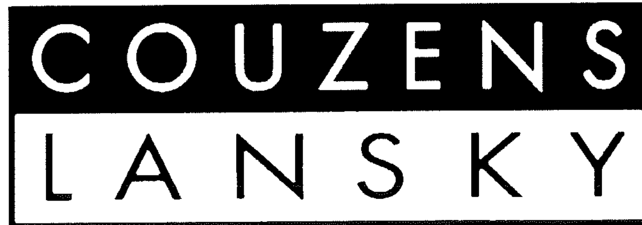

2013
CRITICAL LEGAL DEVELOPMENTS

VisTaTech Center, Livonia, Michigan

November 12, 2013

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TAX AND EMPLOYEE BENEFITS ISSUES FOR SAME SEX COUPLES

ERIC J. GOULD
LAWRENCE F. SCHILLER

TAX AND EMPLOYEE BENEFITS ISSUES FOR SAME-SEX COUPLES

I. WHAT IS IT ALL ABOUT?

A. The Defense of Marriage Act (DOMA) Pub. L. No. 109-199 (1996).

1. DOMA became law in 1996, and contains two key provisions:

a. Section 2 allows states to refuse to recognize same-sex marriages performed under the laws of other states.

b. Section 3 defines terms for purposes of administering federal law:

(1) Marriage -- "the legal union between one man and one woman as husband and wife."

(2) Spouse -- "a person of the opposite sex who is a husband or wife."

2. As a result, in determining the meaning of any act of Congress or any ruling, regulation, or interpretation of the various administrative bureaus and agencies of the United States, the above definitions had to be followed.

3. States may legally recognize same-sex marriages, but the federal government could not accept the validity of those marriages.

B. *United States v. Windsor* 570. U.S. ___, 133 S. Ct. 2675 (2013)

1. Facts.

a. In 1963 Edith Windsor met Thea Spyer. They established a relationship and lived together.

b. In 1993 they registered as domestic partners after that right became available.

c. In 2007, they were legally married in Canada.

d. Spyer died in February, 2009, leaving her entire estate to Windsor. The estate exceeded the exemption amount of $3,500,000. The estate had to pay $363,053 in federal estate tax. No estate tax would have been payable if the marital deduction was permitted.

e. The estate tax was paid and a claim for refund was filed. The government refused to pay the claim for refund. In 2010, litigation was filed seeking a refund of the federal estate tax on the basis that Section 3 of DOMA violated the Equal Protection Clause of the Fifth Amendment to the U.S. Constitution.

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2. Ruling.

a. The District Court held that Section 3 was unconstitutional and Windsor was entitled to a refund of the estate tax paid.

b. The U.S. Second Circuit Court of Appeals affirmed the District Court.

c. The U.S. Supreme Court agreed to review the case and ultimately affirmed the Court of Appeal's ruling. It confirmed that the exclusion of same-sex couples from qualifying for the marital deduction due to DOMA's definition of "spouse" was unconstitutional.

(1) This injured a class of single-sex persons who received the right to marry under a state's sovereign power.

(2) As a result the government subjected them to inequality and non-recognition of their legal marital status; thereby depriving them of federal benefits, including tax benefits, and other marriage-related rights and responsibilities.

d. Lawfully married same-sex couples now have the same benefits as heterosexual couples at the federal level and at the state level in those states that recognize such marriages.

C. Federal Laws and State Laws.

1. *Windsor* only applies to the application of federal laws where state law recognizes same-sex marital status. Over 1,300 federal statutory provisions have been identified involving marriage as a factor in determining federal benefits, rights, privileges, and responsibilities.

2. *Windsor* does not impact state laws that do not recognize same-sex marriages.

3. *Windsor* does not extend to states that recognize civil unions, domestic partnerships, or other relationships that grant rights similar to marriage.

4. Thirteen states and the District of Columbia recognize same-sex marriages.

5. Michigan and 36 other states do not recognize same-sex marriages. Some states have their own DOMA statutes.

D. The Federal Government's Approach.

Based on rulings issued by the Internal Revenue Service (IRS), the Department of Labor, and other agencies, marital status is not based on the state of residence but the "state of celebration". Thus, if the marriage was validly entered into in a state or foreign jurisdiction whose laws authorize the marriage of two individuals

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of the same sex, the federal government will recognize that marriage. It does not matter if the couple's state of residence recognizes the marriage.

