COUZENS LANSKY
ATTORNEYS & COUNSELORS

2016
CRITICAL LEGAL DEVELOPMENTS

VisTaTech Center, Livonia, Michigan

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39395 West Twelve Mile Road, Suite 200
Farmington Hills, MI 48331-2968
(248) 489-8600
(248) 489-4156 Fax
Email: info@couzens.com
Website: www.couzens.com

COUZENS LANSKY
ATTORNEYS & COUNSELORS

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Basics of Estate and Trust Administration

Monica D. Moons

BASICS OF ESTATE AND TRUST ADMINISTRATION

I. INTRODUCTION

A. Methods for Distributing Assets on Death.

1. There are (at least) four ways that people can arrange for ownership of assets to pass to others upon their deaths:

    a. By contract, including beneficiary designations and transfer on death arrangements.

    b. By joint ownership.

    c. Pursuant to the terms of a trust agreement.

    d. Pursuant to the terms of a Will, i.e. through the “probate” process.

2. Assets pass through the “probate" process if they do not pass through one of the other methods.

3. The extent of court involvement, if any, depends on the nature of the assets involved and the manner in which the assets were owned.

B. Key Words and Concepts.

1. “Ancillary Administration” is the procedure for authorizing a personal representative to administer the property of a decedent's estate that is located in a state other than the one in which the decedent lived.

2. “Application” v “Petition”. An Application is the form used to initiate informal proceedings in Probate Court. The Probate Court Register decides whether to grant the relief requested in an Application. A Petition is used to initiate formal proceedings in Probate Court. A Probate Court Judge decides whether to grant the relief requested in a Petition.

3. "EPIC" is Michigan's Estate and Protection Code, MCL 700.1101 et seq. This law covers probate, trust administration and related topics.

4. “Probate Property” or “Probate Estate”. These two phrases mean the same thing. A person has probate property (or probate estate) if, at the time of their death, they own assets that will not pass through any other arrangement (joint property, contract, trust, etc.), and will be subject to probate administration.

5. “Testate” v “Intestate”. A person dies “testate” if they leave a valid Will. If they did not leave a valid Will, they died “intestate”. When people die intestate, if they have “Probate Property”, that property will pass according to the rules of “intestate succession.”

II. GENERAL CONCEPTS IN ESTATE AND TRUST ADMINISTRATION

A. Types of Trusts.

1. "Revocable Trusts" v "Irrevocable Trusts". When a person (the "settlor") creates a trust agreement, they can elect, in the agreement, to reserve the right to alter, amend or revoke the agreement - in which case they will have established a "revocable trust." If the settlor does not reserve or formally gives up the right to alter, amend or revoke, the settlor will not have the authority to alter, amend or revoke the agreement at some later date (at least without court order), and they will have established an "irrevocable trust."

2. "Inter Vivos Trusts" v "Testamentary Trusts". When a person enters into trust agreements, as settlor, during their life, they are creating an "inter vivos trust." These could be revocable or irrevocable. Inter vivos revocable trusts are often called "living trusts." An inter vivos trust may include provisions regarding how the trust assets are to be managed during the settlor's life and after the death of the settlor. Alternately, a person may draft a Will that provides for the creation of a trust upon their death, which trust will be created in the probate process and funded with some or all of the assets that pass through probate. This is called a "testamentary trust." These are rarely used.

B. Types of People.

1. "Current Trust Beneficiary" v "Qualified Trust Beneficiary". These are EPIC terms used to differentiate a trustee's obligation to account and provide information to various trust beneficiaries.

2. "Interested Persons". This is a probate term to define those that are entitled to notice of a particular proceeding, as defined by court rule; or those that have sufficient nexus to the estate to have standing to petition the court for relief regarding some aspect of administration.

C. Allowances and Elective Shares.

1. "Allowances". Certain people are entitled to receive priority distributions from the estate. There is a Homestead Allowance (currently $22,000), a Family Allowance (currently $27,000), and an Exempt Property Allowance (currently $15,000). The personal representative has an affirmative duty to see that these allowances are satisfied. A trustee may have an obligation to satisfy these allowances, as explained later in this outline.

2. "Elective Share" or "Forced Share". These terms have the same meaning. When a person dies leaving a Will, a surviving spouse, and Probate Property; the spouse has a right to accept the property that was left to him or her under the terms of the Will, or reject the terms of a Will and take their "elective share".

The elective share where there are surviving descendants of the decedent who are also descendants of the surviving spouse is the first $222,000 plus ½ of the balance. The elective share where there are no surviving descendants of the decedent but there are surviving parents of the decedent is the first $222,000 plus 3/4 of the balance. Where the decedent leaves surviving descendants none of whom are descendants of the surviving spouse, the elective share is the first $148,000 plus ½ of the balance.

III. MICHIGAN LAW GOVERNING ESTATE AND TRUST ADMINISTRATION

A. EPIC is the overriding estate and trust administration statute.

1. EPIC altered existing procedures, and established new procedures, for the administration of Probate Estates, which procedures reduce court involvement in the administration of most estates.

2. Forms of Probate Estate Administration under EPIC.

a. Administration by Affidavit.

(1) A hospital, convalescent or nursing home, morgue or law enforcement agency in possession of $500 or less in cash and the decedent's clothing, may deliver those items to a spouse, child or parent who signs a sworn statement and meets the requirements of MCL 700.3981.

(2) If an estate consists of less than $22,000 in net assets and contains no real estate, administration can be accomplished by having an individual who is entitled to receive some or all of the property, prepare an affidavit and present it to the person or entity in possession of the asset(s).

b. Small Estate Administration. If, after paying funeral and burial expenses, the value of the assets remaining in the estate is less than $22,000, the court may order the property turned over to the heirs. This allows administration to be completed with the filing of a Petition and Order for Assignment.

c. Unsupervised Administration with option to use formal proceedings to address specific issues.

(1) Unsupervised administration may be initiated formally by filing a Petition for Probate and/or Appointment of Personal Representative, or informally by filing an Application for Informal Probate and/or Appointment of Personal Representative.

(2) Regardless of whether an estate is initiated formally or informally, administration will be unsupervised, unless the

court, in a formal proceeding, orders supervised administration.

(3) In unsupervised administration, the administration of the Probate Estate proceeds free of court supervision, except for specific issues that are brought before the court on Petition, if any.

d. Supervised Administration.

(1) Supervised Administration must be initiated by filing a Petition, or, if a formal proceeding has already been initiated and a determination of testacy has been made, by filing a Petition for Supervised Administration after Previous Adjudication.

(2) Supervised Administration subjects the activities of the personal representative to ongoing court supervision.

e. Summary Proceedings. After initiating a Probate Estate, formally or informally, if it appears the total value of the estate will be less than the combined costs of administration, funeral and burial, last illness, and the various allowances; the personal representative may choose to skip giving notice to creditors, distribute the assets, and close the estate by filing a closing statement.

B. The Michigan Trust Code ("MTC"), MCL 700.7101 et seq.

1. The MTC recognizes that many people are using revocable inter vivos trusts as their primary estate planning document. In response to this development, the MTC imposes many of the same obligations on the trustee of a revocable inter vivos trust, as are imposed on the personal representative of a Probate Estate. The MTC is part of EPIC.

2. While the MTC increases the duties of the trustee with regard to the administration of a revocable inter vivos trust, trust administration remains free of court supervision, except where specific issues are brought before the court by a petition filed by an interested person. Because trusts are generally not subject to court supervision, the State Court Administrators Office has not developed forms to be used by trustees in trust administration.

3. With respect to testamentary trusts, the MTC eliminated ongoing court supervision, which existed under Michigan's prior probate code.

4. Under the MTC:

a. Trust administration is always unsupervised.

b. The court may intervene in trust administration upon petition of an interested person.

c. The trustee is subject to specific notice and default accounting requirements.

d. The trustee is subject to probate-like creditor notice requirements.

e. The Trust estate is potentially subject to allowances, but not subject to the spousal elective share.

C. Notice Requirements.

1. Probate Estate. In the administration of a Probate Estate, the personal representative has a variety of notice requirements established by law and court rule.

a. Notice of Appointment and Attorney Fees. A Notice of Appointment and Notice Regarding Attorneys Fees must be served on the interested persons within 14 days from the date the personal representative is appointed. At the same time each interested person must be served with a copy of the Order of Formal Proceedings or Register's Statement.

b. Notice of Elective Share. If the decedent left a surviving spouse, and the surviving spouse is not the personal representative, the personal representative must serve Notice to Spouse of Rights of Election on the surviving spouse within 28 days after appointment.

c. Inventory. Within 91 days after appointment, the personal representative must serve an inventory on the presumptive distributees and all other interested persons who request it. The personal representative must provide sufficient information to the Probate Court so that an inventory fee can be calculated. If the personal representative employed an appraiser(s) to determine values, the name and address of the appraiser(s) must be included in the inventory. If additional property is discovered afterwards, or later information causes the personal representative to revise the date of death value(s) of asset(s), the personal representative must create a supplemental inventory.

d. Notice to Creditors. A personal representative must prepare a Notice to Creditors, which must be published in a newspaper in the county of administration. The publication triggers the four month claims period. A Probate Estate may not be closed until the claims period has ended. In addition, the personal representative must communicate the same information provided in the notice to creditors to all "known creditors". Known creditors are creditors that the personal representative is aware of, or would be aware of if the personal representative reviewed "available records" for two years immediately preceding the date of death, and reviewed the decedent's mail from the date of death forward. In addition, the personal representative must serve notice on the trustee of an inter vivos revocable trust of which the decedent was

settlor. If the personal representative determines that a claim by a creditor should not be honored, in whole or part, the personal representative must serve a Notice of Disallowance on the creditor.

e. Accounts. Except in supervised estates, a personal representative is not required to file accounts with the court, or to have the accounts approved by the court (although they may choose to do so). However, the personal representative must serve annual accounts, and a final account, on each person who remains interested in the estate at the time the account is due (i.e., they have not received their full distribution).

