital gain, to the extent that the trust has capital gain in the taxable year and had undistributed capital gain from prior years

— Third, as other income (e.g., tax-exempt income), to the extent that the trust has other income in the taxable year and had undistributed other income from prior years

— Fourth, as a distribution from the trust's corpus

Inter vivos transfers into charitable remainder trusts and pooled income funds are methods of converting highly appreciated assets into one generating more income without first paying capital gains taxes; donors may continue to use these transfers after the imposition of the estate carryover basis rules in 2010, since there would be no method of avoiding the capital gains tax by holding the asset until death.

On the other hand, these transfers may become less appealing after the repeal of the estate tax because the estate's executor cannot allocate any portion of the decedent's spousal property basis increase to a charitable remainder trust for the lifetime benefit of the surviving spouse. A QTIP trust for the benefit of the surviving spouse, with a charitable remainder beneficiary, would generally be a superior vehicle for combining spousal and charitable benefits after the repeal of the estate tax.

Charitable lead trusts, however, should continue to be important estate tools.

These trusts are generally used by wealthier clients, whose estates are likely to be taxable notwithstanding the scheduled increases in the applicable exclusion amount. In addition, since the gift tax exemption will remain at $1,000,000 even if the estate tax is repealed, these trusts will remain excellent tools for transferring wealth to one's children or grandchildren during one's lifetime at a substantially reduced gift tax cost.

9. POSTMORTEM ESTATE PLANNING

9.1 Qualified Disclaimers

A disclaimer can be used to alter the plan or disposition. Disclaimers permit a second look at estate planning that was done previously. A disclaimer by a surviving spouse in excess of the minimum amount to reduce the estate tax to zero can be an effective way of saving tax on the spouse's subsequent death.

In order for a disclaimer or renunciation not to be treated as a taxable gift when the interest is passed from a disclaimer to the recipient, the disclaimer must meet the definition of "qualified disclaimer" (IRC Section 2518). A qualified disclaimer is an irrevocable, unqualified refusal to accept an interest in property and must satisfy the four following conditions:

— The refusal must be in writing.

— The written refusal must be received by the transferor, his or her legal representative, or holder of legal title to the property no later than nine months after the date of transfer creating interests or upon the disclaimant obtaining age twenty-one, whichever is later.

— The disclaimant must not accept an interest or the benefits (dividends, interest, or rents are benefits).

— The disclaimant cannot have the authority to direct the transfer to another person.

When the surviving spouse receives an inheritance greater than is necessary to eliminate the estate tax, the surviving spouse can disclaim a portion of his or her inheritance. If so directed in the will, the disclaimed portion could then pass over to a trust of which he or she is income beneficiary. When the inheritance to the spouse is insufficient to eliminate the estate tax, the beneficiaries other than the spouse can disclaim a portion of their inheritance and, if under local law or the governing instrument, the disclaimed property passes to the surviving spouse, there can be estate tax savings. All or an undivided portion (fraction or percentage) of any separate interest can be disclaimed. Each interest in property separately created by a transferor is a separate interest.

The time period for filing a disclaimer for revocable joint tenancy, such as a joint brokerage account or a joint bank account, normally runs from the date the gift becomes complete, that is, at the grantor's death, assuming the surviving joint tenant did not contribute to the joint account and did not accept any benefits of the property (Regs. Sec. 25.2518-2(c)(4)(iii)).

For other property held as joint tenants with right of survivorship or as tenants by the entirety, a qualified disclaimer of the survivorship interest to which the survivor succeeds by operation of law upon the death of the first joint tenant to die must be made no later than nine months after the death of the first joint tenant to die regardless of whether such interest can be unilaterally severed under local law. Such interest is deemed to be a one-half interest in the property. This is the case regardless of the portion of the property attributable to consideration furnished by the disclaimant and regardless of the portion of the property that is included in the decedent's gross estate (Regs. Sec. 25.2518(c)(4)).

In view of all the technical and conceptual changes contained in EGTRRA, as well as the differing effective dates of each, together with potential for change even during the next eight to ten years, postmortem estate planning is likely to become even more important.

Postmortem planning will be necessary and of significant benefit to clients because it should assist them in repairing unintended adverse consequences in estate plans, whether made before or after the enaction of this legislation, or particularly in repairing inadequately planned estates from those who thought that the changes precluded their need to plan.

9.2 Timing Distributions

If the estate is going to be in a lower bracket than that of the beneficiaries of the estate, the executor could accumulate the income of the estate in order to have it taxed as the income of the estate. If the beneficiaries are in a lower bracket than the estate, the executor could accelerate the distributions of income from the estate in order to have it taxed as income of the beneficiaries.

The tax-rate schedule applicable to retained income of estates is compressed as compared with the rates applicable to individuals. For 2004 the first $1,950 of taxable income of estates, a tax rate of 15 percent is used, with any excess taxed from 25 percent to 35 percent (see the chapter on Trusts); in most cases the estate will therefore be in a higher or equal income tax bracket and there would be no advantage to accumulate income over $1,950. In addition, estates begin paying estimated tax in a tax year ending two or more years after the date of the decedent's death. Therefore, estates will be able to file two returns without estimated tax payments. The Tax Reform Act of 1986 repealed the rule that had allowed estates to pay their tax over four equal quarterly installments.

9.3 Deductions of Administration Expenses

The administration expenses and losses during administration can be deducted either from the gross estate or on the estate income tax return. The executor must make an election with respect to the administrative expenses—the executor's commissions, attorney's and accountant's fees, court charges, and other expenses and losses incurred in the administration of the estate—by claiming them either on Form 706 or on Form 1041. If they are claimed on Form 1041, a statement in duplicate must be attached waiving the right to claim them on Form 706 (Regs. Sec. 1.642(g)-1).

10. SUNSET PROVISIONS OF THE TAX ACT OF 2001

If Congress does not re-enact or extend the changes that EGTRRA makes to the estate, gift, and generation-skipping tax laws, those laws will be restored to their current state on January 1, 2011.

This means that:

— The top estate and gift tax rate, and the only generation-skipping tax rate, will be 55 percent, plus the 5 percent surtax for transfers in excess of $10,000,000.

— The applicable exclusion amount for all three taxes would be $1,000,000 (the amount that all were scheduled to have reached in 2006 under prior legislation).

— The estate tax applicable exclusion amount and the generation-skipping tax exemption would again become disassociated.

— Carryover basis for estates would disappear and the present estate basis rules would be returned.

— The state death tax credit and the qualified family-owned business interest (QFOBI) would be resurrected.

— The technical changes made to the conservation easement rules, the generation-skipping allocation rules, and the lien for special use tax recapture would expire.

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