E. The State of Michigan's Approach.

Michigan does not recognize same-sex marriages. The Michigan Department of Treasury posted an undated notice confirming that, while Federal income tax returns may be filed on a joint basis, Michigan returns for same-sex couples must be filed as single taxpayers.

II. IMPACT ON TAXES

A. Federal Income Taxes.

1. Treatment of Same-Sex Spouses. On August 29, 2013, the IRS issued Rev. Rul. 2013-17, 2013–38 I.R.B. 201, dealing with treatment of same-sex spouses for federal income tax purposes.

   a. Are same-sex spouses lawfully married under state or foreign law recognized as spouses for federal tax purposes? Yes they are. The terms "spouse," "husband and wife," "husband," and "wife" include individuals married to a person of the same sex, if the couple is validly married under state or foreign law.

   b. Will the IRS recognize such a marriage for federal tax purposes even if the state in which the couple is domiciled does not recognize the marriage? Yes the IRS will recognize the marriage. IRS has adopted a "place-of-celebration" rule, recognizing the marriage if it was validly entered into in a state or foreign jurisdiction whose laws authorize the marriage of two individuals of the same sex, regardless of whether the marriage is recognized by the state of domicile.

   c. Are registered domestic partners and civil union partners spouses for federal tax purposes? No they are not. The terms "spouse," "husband and wife," "husband," "wife," and "marriage" do not include relationships or persons in relationships not denominated as marriage under the law of the state in which they were entered.

2. Effective Date.

   a. Retroactive Treatment. The Revenue Ruling may be relied on retroactively for open years by taxpayers for purposes of filing tax returns, amended returns, adjusted returns, or claims for credit or refund. This means that individuals may amend tax returns to file jointly and may file claims to recover taxes paid on income that would be non-taxable with married status, among other issues. Employers may also file claims to recover taxes paid on such income.

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b. Prospective Treatment. For all other federal tax purposes, Rev. Rul. 2013-17 applies prospectively as of September 16, 2013. (Note: this prospective application for federal tax purposes does not control potential participant claims under ERISA Title I.)

3. Examples of specific tax provisions include:

a. Same-sex couples married in a place of celebration must now file married filing jointly or married filing separately.

(1). Depending on facts and circumstances (primarily disparity in earnings), the combined tax liability may result in a "marriage bonus" or "marriage penalty".

(2). Joint filing may result in higher tax brackets than when filing as head of household.

b. All dependents of same-sex couples are included on the return.

c. Deductions and credits based on adjusted gross income may become limited or eliminated with combined income.

(1). The value of the Earned Income Tax Credit (EITC), Code[1] Section 32, may be reduced for low-income dual earner couples, as the joint income will push them into the EITC phase-out range or eliminate eligibility altogether.

(2). The amount of the Child and Dependent Care Credit, Code Section 21, is limited to no more than the income of the lower earning spouse. If one spouse has no income, the couple would generally not qualify for the credit.

(3). The Child Tax Credit, Code Section 24, is phased-out as income rises above a certain level. The threshold for married couples is less than twice that for unmarried individuals.

(4). Education Tax Credits, Code Section 25, are available at higher income levels for married couples. Qualification for this credit will depend on the distribution of income of the spouses.

(5). The Adoption Credit, Code Section 36C, is generally not allowed when adopting a spouse's child.

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[1] Internal Revenue Code of 1986, as amended (Code).

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d. Qualification for unlimited spousal transfers.

e. Qualification for IRA contributions for spouse.

f. Qualification for gift-splitting to maximize annual exemption amounts.

g. Qualification for unlimited marital deduction, portability, and QTIP election for estate tax purposes.

B. State Income Taxes. Treatment will vary by state. As noted above, Michigan does not recognize same-sex marriages. Therefore same-sex spouses residing in Michigan and legally married in a state of celebration must file federal return(s) as a married couple but must file Michigan returns as single taxpayers. Each individual must separately report adjusted gross income for Michigan purposes as a single filer. The Department of Treasury expects to post a recalculation worksheet on its website in the future.

C. Federal Withholding Taxes. Notice 2013-61, 2013-44 IRB 432 (Oct. 28, 2013) provides guidance and special administrative procedures for claims for refund or adjustments of overpayments of FICA taxes and federal income tax withholding for certain benefits provided to same-sex spouses and remuneration paid to same-sex spouses.

1. If an employer does not repay or reimburse an employee for the amount of the over-collection before filing the third quarter 2013 Form 941, the employer must report the amount of the over-collection on that return and can use one of the special administrative procedures for 2013 to make an adjustment or claim a refund for the overpayment.