2. Trust Estate. In the administration of an inter vivos revocable trust, the trustee has the following duties to provide information:

a. Notice to Settlor during his/her life. While the settlor is alive, the trustee of a revocable trust has a duty to keep the settlor "reasonably informed" with respect to the administration of the trust. The trustee has no duty to provide information to any other interested persons.

b. Upon Incapacity of Settlor. If the settlor becomes incapacitated, and if the trust agreement does not provide otherwise, the trustee must keep the person who was designated by the settlor to receive trust information in the event of his/her incapacity or if none, the settlor's agent under a durable power of attorney, reasonably informed. If the settlor did not designate someone to receive trust information upon his/her incapacity, the trustee must keep each "current trust beneficiary" reasonably informed. If the settlor's agent under a durable power of attorney and the successor trustee are the same person, then the trustee must also keep trust beneficiaries reasonably informed.

c. Upon the Death of Settlor. Within 28 days of death or acceptance of trust, whichever is later, the trustee must notify each trust beneficiary of the following:

(1) the trust's existence,

(2) the court in which the trust is registered, if any,

(3) the trustee's name and address,

(4) notice that the trustee will provide a copy of the trust's terms that affect that beneficiary and relevant information about the trust assets.

i. The trustee is also obligated to account to the persons entitled to receive accounts, as set forth in the trust agreement, or, as ordered by the court, or, if the trust

agreement does not specifically identify the persons entitled to accounts, and the court has not ordered otherwise, accounts must be given to each current beneficiary.

ii. By preparing an accounting, a trustee may limit the time period during which beneficiaries who received copies of the accounts may object to the contents of the account. Specifically, there is a one-year statute of limitation with respect to trust activities disclosed in the account.

d. Notice Requirements of a Trustee of Inter Vivos Irrevocable Trust or Testamentary Trust. The trustee of an inter vivos irrevocable trust or testamentary trust has the same duties to give notice and account that the trustee of a inter vivos revocable trust has following the death of the settlor.

e. Duty of Trustee of Inter Vivos Revocable Trust to Satisfy Creditors.

(1) If the personal representative of an estate has insufficient assets to pay the administration expenses of the estate, funeral and burial expenses, valid creditor claims against the estate, and allowances (but not elective share), the trustee must provide the personal representative with sufficient funds to satisfy these expenses/claims from the resources of the trust.

(2) In addition, if no personal representative has been appointed, the trustee becomes responsible for publishing notice and notifying known creditors of the decedent. The trustee becomes responsible for giving notice to creditors in much the same manner as the personal representative would, were there a Probate Estate.

D. Record Keeping.

1. Inventory. Fiduciaries, such as personal representatives or trustees, must keep detailed records of the assets they marshall upon accepting their role and the value of those assets at that time. That information will be included in their initial inventory.

2. Accounting. Fiduciaries must also keep detailed accounting records of the income received on those assets and/or any investments they themselves make with the assets they control, and of the expenses paid from those assets during their tenure.

3. Time Records. Fiduciaries must keep detailed time records, if they intend to charge fiduciary fees, showing the tasks performed, the time spent on each such task, and the hourly rate charged.

E. Fees.

1. As noted above, when a personal representative or trustee charges for their time in administering the estate or trust, they are required to provide the interested persons or trust beneficiaries with detailed time records. Professionals, such as attorneys and accountants, are allowed to charge a much higher fee than laypersons. For example, in Oakland County, an attorney acting as trustee may charge $200 per hour, whereas a layperson will likely be limited to $50 per hour.

2. In every case, the court has discretion in determining fees, based on several factors, if a beneficiary objects to the fees charged.

F. Distributing Assets and Closing the Estate or Trust.

1. Probate Estate.

a. Distribution of Assets. Except in Supervised Estates, EPIC does not require a personal representative to obtain court authority to distribute assets to heirs/devisees. However, the following issues should be considered:

(1) Distributions should not be made until all creditors, and all other expenses, are known or satisfied.

(2) EPIC favors in-kind distribution of assets. When coming up with a plan for distributing the remaining estate assets, this preference should be taken into consideration.

(3) EPIC provides a procedure for having a proposed distribution plan accepted by the interested persons. The personal representative can send a proposed distribution plan to those entitled to receive assets from the estate, and if no objections are received within 28 days after mailing the proposal, the personal representative may make the distributions according to the proposal, and the interested persons who received the proposal and did not object have waived their right to object.

b. Closing the Estate. EPIC provides for formal and informal procedures for closing an estate.

(1) An unsupervised estate may be closed by serving a closing statement and final account on all interested persons. The personal representative then files a proof of service and the original closing statement with the court. If no objection is filed within 28 days, the register will issue a Certificate of Completion. The personal representative's appointment will terminate one year after the closing statement is filed.

(2) Alternately, an estate may be closed formally, by filing a Petition for Complete Estate Settlement. When a personal representative petitions for an Order of Complete Estate Settlement, she/he may seek court approval of any aspect of the administration at that time. The personal representative will file the Petition for Complete Estate Settlement with the court and obtain a hearing date. The personal representative will then serve the Petition, with any attachments, and Notice of Hearing on the interested persons, and file the Proof of Service with the court. The personal representative may seek waiver/consent forms from interested persons. If the Petition for Complete Estate Settlement is approved by the court, the court will issue an Order for Complete Estate Settlement.

2. Trust Estate. There are no statutorily defined methods to complete the trust administration. However, the requirements for preparing and serving accounts as discussed above, provide the trustee with a process for serving a final account which, if done properly, can preclude any further claims after one year. To avoid having to wait a year, the trustee can ask beneficiaries to sign a release, in which they approve the trustee's account(s). Filing the final income tax return is often the last act of a trustee.

IV. CONCLUSION

The devil is in the details in estate and trust administration. It is essential for a fiduciary to keep meticulous records and to keep the interested persons or trust beneficiaries informed throughout the process. A fiduciary who follows those two cardinal rules will simplify the administration process and will also fare better if the administration ends up in court upon the objection of an interested person or trust beneficiary.

Updating and Rewriting Estate Plans

Lisa J. Walters

UPDATING AND REWRITING ESTATE PLANS

I. CLIENTS WITHOUT DOCUMENTS

A. State Intestacy laws apply.

1. MCL 700.2101 et seq.

   a. Any part of a decedent's estate not effectively disposed of by Will passes by intestate succession to the decedent's heirs as prescribed in this act, except as modified by the decedent's Will.

   b. Decedent by Will may expressly exclude or limit the right of an individual or class to succeed to property of the decedent that passes by intestate succession. If that individual or a member of that class survives the decedent, the share of the decedent's intestate estate to which that individual or class would have succeeded passes as if that individual or each member of that class had disclaimed his or her intestate share.

2. MCL 700.2102 Share of spouse.

   a. The intestate share of a decedent's surviving spouse is 1 of the following:

      (1) The entire intestate estate if no descendant or parent of the decedent survives the decedent.

      (2) The first $150,000.00, plus 1/2 of any balance of the intestate estate, if all of the decedent's surviving descendants are also descendants of the surviving spouse and there is no other descendant of the surviving spouse who survives the decedent.

      (3) The first $150,000.00, plus 3/4 of any balance of the intestate estate, if no descendant of the decedent survives the decedent, but a parent of the decedent survives the decedent.

      (4) The first $150,000.00, plus 1/2 of any balance of the intestate estate, if all of the decedent's surviving descendants are also descendants of the surviving spouse and the surviving spouse has 1 or more surviving descendants who are not descendants of the decedent.

      (5) The first $150,000.00, plus 1/2 of any balance of the intestate estate, if 1 or more, but not all, of the decedent's surviving descendants are not descendants of the surviving spouse.

(6) The first $100,000.00, plus 1/2 of any balance of the intestate estate, if none of the decedent's surviving descendants are descendants of the surviving spouse.

b. Each dollar amount listed in subsection (a) shall be adjusted as provided in section 1210. (See the Estates and Protected Individuals Code cost of living adjustments for 2016 attached.)

3. MCL 700.2103 Share of heirs other than surviving spouse.

Any part of the intestate estate that does not pass to the decedent's surviving spouse under section 2102, or the entire intestate estate if there is no surviving spouse, passes in the following order to the following individuals who survive the decedent:

a. The decedent's descendants by representation.

b. If there is no surviving descendant, the decedent's parents equally if both survive or to the surviving parent.

c. If there is no surviving descendant or parent, the descendants of the decedent's parents or of either of them by representation.

d. If there is no surviving descendant, parent, or descendant of a parent, but the decedent is survived by 1 or more grandparents or descendants of grandparents, 1/2 of the estate passes to the decedent's paternal grandparents equally if both survive, or to the surviving paternal grandparent, or to the descendants of the decedent's paternal grandparents or either of them if both are deceased, the descendants taking by representation; and the other 1/2 passes to the decedent's maternal relatives in the same manner. If there is no surviving grandparent or descendant of a grandparent on either the paternal or the maternal side, the entire estate passes to the decedent's relatives on the other side in the same manner as the 1/2.

4. By representation or per stirpes.

a. MCL 2718.

(1) If an applicable statute or a governing instrument calls for the property to be distributed “by representation” or “per capita at each generation”, the property is divided into as many equal shares as there are surviving descendants in the generation nearest to the designated ancestor that contains 1 or more surviving descendants and deceased descendants in the same generation who left surviving descendants, if any. Each surviving descendant in the nearest generation is allocated 1 share. The remaining shares, if any, are combined and then divided in the same manner among the surviving descendants of the deceased

descendants as if the surviving descendants who were allocated a share and their surviving descendants had predeceased the distribution date. This rule of construction applies to documents originally created on and after April 1, 2000, and to all instruments amended on and after April 1, 2000, that use the phrase “by representation” or “per capita at each generation”. If an amendment uses either phrase, the rule of this section applies to the entire instrument.

(2) If a governing instrument calls for property to be distributed “per stirpes”, the property is divided into as many equal shares as there are surviving children of the designated ancestor and deceased children who left surviving descendants. Each surviving child, if any, is allocated 1 share. The share of each deceased child with surviving descendants is divided in the same manner, with subdivision repeating at each succeeding generation until the property is fully allocated among surviving descendants.

(3) For the purposes of subsections (1) and (2), a deceased individual who left no surviving descendant is disregarded, and an individual who leaves a surviving ancestor who is a descendant of the designated ancestor is not entitled to a share.

b. For example, Jane Doe, the Testator (the person who wrote the Will) names her two children, John Doe and Betty Doe to receive her assets. Before Jane Doe died, her two children predeceased her. John had two children and Betty three. Is the Estate distributed to each of the 5 grandchildren equally? Or, do John's two children share his 50% and Betty’s three children share her 50%?

The answer to that question goes to the understanding of two probate concepts. The first is per capita or by representation. This concept provides that unless specified otherwise in the Will or Trust, each of the five grandchildren would receive an equal share.

The second concept is called per stirpes. This concept provides that unless specified otherwise in the Will or Trust, each grandchild receives the share that their deceased parent would have received if they had been alive. In the example above, John's two children would share his 50% and Betty’s three children would share her 50%.

The impact should now be clear. With a per capita distribution, each grandchild receives 20% of the estate. With a per stirpes distribution, Betty’s three children each receive 16.7% and John's two children would each receive 25%.

5. Contracts control and override state intestacy laws.

6. Ensure beneficiary designations for life insurance, annuities and retirement plans are appropriate.

7. Joint owners "with rights of survivorship" means the property in question will be owned by the last surviving joint owner.

B. Prepare Appropriate Estate Planning Documents.

1. Living Will - life support statement.

2. Medical Durable Power of Attorney ("Patient Advocate Designation") - permits others to make medical decisions for you when you cannot, subject to your directions known to them.

3. HIPAA Authorization - designation of individuals authorized to receive the Patient's privileged medical information.

4. Funeral Representative Designation - permits others to make your funeral/burial/cremation decisions.

5. Financial Durable Power of Attorney - permits others to sign your name in specified circumstances.

6. Will - specifies disposition of property at death, names guardians, conservators and personal representative-executors; subject to Probate; may be amended during competency. Name beneficiaries (may be different than the heirs who are determined by the State statutes).

7. Living Trust or Revocable Trust - A contract created by a Settlor or Grantor, often with no one else involved. Property is managed by a Trustee for the benefit of beneficiaries. Living or revocable Trusts may be amended, are not subject to Probate and may name successor Trustees and beneficiaries. Beneficiaries may be different than intestacy heirs.

8. Funding Documents - transfer assets to Trusts, avoiding Probate.

9. Irrevocable Trusts - used to receive restricted gifts, especially life insurance where estate taxes might otherwise be incurred.

II. <u>UPDATE DOCUMENTS AS NECESSARY</u>

A. Why should the documents be updated?

1. Laws change (estate tax exemption changed from $600,000 per person in the 1990s to $5,450,000 currently and increasing to $5,490,000 effective January 1, 2017).

2. Families change:

    a. Marriage, divorce, children born or adopted, move to a different state.

    b. Assets change.

3. The Settlor/Grantor's wishes change and beneficiaries may be added or removed and the guidelines directing the use of the inherited property may require revision.

B. When to change documents? Recommend review every 3 to 5 years or when a significant family or law change occurs.

1. April 1, 2000 - the Estates and Protected Individuals Code was enacted in Michigan which significantly revised many statutes relating to Estate planning documents which apply to documents executed by a decedent who dies after April 1, 2000.

2. April 1, 2010 - the Michigan Trust Code was enacted and applies to trust instruments executed before that effective date unless there is a clear indication of a contrary intent in the terms of the trust.

C. What to change?

1. Will:

    a. Are the guardians named for minor children still appropriate?

    b. Are the nominated Personal Representatives still appropriate?

    c. If property is disposed of pursuant to the Will, are the dispositive provisions still appropriate?

    d. Is authority granted over digital assets?

2. Revocable (Living) Trust.

    a. Ensure Marital Trust qualifies for Marital Deduction - is all income required to be distributed?

    b. Are all assets directed to a restrictive Credit Shelter/ Residuary/Family Trust? Is that still in the best interests of the family?

    c. Is the exemption amount allocated to a non-spouse? If so, is the value of the Estate sufficient to provide for the spouse with the excess funds?

    d. Does the Trust include Trustee removal provisions?

    e. Are beneficiaries granted limited powers of appointment?

f. Should a beneficiary's share be held in Trust for life for creditor protection purposes as opposed to being distributed outright or at specified ages?

g. Is authority granted over digital assets?

h. Should a Trust Protector be named?

3. Patient Advocate Designation (Medical Power of Attorney).

a. Are the designated primary and successor Patient Advocates still the correct people?

b. Are successors named?

c. Have the Patient's wishes regarding being maintained (or not) on life support been addressed?

d. Does the Patient have specific wishes regarding donating organs?

4. Durable Power of Attorney (Financial Power of Attorney).

a. Are the designated primary and successor attorneys or agents still the correct people?

b. Are successors named?

c. Is authority granted over digital assets?

d. Is or should authority be granted to seek Medicaid qualification?

III. CLIENTS WITH IRREVOCABLE DOCUMENTS

A. What documents?

1. Revocable Trusts which become irrevocable at the time of the Grantor/Settlor's incapacity or death.

2. Irrevocable Trusts.

3. Gifting Trusts.

B. How to revise irrevocable documents?

1. Exercise of power of appointment granted in the document.

a. Is the power of appointment to be exercised during the life of the beneficiary or only at death?

b. May the power of appointment be exercised by an inter vivos document or only by Will.

c. What limitations are imposed on the exercise of the power of appointment?

2. Termination of the Trust.

a. Does the Trust permit early termination? If so, must the Trust qualify for early termination (does the Trust authorize termination if the value of the Trust property is insufficient to justify the administration expenses or if the value of the Trust is below an identified amount)?

b. Consider asking the appropriate Probate Court for permission to terminate the Trust.

3. Modification or termination of noncharitable trust; consent; "settlor's representative" defined. MCL 700.7411.

a. Subject to subsection (2), a noncharitable irrevocable trust may be modified or terminated in any of the following ways:

(1) By the court upon the consent of the trustee and the qualified trust beneficiaries, if the court concludes that the modification or termination of the trust is consistent with the material purposes of the trust or that continuance of the trust is not necessary to achieve any material purpose of the trust.

(2) Upon the consent of the qualified trust beneficiaries and a trust protector who is given the power under the terms of the trust to grant, veto, or withhold approval of termination or modification of the trust.

(3) By a trustee or trust protector to whom a power to direct the termination or modification of the trust has been given by the terms of a trust.

b. Subsection (1) does not apply to irrevocable trusts created before or to revocable trusts that become irrevocable before April 1, 2010.

4. Trust reformation. MCL 700.7415 Reformation to correct mistakes.

The court may reform the terms of a trust, even if unambiguous, to conform the terms to the settlor's intention if it is proved by clear and convincing evidence that both the settlor's intent and the terms of the trust were affected by a mistake of fact or law, whether in expression or inducement.

5. Non-judicial Settlement Agreements.

a. MCL 700.7111.

(1) Except as otherwise provided in subsection (2), interested persons may enter into a binding nonjudicial settlement agreement with respect to any matter involving a trust.

(2) A nonjudicial settlement agreement is valid only to the extent it does not violate a material purpose of the trust and includes terms and conditions that could be properly approved by the court under this article or other applicable law. A nonjudicial settlement agreement shall not be used to accomplish the termination or modification of the trust.

b. Examples of changes which may be made by non-judicial settlement agreements:

(1) The interpretation or construction of the terms of the trust.

(2) The approval of a trustee's report or accounting.

(3) Direction to a trustee to perform or to refrain from performing a particular act or to grant to or to withhold from a trustee any power.

(4) The resignation or appointment of a trustee and the determination of a trustee's compensation.

(5) Transfer of a trust's principal place of administration.

(6) Liability of a trustee for an action relating to the trust.

6. Trust Protectors.

a. MCL 700.7103

(1) "Trust protector" means a person or committee of persons appointed pursuant to the terms of the trust who has the power to direct certain actions with respect to the trust. Trust protector does not include either of the following:

(2) The settlor of a trust.

(3) The holder of a power of appointment.

b. MCL 700.7809.

(1) A trust protector, other than a trust protector who is a beneficiary of the trust, is subject to all of the following:

Except as provided in subsection (2), the trust protector is a fiduciary to the extent of the powers, duties, and discretions granted to him or her under the terms of the trust.

In exercising or refraining from exercising any power, duty, or discretion, the trust protector shall act in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries.

The trust protector is liable for any loss that results from the breach of his or her fiduciary duties.

(2) The terms of a trust may provide that a trust protector to whom powers of administration described in section 675(4) of the Internal Revenue Code, 26 USC 675, have been granted may exercise those powers in a nonfiduciary capacity. However, the terms of the trust shall not relieve the trust protector from the requirement under subsection (1)(b) that he or she exercise or refrain from exercising any power, duty, or discretion in good faith and in accordance with the terms and purposes of the trust and the interests of the beneficiaries.

(3) Except as otherwise provided in subsection (4), the trustee shall act in accordance with a trust protector's exercise of the trust protector's specified powers and is not liable for so acting.

(4) If either of the following applies to a trust protector's attempted exercise of a specified power, the trustee shall not act in accordance with the attempted exercise of the power unless the trustee receives prior direction from the court:

The exercise is contrary to the terms of the trust.

The exercise would constitute a breach of any fiduciary duty that the trust protector owes to the beneficiaries of the trust.

(5) A trustee is not liable for any loss that results from any of the following:

i. The trustee's compliance with a direction of a trust protector, unless the attempted exercise was described in subsection (4).

ii. The trustee's failure to take any action that requires a prior authorization of the trust protector if the trustee timely sought but failed to receive the authorization.

iii. Seeking a determination from the court regarding the trust protector's actions or directions.

iv. The trustee's refraining from action pursuant to subsection (4).

(6) The terms of a trust may confer upon a trustee or other person a power to direct the modification or termination of the trust.

(7) By accepting an appointment to serve as a trust protector of a trust registered in this state or having its principal place of administration in this state, the trust protector submits to the jurisdiction of the courts of this state even if investment advisory agreements or other related agreements provide otherwise, and the trust protector may be made a party to any action or proceeding relating to a decision, action, or inaction of the trust protector.

(8) A term of a trust that relieves a trust protector from liability for breach of his or her fiduciary duties is unenforceable to the extent that either of the following applies:

i. The term relieves the trust protector of liability for acts committed in bad faith or with reckless indifference to the purposes of the trust or the interests of the trust beneficiaries.

ii. The term was inserted as the result of an abuse by the trust protector of a fiduciary or confidential relationship to the settlor.

7. Decanting - is the distribution of trust assets by a Trustee of an Irrevocable Trust to a new Trust which contains different terms from the distributing Trust. Statutory Authority:

a. MCL 700.7820a - If an irrevocable trust includes a discretionary trust provision, the trustee of the trust may, unless the terms of the first trust expressly provide otherwise, distribute by written instrument all or part of the property subject to that provision to the trustee of a second trust, provided that both of the following conditions are satisfied:

(1) The terms of the second trust do not materially change the beneficial interests of the beneficiaries of the first trust.

(2) If the governing instrument of the first trust expressly indicates an intention that the first trust qualify for a tax benefit or the terms of the first trust are clearly designed to qualify the first trust for a tax benefit, and if the first trust would qualify for the intended tax benefit, the governing instrument of the second trust is not inconsistent with the tax planning that informed the first trust.

b. MCL 556.115a - Beneficiaries of the second Trust may only include 1 or more beneficiaries of the originating trust.

(1) The duration of a 2503(c) Trust may not extend beyond the date on which the original Trust would have been payable.

(2) May not reduce an interest intended to qualify for the marital deduction or charitable deduction.

(3) May not reduce an interest which a beneficiary is entitled to withdraw or exercise.