2. For overpayments for 2013, the Notice provides two optional, alternative special administrative procedures.

3. The Notice also provides a procedure for overpayments of FICA taxes for years before 2013. Employers can make a claim or adjustment for all four calendar quarters of a calendar year on one Form 941-X filed for the fourth quarter of such year if the period of limitations on refunds under Code Sec. 6511 hasn't expired and, in the case of adjustments, the period of limitations will not expire within 90 days of filing the adjusted return. This special administrative procedure is subject to the usual requirements that apply in the case of corrections of overpayments for prior years, including the filing of Forms W-2c, repaying or reimbursing employees for the over-withheld taxes, and obtaining the required written statements (and consents if applicable) from employees. The employer should write "WINDSOR" in dark, bold letters across the top margin of page 1 of Form 941-X. Only corrections made under this special administrative procedure may be shown on this Form 941-X.

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III. IMPACT ON EMPLOYEE BENEFITS

Prior to *Windsor*, individuals married to same sex partners were considered single for purposes of the Code and the Employee Retirement Income Security Act of 1974 (ERISA). The Department of Labor issued Technical Release No. 2013-04 on September 18, 2013 providing guidance for ERISA and tax purposes, following the state of celebration rule adopted by the IRS. As ERISA pre-empts state laws, state DOMA laws do not apply to ERISA plans.

A. Qualified Plans (generally relate to distribution events/issues).

1. Qualified joint and survivor annuity (QJSA)

   In pension plans (defined benefit and money purchase pension plans), payment must be in the form of a joint and survivor annuity (J&S) with the spouse as the joint annuitant, unless the spouse consents to payment in another form. This now will apply to same-sex spouses.

   QUERY: Will consent be required retroactively to legitimize current payment in the form of a life annuity for those married to a same-sex spouse who was considered single? What if consent cannot be obtained? Will payment have to be changed to J&S?

2. Qualified pre-retirement survivor annuity (QPSA).

   Same rule applies as with QJSA: without spousal consent in defined benefit or money purchase pension plan, payment at death must be made in the form of a survivor annuity to the spouse. Payment in another form, or to another beneficiary, cannot occur unless the spouse consents.

   QUERY: If payment at death was to another beneficiary in a lump sum, must it now be recovered and changed to a QPSA to the same-sex spouse since the spouse did not consent to the payment in a form other than a QPSA?

3. Beneficiary designation/election.

   a. Participant now needs spouse consent in pension plan to elect beneficiary other than spouse. Likewise, for defined contribution plans which are not pension plans, beneficiary must be spouse unless spouse agrees otherwise (or else QPSA rules apply). This same sex spousal consent now will also be required for the portion of a pension plan subject to the QJSA and QPSA rules which has been merged into a defined contribution plan (such as what happened a dozen years ago when money purchase pension plans were merged into profit sharing plans when the limitation on deductions for contributions to profit sharing plans was raised to 25% and money purchase pension plans no longer were required in order to maximize employer deductions).

   b. Plan's default beneficiaries (in the absence of beneficiary designation), generally pay to spouse first.

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QUERY: What if lack of beneficiary designation caused benefits to be paid to children or parents, but now *Windsor* requires that it be paid to the same-sex spouse? Or, what if affirmative beneficiary election caused benefits to be paid to parents or children without consent from the same sex spouse?

4. Minimum required distributions at age 70-1/2 (MRDs) (also applies to IRAs).

a. During lifetime, if spouse is sole designated beneficiary, can use longer of joint life expectancies or Uniform Table life expectancy (vs. Uniform Table if designated beneficiary is non-spouse).

b. After participant's death, spousal options are available that are not available to non-spouse—all of which will lengthen the period of time over which the spouse can take MRDs following death.

(1) Delay distribution to surviving spouse until participant's age 70-1/2 if death of participant is before MRDs have begun (vs. commence by end of year following year of death for non-spouse beneficiary).

(2) Surviving spouse can use Uniform Life Table, recalculated (vs. single life table for non-spouse beneficiary, subtracting one each year).

(3) Surviving spouse can rollover deceased participant's account balance or IRA, treating the rollover IRA as if the spouse is the owner, thus permitting payout to be delayed until surviving spouse is age 70-1/2 and permitting surviving spouse to name new stretch-out beneficiary in the event of death (vs. rollover in name of deceased if beneficiary is non-spouse, commencement of payment by end of year following year of participant's death, and no further stretch-out at subsequent death of surviving non-spouse beneficiary).

5. Hardship distribution.

a. If a plan permits hardship distributions, a same-sex spouse's hardship (pre-*Windsor*) could only be considered a hardship if the same-sex spouse was the beneficiary of the participant. Such a provision was not mandatory (i.e., if hardship distributions were allowed, the provisions did not have to allow beneficiary hardship as a distribution event).

b. After *Windsor*, same sex spouse's hardship permits the participant to take a hardship distribution in the same manner as an opposite sex spouse (and the beneficiary need not be changed in order to permit a hardship distribution).

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6. Qualified domestic relations order (QDRO) (also IRAs).

a. Pre-*Windsor*, a QDRO assigning a portion of the participant's account balance pursuant to a state domestic relations law (an exception to the anti-alienation rule) could only relate to a same-sex spouse if that same-sex spouse was a dependent.

b. Post-*Windsor*, a QDRO applies to a same-sex spouse, whether or not a dependent.

7. Definitions of highly compensated employee (HCE) (non-discrimination requirements) and key employee (top heavy)

a. Non-discrimination. Attribution of ownership through family members now applies to same-sex spouse, so that same-sex spouse now would be an HCE (whereas, pre-*Windsor*, would have been a non-HCE).

b. Top heavy. Attribution of ownership could now make a non-top heavy plan a top-heavy plan, thus requiring plan design changes.

B. Health and Welfare Plans.

Windsor does not require that states recognize a same-sex marriage for state law purposes, such as a state's insurance laws. Therefore, a state presumably could, by statute, exclude or except insurance coverage of a same-sex spouse.

1. Group health plans sponsored by the employer.

a. No longer will income have to be imputed to the participant for employer-paid health care coverage of a same-sex spouse (if same sex spouses are covered under the Plan), as was required pre-*Windsor* if the same-sex spouse was not a dependent (also with its payroll tax consequences to both employer and employee).

b. A dependent includes stepchildren, and therefore premiums for coverage of a same-sex partner's children under an employer-provided health plan will not be included in the employee's income.

2. Cafeteria plan flexible spending accounts (FSAs).

a. Health: Deferrals by an employee into an FSA will now be pre-tax (rather than after-tax) when used to pay for the employee's same-sex spousal portion or step-children's portion of employer-provided health care coverage. Reimbursements for spouse expenses will also now be available pre-tax. (Same rules apply to HRAs and HSAs.)

b. Dependent care: Now limited to $5,000 for the married couple (when single, same sex couples could each defer $5,000).

3. Adoption Assistance Program. The adoption credit and exclusion from income for employer-provided adoption assistance require married couples to file jointly to use this benefit.

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4. COBRA. Spouse (same-sex or otherwise) has an independent right to elect COBRA continuation coverage. Divorce, as a qualifying event, now comes into play, as well.

C. Miscellaneous.

1. Controlled group. Attribution is now required for same-sex spouses. (Stepchildren not included.) Stock of a same-sex spouse is now included in determination of a controlled group. (Pre-*Windsor*, the same stock was not included). This may result in, among other things, plans of related companies being considered a single plan for pension purposes.

2. Individual Retirement Accounts (IRAs). The non-working spouse rule is now applicable with respect to deductible limits, thus potentially increasing IRA deductions.

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ESTATE PLANNING STRATEGIES

JACK S. COUZENS, II
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FUNDING CROSS PURCHASE BUY-SELL AGREEMENTS -- AN ALTERNATE APPROACH

I. CROSS PURCHASE BUY-SELL AGREEMENT

A. Definition.

A cross-purchase buy-sell agreement is an agreement among business owners where one or more of the other owners are required to or have the option to purchase, on a pro-rata or other basis, the equity interest of the owner experiencing a triggering event such as death.

B. Funding the purchase obligation.

While personal assets can always be used, the uncertainty of death can be addressed by life insurance. Since the agreement is between stockholders or LLC members, each owner must secure insurance and personally pay the premiums.

II. TRADITIONAL APPROACH

A. Purchase insurance on other owner's life.

1. Each owner must purchase a policy on the life of each of the other owners.
2. Amount of insurance each owner must carry is inversely proportionate to his or her interest. If A owns 70% of the company and B owns 30%, B must carry insurance equal to 70% of the company's value.