Avoiding Fatal Mistakes in Buy-Sell Agreements

Christopher M. Williams

AVOIDING FATAL MISTAKES IN BUY-SELL AGREEMENTS

I. DEFINING A BUY-SELL AGREEMENT

A. A legally binding agreement among the owners of a company designed to control the transfer of ownership.

B. This can be a separate stand-alone agreement (generally corporations) or incorporated into the governing documents of a company (generally partnerships and limited liability companies).

II. PURPOSE OF BUY-SELL AGREEMENTS

A. Restrict transfer of ownership: ownership interests are freely transferable unless restrictions are imposed by governing documents or an agreement among owners.

B. Provide a plan for transfer of ownership.

1. Remaining business owners are guaranteed full control of the business.

2. Specify Triggering Events (i.e. those occurrences that activate a right or obligation to purchase or sell ownership).

3. Provide a funding structure and incentive for owners to remain with the company.

C. Create a market for the sale of ownership interests in a closely held company.

1. Difficult to value ownership interests in a closely held company.

2. Can help determine the value of a deceased business owner's interest for estate tax purposes.

III. TYPES OF BUY-SELL AGREEMENTS

A. Redemption (Entity Plan): a selling owner agrees to sell, and the company agrees to buy, the selling owner's interest in the company.

1. Pros:

a. Only one life insurance policy is required on the life of each owner when a buy-sell agreement is funded with life insurance.

b. Remaining owners have no personal liability.

2. Cons:

a. The remaining owners do not receive a stepped-up basis in their ownership interests.

b. Possible imposition of the 20% alternative minimum tax ("AMT") on any life insurance proceeds payable to a C corporation.

c. Attribution rules of IRC 318 impact family-owned corporations and can potentially cause the purchase price to be taxable to the seller (or the seller's estate) as a dividend.

B. Cross-Purchase: a selling owner agrees to sell, and the other owners agree to buy, the selling owner's interest in the company.

1. Pros:

a. Remaining owners receive a stepped-up basis in their ownership interests equal to the purchase price paid for the ownership interests.

b. No AMT on insurance proceeds received by a C corporation.

c. No concern that the attribution rules of IRC 318 will cause the purchase price received by a seller (or the seller's estate) in a family-owned corporation to be taxable to the seller (or the seller's estate) as a dividend.

2. Cons:

a. Multiple insurance policies are required on the life of each owner when a buy-sell agreement is funded with life insurance.

b. There may be a disparity in premium payments for life insurance policies based on the health, ages, and ownership interests of the owners.

C. Hybrid (Wait-and-See): a selling owner agrees to sell, and either the company redeems the selling owner's interest or the other owners agree to buy, the selling owner's interest in the company.

1. Pro: Flexibility to structure a sale as a redemption or cross-purchase.

2. Con: Longer and more involved than a Redemption or Cross-Purchase agreement.

IV. FATAL MISTAKES

A. Failing to adequately identify and define Triggering Events.

1. Death.

2. Disability (define total and permanent disability or failure to work for a specified time).

3. Divorce.

4. Termination of employment (both voluntary and involuntary).

5. Retirement (specify the age of retirement).

6. Bankruptcy.

7. Assignment.

8. Attempted sale.

9. Gift.

10. Other involuntary transfers (e.g. receivership, court orders, etc.).

11. Deadlock.

B. Failing to properly structure buy-out provisions.

1. Death, Disability, and Retirement are generally mandatory purchases.

a. Should there be exceptions (e.g. family members, key employee, etc.)?

b. Alternatively, should there be only a put or call right?

2. Other Triggering Events generally provide an option to purchase or right of first refusal.

3. Consider whether a super-majority owner should have special rights.

4. Should there be drag-along provisions (committing minority owners to sell when a majority owner wants to sell to a third-party) or tag-along provisions (committing a majority owner to permit minority owners to join a majority owner's sale to a third-party)?

C. Failing to use an appropriate method for determining the purchase price.

1. Fixed Valuation.

a. Valuation may reflect value at formation rather than present value.

b. Failure to review and update valuation.

c. Permitting parties to negotiate the price in the future may result in unfairness due to changing dynamics (e.g. remaining owners vs. surviving spouse).

2. Valuation Formulas (e.g. Net Book Value, Adjusted Book Value, Fair Market Value, Multiple-of-Earnings, etc.).

a. What are the parties' goals and objectives?

(1) Is the objective to address estate planning?

(i) A properly implemented buy-sell agreement can fix the estate value of a deceased owner's ownership interest ("estate freezing"). Under the buy-sell agreement, an estate must be obligated to sell at death, the purchase price must be fixed by its terms or contain a formula or method for determining the price, the owner must be prohibited from disposing of the owner's interest without first offering it to the company or the other owners at no more than the price as provided by the agreement, and the price must be fair and adequate when the agreement is entered into.

(ii) In order to take advantage of estate freezing in buy-sell agreements between family members, in addition to the criteria set forth above, the agreement must be a bona fide business arrangement, it may not be a device to transfer property for less than full and adequate consideration in money or money's worth, and it must have terms comparable to those entered into by persons in an arm's-length transaction. IRC 2703. These requirements do not apply if more than 50% of the business interests are held by unrelated owners.

(iii) Valuation for estate planning purposes tends to be lower than if the objective is to maximize profit.

(2) Is the objective to maximize profit? Consider who you are representing (e.g. the company, an owner with a majority interest, an owner with a minority interest, or all of the above).

b. Is the formula appropriate based on the maturity of the company?

(1) Net Book Value (total assets less total liabilities as reflected on its balance sheet) may be appropriate for a new company with no earnings history, but it will understate the value for a growing or mature business.

(2) Multiple-of-Earnings (multiplying earnings by a multiplier) may be an appropriate approach for a growing or mature business. However, you must carefully note how "earnings" are calculated (including any adjustment which may cause earnings to be understated or overstated) and whether the multiplier is appropriate based on the risk involved and the industry.

c. Does the company have goodwill that should be taken into account in determining the value of the company? Certain formulas do not take goodwill into consideration (e.g. Net Book Value and Adjusted Net Book Value [Net Book Value adjusted up or down to reflect the current Fair Market Value of tangible assets]).

d. Has an appropriate valuation date been identified? If life insurance is used to pay the purchase price, the valuation date should be the last day of the month immediately preceding the Triggering Event, otherwise the life insurance proceeds will inflate the value of the company and the resulting purchase price.

e. Should discounts to value for lack of control and marketability be considered? Consider the inactive or silent owner with a minority interest.

f. If Fair Market Value is used, what formulas are used and how are they being weighted?

3. Procedure for determining the purchase price.

a. If the company is valued pursuant to a formula:

(1) Who will be performing the valuation (accountant, appraiser, valuation expert, etc.) and how will that person be selected?

(2) What if there is a dispute in who should be performing the valuation?

(3) What if there is a dispute concerning the valuation result?

b. What is the time table for determining when the purchase price is determined and, in the case of a Wait-and-See agreement, what is the time table for options to purchase being exercised and a closing to occur?

D. Failing to utilize appropriate payment terms.

1. Identify payment terms and use a promissory note.

a. Down payment.

b. Payment term.

c. Due dates.

d. Interest rate.

(1) Floating rates tied to prime lending rates.

(2) Pay attention to the Applicable Federal Rate where low rates are desired to avoid imputed interest (e.g. family transactions).

e. Subordination.

f. Prepayment.

2. Will security be used where a purchase price is deferred?

a. Security Agreement.

b. Guaranty.

c. Pledge of ownership interest.

d. Mortgage.

3. Will there be operating restrictions on the company where a purchase price is deferred?

a. Increases in compensation for owners and family members.

b. A sale of the company or substantially all of its assets.

c. Merger or consolidation.

d. Debt limits.

e. Changes in voting control.

4. Address insufficient funds to pay the purchase price. What if a buying company has cash-flow problems during payment of the purchase price?

E. Failing to properly fund the Buy-Sell Agreement.

1. Inadequate funding.

a. No funding due to lack of capital at start-up or other priorities during the growth phase (e.g. product development, equipment acquisition, etc.).

b. Adequacy of insurance coverages changes over time.

(1) If additional insurance is needed, it will be subject to additional underwriting which could mean higher premiums or declined coverage.

(2) Consider policies which permit death benefit increases without additional underwriting or inflation protection for disability income insurance policies.

c. Should a sinking fund be used (i.e. holding back company profits and creating an after tax cash reserve to cover the costs of the buy-sell agreement)?

2. Make sure insurance ownership and beneficiary designations are correct.

a. Beware "Transfer-for-Value" issues which can convert a portion of otherwise tax free life insurance proceeds into taxable income. For example, if an insured transfers his or her own life insurance policy to another owner of the business as owner and beneficiary of the policy, it would constitute a Transfer-for-Value unless one of the limited exceptions applies.

b. Beware of owners owning a policy on the life of another owner and naming the surviving spouse of the insured as the beneficiary. The surviving owner would not receive the funds needed to pay for the ownership interest being purchased.

F. Using a Redemption Agreement in a family-owned corporation or a C corporation.

1. Possible imposition of the 20% AMT on any life insurance proceeds payable to a C corporation.

2. Attribution rules of IRC 318 impact family-owned corporations and can potentially cause the purchase price to be taxable to the seller (or the seller's estate) as a dividend.

G. Failing to place a legend on stock certificates giving notice of restrictions under a buy-sell agreement. MCL 450.1472(2). A shareholder will not be restricted from transferring shares of stock by a buy-sell agreement, unless the restriction is conspicuously noted on the front or back of the stock certificate or the shareholder has actual knowledge of the restriction.

H. Failing to comply with the notice and consent provisions of IRC 101(j) prior to an employer-owned life insurance contract being entered into that insures the life of an employee, officer or director of the company.

1. If a company fails to comply with the notice and consent requirements, the proceeds received from a life insurance policy are taxable as ordinary income to the extent they exceed the company's costs of the policy.

2. The notice and consent requirements require that an insured:

a. be notified in writing of the company's intention to insure the insured's life, the maximum face amount for which the insured could be insured, and that the company will be the beneficiary of the death proceeds, and

b. consent in writing both to being insured under the contract and that such coverage may continue after the insured terminates employment.

3. The notice and consent provisions can be incorporated into a buy-sell agreement if it is signed before the insurance contract is entered into.

I. Failing to meet the requirements of IRC 2703 in a family buy-sell agreement.

1. Selling estate may receive less for the business interest than the estate tax obligation for the interest.

2. The company must be valued using Fair Market Value in order to satisfy the requirements of IRC 2703.

V. ILLUSTRATION: PROBLEMS AND SOLUTIONS

Bill and his son, Ted, own an amusement park: Bill and Ted's Excellent Adventure. The company is structured as an S corporation with Bill owning 75% of the stock of the company and Ted owing 25% of the stock of the company. The company has been successfully operating for 25 years. However, cash flow is variable throughout the year as the company makes most of its money in the summer. Bill is concerned about the transition of the business in the future. Bill and his wife have several other children, but only Ted has been active in the company. Bill's wife and his children, including Ted, are all beneficiaries of his estate. Bill would ultimately like his son to become the majority owner of the company, but he also needs to make sure his wife is financially provided for in the event something happens to him. His friend, Al, tells him that his company uses a stock redemption agreement. He likes it because it is "simple simple" and he was able to get it online from a legal service provider, Legal Boom. Bill likes the sound of that so he also orders a stock redemption agreement online from Legal Boom. The redemption agreement uses a fixed valuation method where he and Ted can agree on a regular basis what the value of the company is by simply filling in the amount on a schedule attached to the back of the agreement. In order to fund the redemption agreement, the company takes a life insurance policy out on each of Bill and Ted. The company does not comply with any notice and consent requirements, because Bill was not aware of them. Under the agreement, the company will have to use the life insurance proceeds to pay the purchase price. If the life insurance proceeds are insufficient to fully pay the purchase price, the remainder will be paid in equal monthly installments over 10 years at a 0% interest rate. Since they are family, Bill doesn't think charging interest is appropriate. The redemption agreement does not address security for the purchase price or place any operating restrictions on Ted or the company. Bill and Ted sign the agreement and Bill rests easy knowing that his family will be well cared for.

A. Problems with this illustration:

1. By using a redemption agreement, the remaining owner will not get the benefits of a stepped-up basis in the selling owner's stock.

2. Due to the attribution rules of IRC 318, the purchase price may be taxable to the selling owner as a dividend.

3. By using a fixed valuation rather than Fair Market Value, a deceased owner's estate will likely not be able to take advantage of estate freezing to fix the value of his ownership interest.

4. A deceased owner's estate may receive less for the business interests that the estate tax obligation on the interest.

5. In the event that the remaining owner runs the business into the ground and there are insufficient insurance proceeds, there is no security to ensure that the selling owner will receive full payment of the purchase price.

6. There are no protections in place to make sure that the company keeps sufficient capital in place to pay off the obligations to the selling owner.

7. The payment plan does not address the company's inconsistent cash flow, which could cause the company to inadvertently default even though it is operating consistent with past practices.

8. By failing to charge interest on the unpaid portion of the purchase price, the selling owner is subject to imputed interest on such portion.

9. Since the company didn't comply with the notice and consent provisions of IRC 101(j), a portion of the life insurance proceeds payable to the company will be taxable as ordinary income.

B. Solutions:

1. Use a Cross-Purchase buy-sell agreement.

2. Value the company using Fair Market Value determined by an independent appraiser.

3. The stock to be redeemed should be pledged as security for repayment of the purchase price and there should be a security interest in the assets of the company.

4. Have operating restrictions on the company until the purchase price is paid off.

5. Use a promissory note to reflect any unpaid portion of the purchase price and utilize a payment plan which takes into account the company's inconsistent cash flows.

6. Interest in the promissory note should be consistent with the appropriate Applicable Federal Rate.

7. Have notice and consent provisions consistent with IRC 101(j) included in the buy-sell agreement and have it signed before the life insurance contract is entered into.

8. Integrate the buy-sell agreement with each owner's estate plan.

VI. BEST PRACTICES

A. Understand the objectives of your client.

B. Map out the various scenarios that need to be addressed.

C. Define terms.

D. Clearly explain processes.

E. Use a valuation process that fits the company.

F. Understand the tax consequences of the various options.

G. Be aware of complications that can arise from family-owned businesses.

H. Fund the buy-sell agreement with appropriate products.

I. Regularly review and modify the buy-sell agreement as appropriate.

J. Make sure the buy-sell agreement can be modified.

K. Work with experts.

Utilizing Limited Liability Companies to Accomplish Your Client's Federal Income Tax Objectives

Gary Schwarcz

UTILIZING LIMITED LIABILITY COMPANIES TO ACCOMPLISH YOUR CLIENT'S FEDERAL INCOME TAX OBJECTIVES

I. CONTRIBUTIONS OF APPRECIATED PROPERTY TO S CORPORATION

A. No gain or loss is recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation; and

B. Immediately after the exchange, the person or persons who transferred the property own stock in the corporation possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of the corporation's stock.

II. CONTRIBUTION OF APPRECIATED PROPERTY TO A PARTNERSHIP

A. As a general rule, no gain or loss shall be recognized to a partnership or to any of its partners upon the contribution of property to a partnership in exchange for a partnership interest.

B. Code §704(c) provides that gain or loss with respect to property contributed to a partnership by a partner must generally be allocated to the contributing partner.

III. BASIS

A. A partner's basis in his partnership interest includes not only the adjusted basis of property contributed and the amount of cash contributed, but also his share of partnership liabilities.

B. Since a partner's share of partnership debt is deemed to be a cash contribution to the partnership, it will increase the partner's outside basis. Partnership debts owed to third parties are generally included in a partner's basis in his partnership interest. Thus, a partner may more easily be able to deduct entity losses than a shareholder of an S corporation.

C. A partner's share of recourse liability equals the portion of the liability for which the partner bears the economic risk of loss.

D. A partner bears the economic risk of loss for a partnership liability to the extent that, if the partnership constructively liquidated, the partner would be obligated to make a payment to any person or a contribution to the partnership because the liability became due and payable.

E. A partnership liability is treated as a nonrecourse liability to the extent that no partner or related person bears the economic risk of loss for that liability.

F. A partner's share of nonrecourse liabilities equals the sum of:

1. The partner's share of the partnership's minimum gain determined in accordance with Code §704(b);

2. The amount of any taxable gain that would be allocated to the partner under §704(c) if the partnership disposed of all partnership property in a taxable transaction subject to one or more nonrecourse liabilities of the partnership in full satisfaction of the liabilities and for no other consideration; and

3. The partner's share of the excess nonrecourse liabilities of the partnership.

G. A partner's share of excess nonrecourse liabilities is generally determined in accordance with the partner's share of partnership profits.

H. An operating agreement may specify the partner's interest in the partnership profits for purposes of allocating excess nonrecourse liabilities provided that the interests specified are reasonably consistent with allocations that have substantial economic effect of some other significant item of partnership loss or gain.

I. A shareholder's basis in his S corporation stock does not include the prorata share of the S corporation's liabilities.

J. A shareholder's basis in the stock of an S corporation is increased by his share of the corporation's income items that are passed through to him.

K. A loan made by a shareholder to an S corporation will provide additional basis.

IV. RELIEF FROM LIABILITIES

A. While a contribution of appreciated property to both a partnership or to an S corporation may result in no taxable income, the result may be significantly different if the contributed property is subject to a liability.

B. The Code provides that any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by the reason of the assumption by the partnership of such individual's liabilities, shall be considered a distribution of money to the partner by the partnership.

C. A partner's basis for his partnership interest does include his share of the partnership's liabilities.

1. Code §357(c) provides that if the sum of the amount of liabilities assumed by a corporation, plus the amount of the liabilities to which contributed property is subject, exceeds the total of the adjusted basis of the property transferred to a corporation, such excess is taxable to the contributor.

2. Thus, the rules between contributions of encumbered property to a partnership or to a corporation are significantly different.

3. In the partnership context, the partner may include his share of partnership liabilities in the basis for his partnership interest in

determining whether the deemed distribution of liabilities to him becomes taxable.

4. In the corporate context, the contributing shareholder must look strictly at the basis of the property and the amount of money contributed to the corporation.

D. Generally, neither a partner nor the partnership recognizes gain or loss upon partnership distributions.

E. A partner will, however, recognize gain to the extent that the cash received from a partnership exceeds his basis in his partnership interest.

F. For these purposes, a reduction in a partner's share of partnership liabilities is treated as a distribution of cash.

G. If a business venture desires to distribute appreciated property to its owner, the partnership format of business is considerably more favorable than the S corporation from a tax perspective. In addition, liquidations of partnerships are generally non-taxable events.

H. A distribution of appreciated property from a partnership is generally non-taxable.

I. Liquidations of partnerships are generally non-taxable events.

J. If partners no longer get along and desire to split up an active business, they may do so in a non-taxable fashion.

K. If an S corporation makes a distribution of an appreciated asset, the S corporation will recognize gain on the distribution as if the property were sold at its fair market value.

L. Similarly, if an S corporation is liquidated, gain will be recognized at the S corporation level to the extent the liquidated assets of the S corporation have a fair market value in excess of their adjusted tax basis.

V. ALLOCATION OF PROFITS AND LOSSES

A. In the event a partnership agreement provides for an allocation of income, gain, loss, deduction and credit, those items must be allocated in accordance with the agreement, unless the provisions of Code §704(b) require a different allocation.

B. In contrast to a partnership, an S corporation must allocate its income, gain, loss and deduction amongst the shareholders on a pro-rata basis.

VI. OWNERSHIP

A. A partnership has no restrictions as to permissible partners, the number of participants or classes of ownership.

B. In contrast, an S corporation's ownership is limited generally to individuals (other than non-resident aliens), estates, grantor trusts, voting trusts, qualified sub-

chapter S-trusts, electing small business trusts and certain charitable organizations and qualified retirement plans.

VII. SELF-EMPLOYMENT TAX

A. S CORPORATION - If an employee-shareholder's salary is reasonable, an employee-shareholder may be able to avoid the FICA, FUTA and Medicare taxes if income is distributed as a dividend.

B. Under 1997 Proposed Regulations, a member of a limited liability company will be treated as a limited partner unless:

1. The member has personal liability for the debts of the entity;

2. The member has authority to contract on behalf of the entity under the state law; or

3. The member participates in the entity's trade or business for more than 500 hours during the taxable year.

An Overview of Title Insurance

Phillip J. Neuman

TITLE INSURANCE 101: WHAT YOU SHOULD KNOW ABOUT TITLE INSURANCE

I. WHAT IS TITLE INSURANCE?

A. Contract of Indemnity.

B. Title insurance vs. other types of insurance.

C. Title Search vs. Title Commitment vs. Title Policy.

D. Owners' Policy vs. Loan Policy.

E. Underwriters vs. Agents.

F. Endorsements to the policy.

G. Standard Exceptions:

1. Rights of parties in possession.
2. Encroachments, boundary issues, and other matters that an accurate survey would disclose.
3. Any easements not shown by the public records.
4. Construction liens.
5. Any oil, gas or mineral rights.