B. "Unused" policies.

1. Upon death of one owner, his or her estate or trust now owns a policy on the life of the remaining owner(s) but has no future obligation to purchase.
2. If trigger events other than death occur (disability or retirement), or if the company is sold, each owner is insured by others.

C. Transfer of policies.

1. Owners can cancel policies and retain any cash value.
2. Owners may wish to retain existing policies based on favorable ratings and premiums, or a change in health.
3. Policies can be sold, with careful planning to avoid any gain on the sale.
4. Transfer for value rule, Code Section 101(a)(2), does not apply if the transfer is to the insured. This is a statutory exclusion under Code Section 101(a)(2)(B)(i).

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III. ALTERNATE APPROACH

A. Purchase insurance on own life and endorse death benefit.

The owners must enter into a cross-endorsement agreement. This is a form of a private split-dollar arrangement. Each owner obtains and owns the policy, endorsing the death benefit to the other(s). The endorsed death benefit funds the endorsee's purchase obligation upon death of the owner.

1. Owners continue to own policy if no death, or they survive the other owner(s).

2. Owners retain policy and all benefits of ownership.

3. The agreement must contain a termination provision to address death of endorsee(s) and other conditions.

4. The agreement must address policy loans and access to cash value during pendency of agreement.

B. Split-dollar rules.

1. Endorsees receive access to the death benefit, and therefore must pay the cost. They are renting the death benefit from the policy owner.

2. The rental equals the economic cost of the death benefit. This is only a portion of the premium, and is measured by the lower of the Table 2001 rates or the insurer's alternate term rates.

3. The rental payment is income to the policy owner.

C. Transfer for value rules.

The transfer for value rules do not apply unless there is a future transfer of the policy.

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LIVING TRUSTS FOR MARRIED COUPLES IN A WORLD OF HIGH EXEMPTIONS AND PORTABILITY

I. THE CASE FOR REVOCABLE LIVING TRUSTS

A. Provide a method to avoid probate of all assets.

B. Create organization and ease of administration.

1. Trust should be funded upon creation through transfer of assets into name of trust. Future acquired assets should be titled to the trust.

2. Successors are named and already in place.

3. Provides certainty and simplicity in the event of disability or death.

C. Provide support for the surviving spouse.

D. Offer protection of benefits for children and other heirs.

1. Trust assets are protected from the claims of a beneficiary's creditors.

2. Staggered outright distributions of principal offer an orderly approach to preserve trust assets for a period of time.

3. Discretionary trusts offer better protection of assets from creditor claims.

II. SINGLE JOINT TRUST VS. TWO SEPARATE TRUSTS. The choice of a joint trust or separate trusts is based on various considerations.

A. Distribution of assets.

1. Identical distribution of assets upon the death of either spouse supports a joint trust.

a. Simplicity.

(1). All assets are transferred to a single trust.

(2). Upon the death of the first spouse, no action is required.

(3). No estate tax due as long as assets do not exceed the unified credit amount ($5,250,000 for 2013).

b. If dual trusts currently exist, they could become separate shares of the joint trust, avoiding the need to retitle assets.

2. Different distribution of assets upon the death of either spouse supports separate trusts.

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B. Control upon the death of the first spouse.

1. A joint trust provides the surviving spouse full control over the administration of the trust.

2. Separate trusts provide an ability to balance or limit control.

a. The grantor can appoint a co-trustee or a non-spousal trustee.

b. Separate trusts can reduce the possibility of the grantor's assets going to a potential future spouse of the survivor.

c. Separate trusts can protect assets from spousal direction or discretion with the trust being named a beneficiary of assets, such as retirement plans, IRAs, and life insurance policies.

III. SEPARATE TRUST SCENARIOS

A. Creditor protection for a high-risk spouse.

1. Separate trusts provide an ability to fund the trust of the low-risk spouse.

2. Consider naming both spouses as current trustees of both trusts.

B. Combined estate exceeds the estate tax exemption amount.

1. Use credit shelter provisions to insure assets are not subject to estate tax at any time.

2. Risks associated with the portability rules.

a. To obtain the benefits of portability, the estate must comply with all of the rules and requirements. This includes timely filing a Form 706 with the proper election.

b. Remarriage "resets" the surviving spouse's portability if the second spouse dies first.

c. Separate trusts can keep assets separate, e.g. second marriage.