II. WHERE DO THE FORMS COME FROM?

A. American Land Title Association has created generally accepted forms and endorsements.

B. Forms and endorsements are approved by the Commissioner of Insurance.

C. Both underwriters and agents have access to the forms and endorsements.

III. SPECIFIC TYPES OF FORMS

A. Homeowner's Policy of Title Insurance (2-3-10).

B. Owner's Policy of Title Insurance (6-7-06).

C. Policy of Title Insurance (10-17-92).

D. Policy of Title Insurance (10-17-70).

IV. WHAT RISKS ARE COVERED BY TITLE INSURANCE?

A. The 1970 and 1992 Policies cover 4 separate risks:

1. Title being vested other than as stated on Schedule A.

2. Any defect in or lien or encumbrance on the title.

3. Unmarketability of title.

4. Lack of a right of access to and from the land.

B. The 2006 Policy covers 10 separate risks.

1. Title being vested other than as stated on Schedule A.

2. Any defect in or lien or encumbrance on the title.

3. Unmarketability of title.

4. Lack of a right of access to and from the land.

5. Violation or enforcement of any law, ordinance, permit or regulation relating to the land or any improvement on the land.

6. An enforcement action based on the exercise of a governmental police power not covered by Covered Risk 5 if a notice of the enforcement action is recorded in the public records.

7. The exercise of eminent domain if a notice is recorded in the public records describing the issue.

8. Any taking by a governmental body that is binding on the rights of a purchaser for value without knowledge.

9. The enforcement of creditor's rights laws.

10. Any defect occurring in the gap between the Date of Policy and the date the vesting deed is recorded in the public records.

C. The 2010 Homeowners Policy covers 32 separate risks.

1. All of the above-listed risks and additional risks such as the owner being forced to remove an existing structure because it encroaches on a neighbor’s land or use as a single family residence violates an existing zoning law or regulation.

2. Some of the covered risks include events that take place **after** the Date of Policy.

a. Someone else has a right to limit the use of the land.

b. Someone else has an easement on the land.

c. A neighbor builds any structure other than a boundary wall or fence that encroaches onto the land.

d. A taxing authority assesses supplemental property taxes due to construction or a change of ownership that occurred before the Date of Policy.

V. HOW LONG DOES COVERAGE LAST?

A. Under the 1970, 1992 and 2006 Policies, coverage lasts so long as the insured retains an interest in the land or has liability because of covenants of warranty made in any transfer or conveyance of the property.

B. Under the 2010 Policy, coverage lasts forever.

C. Under the 2006 and 2010 Policies, coverage also flows to heirs, devisees, personal representatives or trustees of an estate planning trust.

2006 Policy language:	2010 Policy language:
(d) "Insured": The Insured named in Schedule A. (i) The term "Insured" also includes (A) successors to the Title of the Insured by operation of law as distinguished from purchase, including heirs, devisees, survivors, personal representatives, or next of kin; (B) successors to an insured by dissolution, merger, consolidation, distribution, or reorganization; (C) successors to an Insured by its conversion to another kind of Entity; (D) a grantee of an Insured under a deed delivered without payment of actual valuable consideration conveying the Title (1) if the stock, shares, memberships, or other equity interests of the grantee are wholly-owned by the named Insured, (2) if the grantee wholly owns the named Insured, (3) if the grantee is wholly-owned by an affiliated Entity of the named Insured, provided the affiliated Entity and the named Insured are both wholly-owned by the same person or Entity, or (4) if the grantee is a trustee or beneficiary or a trust created by a written instrument established by the Insured named in Schedule A for estate planning purposes.	2. CONTINUATION OF COVERAGE a. This Policy insures You forever, even after You no longer have Your Title. You cannot assign this Policy to anyone else. b. This Policy also insures: (1) anyone who inherits Your Title because of Your death; (2) Your spouse who receives Your Title because of dissolution of Your marriage; (3) the trustee or successor trustee of a Trust or any Estate Planning Entity to whom You transfer Your Title after the Policy Date; (4) the beneficiaries of Your Trust upon Your death; or (5) anyone who receives Your Title by a transfer effective on Your death as authorized by law. c. We may assert against the insureds identified in Section 2.b. any rights and defenses that We have against any previous insured under this Policy.

VI. WHAT HAPPENS WHEN YOU HAVE A CLAIM?

A. Whenever there is an issue with respect to the title to the insured property, the title insurance company should be placed on notice.

B. The policy jacket usually contains information on how to tender a claim.

C. Most title insurance underwriters have information on their websites on how to tender a claim.

VII. HOW IS A CLAIM HANDLED?

A. Typically there will be a claim handler from the underwriter's office who determines how to resolve the claim.

B. If there is litigation pending, outside counsel will be retained to represent the insured.

C. If there is no pending litigation, the claims handler has options on how to address the claim:

1. Cure the title defect.

2. Pay the owner the difference in value of the property with and without the title defect or policy limits, whichever is less.

3. Some covered risks have a maximum dollar limit of liability that is less than policy limits; in those cases the insurer can pay the maximum dollar limit.

Show Me the Money - An Overview and Update on Commercial Real Estate Finance Alternatives

Ronn S. Nadis

SHOW ME THE MONEY - AN OVERVIEW AND UPDATE ON COMMERCIAL REAL ESTATE FINANCE ALTERNATIVES

I. INTRODUCTION

A. Availability of financing for commercial real estate (CRE) has varied dramatically.

B. Availability and terms vary significantly by source.

II. LIFE INSURANCE COMPANY LOANS

A. The basics.

1. Insurers are portfolio lenders.

2. Premiums are invested.

3. CRE investment is a limited percentage of total portfolio.

B. Characteristics of life insurance company loans.

1. Frequently nonrecourse.

2. Long terms.

3. Fixed interest.

4. Lower loan to value (LTV) ratios.

5. Prepayment penalties are common.

6. Higher debt service coverage ratios (DSCR).

C. Trends.

III. COMMERCIAL MORTGAGE BACKED SECURITIES (CMBS) LOANS

A. The basics.

1. Pooled commercial loans held in trust by a pass through entity known as a Real Estate Mortgage Investment Conduit (REMIC).

2. Popularity has varied.

3. Regulatory headwinds are increasing.

B. Characteristics of CMBS loans.

1. Relatively expensive in the short term - underwriting, due diligence costs.

2. Usually nonrecourse, so substantial up front reserves are required.

3. Interest rates are usually lower.

4. Rent lock boxes are standard.

5. Month-to-month leases will be dramatically discounted.

6. Vacant space will be given little value.

C. Trends.

1. Dodd-Frank Regulations - Lead lender senior CMBS executive takes on personal liability by certifying that information provided to investors is accurate.

2. Risk Retention Rules apply.

3. Springing recourse provisions are problematic.

a. Blue Hills Office Park LLC v J.P. Morgan Chase Bank, as Trustee for the Registered holders of Credit Suisse First Boston Mortgage Securities Corp., Commercial Mortgage Pass-Through Certificates, Series 1999-C1, and CSFB 1999-C1 Royall Street, LLC, 447 F.Supp. 2d 366 (D. Mass. 2007), enforced such carve out liability. 53182 Gratiot Holdings, LLC v Chesterfield Development Co., 835 F.Supp. 2d 384 (E.D. Mich. 2011) agreed.

b. See also Wells Fargo Bank, NA v. Cherryland Mall Limited Partnership, 295 Mich. App 99; 812 NW2d 799 (2011) and Wells Fargo Bank, N.A. v Cherryland Mall Limited Partnership, 300 Mich. App. 361; 835 N.W. 2d 593 (2013).

c. Michigan adopted the Nonrecourse Mortgage Loan Act, MCL 445.1592 et seq. (NMLA), making post-closing solvency covenants in a nonrecourse loan unenforceable as a matter of law. NMLA was held constitutional in Borman, LLC v 18718 Borman, LLC, et al, 777 F3d 816 (6th Cir. 2015). Nevertheless, caution is essential.

IV. COMMERCIAL BANK AND CREDIT UNION LOANS

A. The basics.

1. Commercial banks and credit unions are portfolio lenders.

2. Deposited funds are lent.

3. Lender size and type impact loan limits and participations.

B. Characteristics of commercial bank and credit union loans.

1. Higher interest than life insurance company and CMBS lenders.

2. Less costly and cumbersome structure and documentation.

3. Shorter terms, often five years.

4. Recourse loans are preferred.

5. Lower up-front and escrow reserves are typical.

6. Rates may be fixed or floating, with the latter often not subject to prepayment penalties.

C. Trends.

1. Commercial banks in Detroit generally have been hesitant of late.

2. Basel III regulations impose higher capital requirements with "high-volatility commercial real estate loans" (HVCRE).

3. HVCRE is "a credit facility that finances or has financed acquisition, development, or construction (ADC) of real property." There are a number of significant exemptions and safe harbors that avoid this classification.

4. The Basel regulations do not apply to credit unions, but the National Credit Union Administration recently adopted similar rules called "Risk-Based Capital 2". Expert guidance is needed.

V. HARD MONEY LOANS

A. The basics.

1. These are private, generally unregulated lenders.

2. Terms are typically short, under 3 years.

3. Risk and cost are generally high, compared to other types of CRE loans.

4. Lenders look primarily to the collateral for repayment, using one or more of a mortgage, assignment of rents, pledges of membership interests in the ownership entity, deeds-in-lieu of foreclosure in escrow and other instruments.

5. Many of these lenders are "loan to own" lenders, seeking ownership.

B. Characteristics of Hard Money Loans.

1. Higher than market interest, although payments may be interest only.

2. One to three points are typically payable at loan consummation and at payoff.

3. Reserves may be required for taxes, maintenance and repairs.

4. Higher loan to value ratios may be required.

C. Trends.

1. Hard money lenders are increasingly significant CRE parties.

2. Significant private capital is available.

3. Hard money loans are important bridge or stop gap resources.

VI. CONCLUSIONS

A. The CRE market is alive, well and increasingly complex.

B. All parties are more conscious of the possibility of default in structuring loans.

C. There is increasing government regulation.

D. Expert guidance is more important than ever.

VII. GLOSSARY

A. Commercial Real Estate (CRE) includes real estate used for multi-family, retail, industrial, office, hospitality and other (e.g. self-storage) purposes.

B. Debt Service Coverage Ratio (DSCR) is the ratio of the net operating income derived from the real estate to the mortgage payments (principal and interest) plus required reserve payments, usually measured over 12 month periods. Lenders typically require that income exceed the debt service by 1.2 to 1.3x during the life of the loan. Failure to do so can constitute a loan default.

C. Debt Yield Ratio is the Net Operating Income divided by the first mortgage debt times 100% (NOI/1st mtg. loan x 100%). Thus, if a commercial property has an NOI of $350,000 per year, and the lender makes a new first mortgage loan in the amount of $3,000,000, the Debt Yield would be $350,000/$3,000,000 x 100%) = 11.6%. Accordingly, if the lender immediately foreclosed on the property, the NOI would yield an 11.6% cash on cash return. An 8% debt yield is considered acceptable by many CRE lenders.