IV. ADJUSTMENT OF BASIS RULES ("STEPPED-UP BASIS")

A. Code Section 1014.

1. The general rule is that the income tax basis of an inherited asset is the fair market value as of the date of death.

2. Code Section 1014(e) restricts this step-up in basis if:

a. the decedent received appreciated property as a gift during the one-year period ending with his or her death; and

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b. the property is acquired from the decedent by the donor (or the donor's spouse).

B. Adjustment to basis of spousal joint assets. One-half of the property's basis is stepped-up upon the death of the first spouse. The remaining one-half of the basis is stepped-up upon the death of the surviving spouse.

C. Adjustment to basis of assets in a separate trust. Upon the grantor's death, only the assets in that trust receive a step-up in basis.

D. Adjustment to basis of assets in a joint trust. With proper planning and trust language, the potential exists for trust assets to receive a full step-up in basis upon the death of the first spouse and a second step-up of a portion of assets upon the death of the surviving spouse if a QTIP trust is used. This requires inclusion of all assets in the estate of the first deceased spouse. Alternatively, all assets may potentially receive a full step-up at the second death.

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PATIENT PROTECTION AND AFFORDABLE CARE ACT UPDATE

CYNTHIA L. M. JOHNSON

PATIENT PROTECTION AND AFFORDABLE CARE ACT UPDATE

I. IMPLEMENTATION DELAYS

A. Employer Mandate -- "Employer Shared Responsibility Rules".

The employer shared responsibility rules of the Patient Protection and Affordable Care Act, Pub. Law No. 111-148 (2010), originally to be effective as of January 1, 2014, have been delayed for one year. IRS Notice 2013-45, 2013-31 IRB 116 (July 29, 2013).

1. Employers with at least 50 full-time equivalent employees that do not yet offer employees health coverage that meets minimum standards and that is considered affordable are not yet subject to the penalties under Code Section 4980H.

2. Employers wishing to use safe harbor provisions set forth in the proposed regulations must initiate action to satisfy the look-back measurement periods set forth in the regulations.

3. The delay is only for the Section 4980H penalties. It does not alter the proposed regulations or the safe harbor provisions for measuring employee hours.

4. Hour measurement should be reviewed and determinations made as soon as possible.

B. Individual Mandate.

Due to problems encountered with the Exchange website, www.heathcare.gov, the date individuals must have health insurance has been extended from January 1, 2014 to March 31, 2014.

II. CHANGES REQUIRED AS OF JANUARY 1, 2014

A. Prohibited discrimination.

Policies must be issued to individuals with pre-existing conditions. In the individual and small group market, companies cannot charge higher rates based on gender or health status.

B. Elimination of coverage limits.

New and existing plans may not impose annual dollar limits on the amount of coverage an individual may receive.

C. Ensuring coverage for individuals participating in clinical trials.

Insurers cannot drop or limit coverage because an individual chooses to participate in a clinical trial. This applies to all clinical trials that treat cancer or other life-threatening diseases.

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D. Extension of coverage for grandfathered plans.

These plans must now extend coverage to dependent children through age 26 even if the children are eligible for other employer coverage.

III. SUGGESTED AREAS OF FOCUS

A. Non-grandfathered large group insurance plans (more than 50 employees).

1. Eligibility waiting period maximum of 90 days.
2. Pre-existing condition exclusions are not permitted for anyone.
3. Annual dollar limits prohibited on essential health benefits.
4. Protections for those in clinical trials.
5. Out of pocket amounts may not exceed $6,350 for individuals and $12,700 for families.
6. Revise wellness program rules.

B. Non-grandfathered small group insurance plans (50 or fewer employees).

1. Eligibility waiting period maximum of 90 days.
2. Pre-existing condition exclusions are not permitted for anyone.
3. Annual dollar limits prohibited on essential health benefits.
4. Protections for those in clinical trials.
5. Out of pocket amounts may not exceed $6,350 for individuals and $12,700 for families.
6. Revise wellness program rules.
7. Essential health benefits must be offered.
8. Must meet the "metal levels" (i.e. 60%, 70%, 80%, 90%).
9. Single risk pool.
10. Deductible generally may not exceed $2,000 for individuals and $4,000 for families.

C. Small or large self-funded plans.

1. Eligibility waiting period maximum of 90 days.
2. Pre-existing condition exclusions are not permitted for anyone.

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3. Annual dollar limits prohibited on essential health benefits.

4. Protections for those in clinical trials.

5. Out of pocket amounts may not exceed $6,350 for individuals and $12,700 for families.

6. Revise wellness program rules.

7. Transitional reinsurance fee.

D. Employer plan documentation.

1. Employers should be reviewing and revising summary plan descriptions.

2. Employers must now be issuing to an employee at the time of hiring the Marketplace Exchange Notice. "At the time of hiring" is interpreted as within 14 days of the employee's start date.

3. COBRA notices must be modified to reflect the new health care exchanges. (Requirement date is as of November 1, 2013.)

4. Summary of benefits and coverage must now reflect an updated template describing coverage.

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FEDERAL AND STATE TAX UPDATE

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FEDERAL AND STATE TAX UPDATE

I. FEDERAL TAX ISSUES

A. Updated guidance for Ponzi scheme victims.

1. Rev. Rul. 2009-9, 2009-14 IRB 735 describes proper income tax treatment for losses resulting from fraudulent investment schemes. The loss is generally the initial investment amount plus additional investments, less amounts withdrawn, reimbursed, recovered, and claims for which there is a reasonable prospect of recovery. Amounts previously reported as taxable income but not actually realized will increase the investor's theft loss. It provides a safe harbor to avoid the problems in establishing how much income reported in prior years was fictitious.

2. Program Manager Technical Advice 2013-003 was recently released, providing guidance to persons who have "phantom income" from a fraudulent investment scheme and who do not or cannot use the safe-harbor procedures in Rev. Rul. 2009-9 and Rev. Proc. 2009-20, 2009-14 IRB 749.

   a. Amounts withdrawn can be treated as a recovery of basis.

   b. Returns for open years can be amended to eliminate the income taxpayers can prove were fraudulently reported as income from the investment scheme.

   c. For closed years, a question arises if the fictitious income can increase a taxpayer's basis. The Advice clarifies that amounts included in income on a return filed in a closed year should be includable in the taxpayer's basis not only for purposes of computing the amount of theft loss deduction, but also for the purposes of re-characterizing income in open years under Code Section 61, and that this treatment applies whether or not the closed-year income was genuine, fictitious, or a combination of both.

B. Reasonable Compensation. The United States Tax Court has issued several cases this year on this issue. *Thousand Oaks Residential Care Home I, Inc. v. Comm'r*, T.C. Memo 2013-10; *K&K Veterinary Supply, Inc. v. Comm'r*, T.C. Memo 2013-84; *Aries Communications Inc. & Subs. v. Comm'r*, T.C. Memo 2013-97.

The court's analysis went beyond traditional factors of industry comparisons and the nature and extent of services performed. There is greater reliance on the "independent investor test" -- a determination of a return on an investment that an independent investor would expect to realize. A 10-20% rate of return was deemed to be acceptable.

Compensation planning should include a determination that would still allow for an annual return on investment of 10-20%, as well as traditional factors.

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C. PTIN renewal.

The IRS issued a news release reminding return preparers that their current numbers expire on December 31. Renewals can be secured online via **http://www.irs.gov/ptin**. Paper applications will take four to six weeks to process. Enhancements have been made to the online PTIN system, including:

1. The "Manage My Account" tool allows preparers to self-correct almost any field at any time. (Previously, most changes had to be made during renewal, and a phone call was required for users to make changes during the rest of the year.) IRS noted, however, that name changes still require written documentation.

2. Preparers can now view completed continuing education programs reported by IRS-approved providers beginning with 2013 courses.

3. Certain preparers who plan to take a full year (or more) off can inactivate their PTINs voluntarily and then reactivate the same number when they return to work. IRS cautioned, however, that enrolled agents must maintain a valid PTIN each year in order to maintain their EA credential and therefore are not eligible to inactivate their PTIN.

D. Delay of filing season for 2013 returns.

Due to the government shutdown in October, the IRS announced a delay in the start date of the filing season. While the original start date was January 21, 2014, that date has been delayed. IRS will start accepting and processing 2013 individual tax returns no earlier than January 28 and no later than February 4. Of course the due date remains April 15!

E. Updated guidance for claims for innocent spouse relief.

Rev. Proc. 2013-34, 2013-42 IRB ___, was issued on September 16, 2013, providing clarification on streamlined determinations and equitable factors to be taken into consideration for innocent spouse relief claims.

1. Streamlined determinations will be made in granting equitable relief with satisfaction of certain conditions and establishment that the requesting spouse:

   a. is no longer married to the non-requesting spouse;

   b. would suffer economic hardship if relief is not granted; and

   c. did not know or have reason to know of the deficiency or that the underpayment would not have been paid (with an exception for situations of abuse or financial control).