D. Federal Deposit Insurance Corporation (FDIC) is an independent agency created by Congress. In addition to insuring customer deposits, the FDIC (among other things) examines and supervises financial institutions for safety and soundness.

E. Loan to Value (LTV) is the ratio of the loan amount to the value of the real estate. LTV reflects the cushion built into the loan in the context of the lender selling the real estate to pay the loan. Most lenders prefer that the LTV be less than 75%.

F. Mezzanine loan is a hybrid of debt and equity typically subordinate to the first or senior debt (which is secured by a mortgage) and equity investments which are not secured. These loans are often secured by the membership interest the principals hold in the borrowing entity which gives the mezzanine lender certain rights to step into the shoes of its borrower but not the ability to foreclose on the property. Mezzanine loans often fill the gap between minimum LTV required by the first mortgage lender and as much as 85 to 90% LTV. The increased risk is accompanied by increased interest rates and fees.

G. National Association of Insurance Commissioners (NAIC) is the U.S. standard-setting and regulatory support organization created and governed by the chief insurance regulators from the 50 states and the District of Columbia and 5 U.S. territories. Through the NAIC, state insurance regulators establish standards and best practices, conduct peer review and coordinate their regulatory oversight.

H. National Credit Union Administration (NCUA) is a federal agency charged with regulating and administrating federally chartered and federally insured state chartered credit unions.

I. Net Operating Income (NOI) is the annual net income generated from an income-producing property less payment of commercially reasonable expenses incurred by the owner in maintaining and operating the property. NOI is a critical variable in determining the value of CRE.

J. Nonrecourse Loans are loans in which neither the borrower nor any individual guarantor is liable for the loan balance after a default or for the deficiency after a foreclosure sale. The lender's recourse is to the real estate only. Most nonrecourse loans are subject to carve outs for bad acts by the borrower (the "Bad-Boy Carveouts") and for violations of SPE/Separateness provisions in the loan among other things, the violation of which results in springing full or indemnity recourse.

K. Yield Maintenance is essentially a prepayment penalty designed to allow the lender (and its investors) to attain the same yield as if the borrower had made all the scheduled loan payments until maturity.

Guidance for Employers on Changes to Overtime Rules

David A. Lawrence

GUIDANCE FOR EMPLOYERS ON CHANGES TO OVERTIME RULES

I. SUMMARY OF CHANGES

A. On May 18, 2016, the Department of Labor issued the long-anticipated Final Rule increasing the minimum required salary for overtime exemptions under the Fair Labor Standards Act (FLSA). The Final Rule will be effective as of December 1, 2016. All employers that engage in interstate commerce, have annual gross income of $500,000, are a public agency or operate a hospital, health care facility or school must comply.

B. Currently, to avoid the obligation to pay employees for overtime, the employer is required to establish that the employee works in an "executive", "administrative" or "professional" capacity (or fits one of the few specific exemptions) AND is paid a salary of at least $455 per week or $23,660 annually.

C. Under the Final Rule, employees who work in an exempt category must be paid **a salary of at least $913 per week, or $47,476 annually**, to be exempt from overtime pay requirements of the FLSA.

D. The Final Rule also provides for:

1. Mandatory updates to the salary threshold every three years. The threshold will be adjusted to keep the standard salary level at the 40th percentile of full-time salaried workers in the lowest-wage Census Region;

2. An increase in the "highly compensated employee" exemption threshold from $100,000 to $134,004 annually; and

3. The ability for employers to use nondiscretionary bonuses and incentive payments to satisfy up to 10% of the new salary threshold.

II. APPLYING EXEMPTIONS

A. The exemptions for executive, administrative or professional employees are sometimes referred to as the "white collar" exemptions. However, not all salaried white collar employees qualify for an exemption and are entitled to minimum wage and overtime.

B. Three tests must be met in order to claim a white collar exemption.

1. The employee must be paid on a salary basis not subject to reduction based on quality or quantity of work (salary basis test) rather than, for example, on an hourly basis;

2. The employee must meet a minimum salary level. After December 1, 2016, the minimum salary will be $913 per week, or $47,476 annually for a full-year worker (salary level test); and

3. The employee's primary job duty must involve the kind of work associated with exempt executive, administrative or professional employees (the standard duties test).

C. The Final Rule does not alter the standard duties test for the executive, administrative and professional exemptions or the additional specific exemptions.

1. Professional: The employee must primarily perform work that either requires advanced knowledge in a field or science or learning, or that requires invention, imagination, originality or talent in a recognized field or artistic or creative endeavor. The salary level and salary basis requirements do not apply to teachers, lawyers or doctors.

2. Administrative: The employee's primary duty must be the performance of office or non-manual work directly related to the management or general business operations of the employer or the employer's customers. In addition, the work must include the exercise of discretion and independent judgment regarding significant matters.

3. Executive: The employee must customarily and regularly direct the work of at least two other full-time employees or their equivalent and have the authority to hire or fire other employees, or the employee's suggestions and recommendations as to the hiring, firing, advancement, promotion or any other change of status of other employees must be given particular weight.

D. Other exempt categories:

1. "Highly compensated Worker" - any employee earning more than $134,004 per year and who regularly performs even one of the exempt duties of an executive, administrative or professional employee.

2. Computer-related professional - a computer systems analyst, programmer, software engineer or other similarly skilled employee earning at least $913 per week or $47,476 per year.

3. Outside sales employee - a salesperson who spends most of her time away from the employer's place of business while selling or obtaining orders or contracts. No minimum salary requirement applies.

III. OPTIONS FOR COMPLYING WITH UPDATED SALARY AND COMPENSATION LEVELS

A. Employers may comply with the Final Rule in a number of ways. The Final Rule is not a minimum wage requirement. It applies only if an employer is claiming an applicable white collar exemption. The Final Rule does not require an employer to increase a currently exempt employee's salary to meet the threshold. Instead, an employer can reclassify an exempt employee as nonexempt and pay overtime for hours worked in excess of 40 hours per week. Also, the FLSA does not require that over-time eligible workers be paid on an hourly basis. Therefore an

employer can keep a non-exempt employee on a salary basis, subject to overtime.

B. Options for a previously exempt employee that earns less than $913 per week but does not regularly work overtime.

No changes to pay or hours are necessary. The Final Rule will have no effect on the employee's pay because he does not work any overtime. The employer can continue to pay the employee a salary as before. However, the employee will become non-exempt and overtime-eligible under the Final Rule.

C. Options for a previously exempt employee that earns less than $913 per week and regularly works overtime.

1. Option #1: Raise salaries. To maintain the employee's exempt status under the Final Rule and avoid the obligation to pay overtime, the employer must raise the employee's salary to at least $913 per week.

2. Option #2: Convert wages to hourly. An employer can reclassify an exempt employee as nonexempt and reallocate his salary between regular hourly wages and overtime so that the overall amount paid to the employee remains the same. *Example*: A supervisor earns a salary of $39,500 per year (or $759.60/week) and regularly works 45 hours per week. The employer may choose to instead pay the supervisor an hourly rate of $16 for 40 hours and pay overtime ($24) for 5 hours ($760/week).

3. Option #3: Pay overtime above a salary. An employer may choose to continue to pay an employee a salary less than $913 per week. The employee will become non-exempt and overtime-eligible. An employer may pay a salary covering a fixed number of hours, which could include hours above 40. There are several ways to accomplish this.

a. Pay a salary for the first 40 hours of work per week, and then pay overtime for any hours over 40. This option might work well for an employee that does not often work overtime, or does not consistently work the same amount of overtime. Example: A salaried employee earns $880 for a 40 hour workweek. The rate of pay is $22/hour. If the employee works 45 hours one week, the employer would pay overtime for 5 hours at a rate of $33/hour (1.5 times the regular rate).

b. Pay a straight-time salary for more than 40 hours in a week for an employee who regularly works more than 40 hours, and pay overtime in addition to the salary. *Example*: A salaried employee earns $900 for a 50 hour workweek. The rate of pay is $18/hour. The employer would pay the employee an additional half-time overtime premium for the 10 hours of overtime ($9.00/hour). If the employee worked more than 50 hours in a particular week, the employer would also pay the employee overtime for the additional hours at a rate of $27.00/hour (1.5 times the regular rate).

c. Pay a fixed salary for a workweek of more than 40 hours, which includes overtime compensation under certain conditions. However, if the employee's schedule changes during the week, the employer must adjust the salary for the week. *Example*: An employee agrees to a fixed salary of $39,520 per year for a 45 hour workweek, which includes straight-time for the first 40 hours ($16/hour) and overtime compensation for 5 overtime hours ($24/hour). If the employee's schedule changes for any week, his salary needs to be adjusted to reflect the hours actually worked that week.

IV. OTHER CONSIDERATIONS

A. Overtime Records. Overtime compensation must be appropriately documented in the employer's records. Employers may use any method for tracking overtime hours, so long as it is complete and accurate. Employers may require an employee to "punch in" and "punch out" or simply allow an employee to verify the number of hours worked each day, including the number of overtime hours, by the end of each pay period.

B. Travel Time. Non-exempt employees are entitled to pay for time spent traveling. Regular commuting time between home and work doesn't count, but time spent traveling as part of the employee's job duties does count.

C. Waiting or "On-Call" Time. The time an employee spends waiting for work counts as paid time. If an employee is required to be present even though there are no tasks for her to perform, she has been "engaged to wait" and must be paid for the time. Whether time spent "on-call" must be compensated depends on the specific facts. In general, if an employee is free to engage in personal activities while on-call, the geographic/time limitations are not excessive and the employee is not actually called back so often as to interfere with effective use of personal time, she is "waiting to be engaged" and the time is not compensable.

D. Training Programs. If an employee attends a training program that is related to her job and attendance is required or encouraged by the employer, the time counts as paid time.

E. Calculating the "regular rate" for overtime purposes. Employers must pay overtime to every nonexempt employee who works more than 40 hours in a single workweek. The overtime rate is one and a half times an employee's "regular rate." If an employee earns a fixed hourly rate with no other compensation, computing the regular rate is straightforward. But in many cases, it is more difficult.

1. Different rates: If an employee does two or more jobs with different hourly rates, the employer must calculate the "regular rate" for overtime purposes by taking his total earnings from all rates for the week and dividing that by the total hours he worked at all jobs.

2. Commissions, bonuses, etc: The FLSA requires that an employer include <u>all</u> compensation in the "regular rate," except some specific exceptions

(such as discretionary bonuses, gifts, certain profit-sharing plans and stock options). The types of payments that are usually considered part of an employee's regular rate include:

a. Commissions

b. Attendance bonuses

c. Productivity bonuses

d. Bonuses for quality and accuracy of work

e. Nonmonetary awards

f. Premiums paid for hazardous work or night work

g. Overtime premiums

These payments must be added to the employee's earnings for that week. The employer will calculate the "regular rate" for that week by taking the total earnings divided by the number of hours worked that week. If a commission or bonus payment covers more than one workweek, it must be allocated to the weeks in which it was actually earned, and overtime paid retroactively if necessary.

F. Fines and Penalties. The FLSA may be enforced through civil lawsuits by the federal government, criminal prosecutions by the Department of Labor or private lawsuits by employees. Violations of the FLSA overtime provisions may result in penalties including back pay, liquidated damages (in an amount equal to the back pay) and interest in administrative investigations, as well as attorneys' fees and court costs when litigation is conducted. Employers may also be assessed civil money penalties ("CMPs") of up to $1,100 for each willful or repeated violation of the minimum wage or overtime pay provisions of the law. Government and private claims typically look back 2 years but can seek damages for the past 3 years for "willful" violations. The FLSA also allows for claims against individual corporate officers and supervisors for "willful" breaches of the law. Individuals may face fines of up to $10,000 per violation and jail time for a second conviction.

Common FLSA violations include:

1. Misclassifying employees as exempt;

2. Using unpaid "interns";

3. Paying incorrectly for travel time;

4. Not accurately tracking hours actually worked; and

5. Providing comp time in lieu of overtime.

Qualifying Nonprofit Entities for Tax Exempt Status

Stacey L. DiDomenico

QUALIFYING NONPROFIT ENTITIES FOR TAX EXEMPT STATUS

I. INCORPORATION OF THE ENTITY

A. Articles of Incorporation.

1. Stock or nonstock basis. A nonprofit may issue stock and have shareholders, although it is not common to do so.

2. Membership or directorship. In a membership corporation, the members are entitled to vote on corporate actions. In a directorship corporation, the corporation may still have members, but the voting power is given to the Board of Directors.

3. Mission Statement/Purpose. The purpose should include both the organization's specific charitable goals and proposed activities.

4. Required provisions to obtain tax exempt status. The Articles should also contain certain standard language the IRS will require if the organization seeks to obtain tax exempt status. There are additional requirements for private foundations, including a provision regarding avoidance of activities that would lead to the imposition of excise taxes.

5. Indemnification. It is important to include an article indemnifying the officers and directors of the corporation, whereby the corporation assumes all liability for the acts and omissions of the officers and directors who are acting in good faith.

6. Registered agent. The corporation must designate a person or entity with a physical address in Michigan which can be used to accept service of process on behalf of the corporation.

7. Other Entities. A nonprofit organization may be formed as a trust or an unincorporated association, but a corporation is most often used.

B. Charitable Organizations and Solicitations Act.

Charitable organizations are required to register with the Michigan Attorney General unless a specific exemption applies.

C. Bylaws.

The bylaws are the governing document of the corporation.

1. Board of Directors.

   a. Public Charities: Need at least three directors, preferably not all related to each other.

   b. Private foundations: Need only one director, but can have more.

2. Officers. All corporations must have a President, Secretary and Treasurer.

3. Voting procedures. The bylaws should state what constitutes a quorum for voting and what percentage of votes is required to pass corporate action.

D. Obtain Tax Identification Number.

II. TYPES OF TAX EXEMPT ORGANIZATIONS

A. There are many different types of tax exempt organizations under the Internal Revenue Code (Code). Some of the most common include:

1. 501(c)(3): Religious, Educational, Charitable, Scientific, Literary, Testing for Public Safety, to Foster National or International Amateur Sports Competition or Prevention of Cruelty to Children or Animals Organizations.

2. 501(c)(4): Civic Leagues, Social Welfare Organizations and Local Associations of Employees.

3. 501(c)(5): Labor, Agricultural and Horticultural Organizations.

4. 501(c)(6): Business Leagues, Chambers of Commerce, Real Estate Boards, etc.

5. 501(c)(7): Social and Recreational Clubs.

6. 501(c)(8): Fraternal Beneficiary Societies and Associations.

7. 527: Political Organizations.

B. Not all donations to tax exempt organizations are deductible by donors. Donations made to 501(c)(3) organizations qualify for deduction as charitable gifts. Contributions to most other tax exempt organizations are not deductible as charitable gifts. See Code Section 170.

III. PUBLIC CHARITIES VS PRIVATE FOUNDATIONS

501(c)(3) organizations can either be public charities or private foundations. There is a presumption that a 501(c)(3) organization is a private foundation, unless it proves otherwise.

1. Public Charities.

a. Examples: American Cancer Society, William Beaumont Hospital, The Detroit Institute of Arts.

b. To be a public charity, an organization must generally meet one of the following tests:

(1) 509(a)(1) Public support test:

i. An organization that receives at least one-third of its financial support from the general public or from governmental units, commonly in the form of gifts, grants, contributions and membership fees; or

ii. Facts and circumstances test: If an organization cannot meet the public support test, it may still qualify as a public charity if it receives at least 10% of its financial support from the general public or governmental units and is able to prove that it is a "publicly supported" organization.

(2) 509(a)(2) Public support test: An organization that meets the following:

i. Investment income cannot exceed one-third of the organization's total support; and

ii. More than one-third of the organization's total support must be received from one or more of the following sources:

- Gifts, grants, contributions and membership dues from non-disqualified persons.
- Admission fees to exempt function facilities or performances.
- Fees for the performance of exempt function services.
- Sales of merchandise related to the organization's activities.

(3) Supporting organization: The organization is a supporting organization of another qualified tax exempt organization.

2. Private Foundations. Typically, those nonprofits that are unable to meet any of the public charity tests are private foundations. These organizations receive most of their funding from one individual or family or a corporation. Private foundations generally carry out their charitable activities by making grants to public charities.

a. Examples: Ford Foundation, The Kresge Foundation, W. K. Kellogg Foundation.

b. Private operating foundation. Some private foundations are classified as private operating foundations. These foundations conduct their own charitable programs, instead of making grants to public charities. The foundation must spend at least 85% of its adjusted net income or minimum distribution amount directly for its exempt activities. In addition, the foundation must meet an IRS assets test, endowment test or support test. If qualified as an operating foundation, an organization is not subject to the excise tax on failure to distribute income, and contributions are deductible by donors to the extent of 50% of the donor's AGI.

3. There are some important distinctions between public charities and private foundations:

   a. Lower deductibility for contributions to private foundations. Donors making cash contributions to public charities are eligible for a deduction of 50% of the donor's AGI, while contributions to private foundations are eligible for a deduction of 30% of AGI.

   b. Investment income tax. Private foundations are subject to a 1-2% excise tax on net investment income.

   c. Prohibition against self-dealing. Certain "disqualified" persons who engage in acts of self-dealing with the foundation are subject to excise taxes.

   d. Excess business holdings. Private foundations may not hold more than 20% of the voting stock of a corporation.

   e. Jeopardizing investments. Private foundations are subject to an excise tax on investments lacking reasonable business care and prudence.

   f. Minimum distribution requirements. Private foundations (which are not operating foundations) must distribute at least 5% of their net investment assets each year, or they are subject to an excise tax.

   g. Prohibition against lobbying and political activity. Public charities may engage in limited lobbying, but private foundations are prohibited from engaging in any lobbying or political activity.

   h. Expenditure responsibility. Private foundations must ensure grant money is properly spent by grantees.

4. Note that public charities must continue to meet a public charity test even after recognition of public charity status from the IRS.

IV. IRS APPLICATION PROCESS (FORM 1023 AND 1023-EZ)

A. Why is tax exempt status important?

1. Donors want a charitable deduction for their donations.

2. Most private foundations and governmental entities will only give grants to organizations that are recognized as tax exempt.

3. Some organizations do not have to apply for tax exempt status, including churches, small nonprofits (not private foundations) which have annual gross receipts of less than $5,000 and organizations covered under a group exemption umbrella.

B. Seven requirements to qualify as a tax exempt organization:

1. Proper organization: corporation, trust, fund or foundation.

2. Proper operation: operated exclusively for an exempt purpose.

3. Proper purpose: religious, charitable, scientific, educational, etc.

4. No private inurement: net earnings should not inure to the benefit of a private individual.

5. No substantial lobbying.

6. No political activity.

7. Public benefit: must serve a public purpose or confer a public benefit.

C. Form 1023.

1. A 501(c)(3) organization may seek tax exempt status by filing Form 1023 with the IRS. Certain small nonprofits may be eligible to file the 1023-EZ form, as discussed below.

2. There are some aspects of the 1023 application that are very important and require special attention:

a. Narrative description of activities. Here the organization will describe its current and future planned activities. The IRS will review to ensure that the activities further a legitimate charitable purpose. The description should be broad enough to cover expected future activity, otherwise subsequent IRS notice and approval might be required to stay in compliance with the tax exemption ruling letter.

b. List of officers and directors. Any family or business relationships must be disclosed, plus any compensation paid to these individuals.

c. Financial Data. The organization must prepare a statement of revenues and expenses for the current tax year and the three prior or two succeeding tax years. A qualified accountant who is familiar with the organization's purpose, structure and financial status should prepare the budget. The information disclosed in this section will help the IRS determine whether the organization qualifies as a public charity or a private foundation. A balance sheet must also be completed for the most recent tax year, if the organization has completed a tax year as of the date of the application.

d. Depending upon the answers given in the application, the organization may be required to complete and submit pertinent schedules with the completed application.

D. Form 1023-EZ.

1. The 1023-EZ is a streamlined application for smaller nonprofits.

2. It is a "check the box" form.

3. To be eligible to file the EZ form, the organization must have annual gross receipts (anticipated or actual) of less than $50,000 for the first three years, or have total assets the fair market value of which does not exceed $250,000.

4. There are other organizations that are not eligible to use the EZ form. An organization seeking to use the Form 1023-EZ should first complete the 1023-EZ Eligibility Worksheet. This is not required to be submitted to the IRS, but it is important for the corporation to verify that it is eligible to apply for tax exempt status using the EZ form.

5. No budget or financial data required.

6. No narrative of activities required.

7. The 1023-EZ form may only be filed electronically on Pay.gov.

E. Other 501(c) organizations file Form 1024.

F. How long does it take to hear back from the IRS?

1. Traditional 1023: 2 - 6 months on average

2. 1023-EZ: as little as 3 - 6 weeks

G. Other important takeaways:

1. Existing organizations which have not yet applied for tax exempt status can do so if the formation occurred in the last 27 months. The exemption will apply retroactively to the date of formation.

2. Annual 990 tax returns are due each year within 5 1/2 months of the end of the organization's tax year.

3. File a 990 even if the application for exempt status is still pending.

4. Public disclosure of the 990 is typically necessary.