2. This procedure gives greater deference to the presence of abuse than Rev. Proc. 2003-61, 2003-2 C.B. 296.

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3. A new exception is added so that relief would not be precluded for an item attributable to the requesting spouse if the non-requesting spouse's fraud gave rise to the understatement of tax or deficiency.

4. Clarification is provided that no one factor or a majority of factors controls the determination. Depending on facts and circumstances, relief may still be granted even if more factors weigh against relief than the number of factors weighing in favor of relief (and vice-versa).

5. A lack of a finding of financial hardship no longer weighs against relief, as provided in Rev. Proc. 2003-61, and instead will be neutral.

6. The Revenue Procedure is effective for all requests filed on or after September 16, as well as all requests for equitable relief pending on that date.

F. Expanded relief for late S corporation elections.

Rev. Proc. 2013-30, 2013-36 IRB 173, was issued on August 14, 2013 and provides a simplified method for taxpayers to request relief for late S corporation, Electing Small Business Trust (ESBT), Qualified Subchapter S Trust (QSST), Qualified Subchapter S Subsidiary (QSub), and corporate classification elections intended to be effective on the same date as the S corporation election for the entity.

1. The simplified method for requesting relief is in lieu of the letter ruling process ordinarily used for a late election under Subchapter S and no user fees apply. A taxpayer that does not meet these requirements or is denied relief under its procedures may seek relief by requesting a letter ruling.

2. The taxpayer requesting relief (i.e., the "Requesting Entity")—the corporation or eligible entity seeking to be treated as an S corporation, the trustee seeking to treat a trust as an ESBT, a trust beneficiary seeking to treat a trust as a QSST, or a parent S corporation seeking to treat a subsidiary as a QSub—must generally request relief within three years and 75 days after the date the election is intended to be effective.

3. This time limit is not applicable to a corporation that fails to qualify as an S corporation solely because Form 2553 was not timely filed where the corporation and its shareholders consistently reported their income as if it was an S corporation; and neither the corporation nor its shareholders were notified by the IRS of the problem within 6 months of the date on which the Form 1120S for the first year was timely filed.

4. Additionally, the failure to qualify as an S corporation, ESBT, QSST, or QSub must have resulted from the election under Subchapter S not being timely filed by the due date applicable to the election.

5. For relief for a late S corporation or QSub election, the requesting taxpayer must have reasonable cause for the failure to make the timely election under Subchapter S and have acted diligently to correct the

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mistake upon its discovery. For relief for an inadvertently invalid S corporation election or the termination of an S corporation election due to the failure to make the timely ESBT or QSST election, the failure to file the timely election under Subchapter S must have been inadvertent and the S corporation and the person or entity seeking relief must have acted diligently to correct the mistake upon its discovery.

6. Relief is requested by properly completing the proper election form(s), attaching the required supporting documents, and filing it with the appropriate IRS Service Center. This is done by:

   a. attaching the form to the S corporation's current year Form 1120S (as long as the current year Form 1120S is filed within 3 years and 75 days after the effective date, without considering extensions);

   b. attaching the form to one of the S corporation's late filed prior year Forms 1120S; or

   c. filing the form independent of Form 1120S.

7. On receipt of a completed request for relief, the IRS will determine whether the requirements for granting additional time to file the election under Subchapter S have been satisfied and will notify the requesting taxpayer of its determination.

G. <u>Penalty exposure for incorrect basis reporting</u>.

Code Section 6045 requires the reporting of tax basis in securities transactions. Other provisions expose persons required to file 1099s, tax practitioners, and taxpayers to penalties for non-compliance.

1. Brokers are required to provide information returns. Penalties are imposed for failure to issue these returns on a timely basis and for errors and/or omissions.

2. Tax practitioners are subject to penalties if they prepare returns with positions that lack substantial authority and know (or reasonably should know) that such a position is erroneous. They are also subject to malpractice claims by the client.

3. Taxpayers' primary exposure is the accuracy-related penalty under Code Section 6662. The penalty is imposed under several conditions, including negligent action or there is a substantial understatement of income tax. A substantial understatement is an understatement of tax that exceeds the greater of 10% of the tax required to be shown on the return or $5,000. The penalty equals 20% of the underpayment portion attributable to the taxpayer's action or inaction.

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4. Penalties may be waived if the party can establish the action was due to reasonable cause.

   a. Brokers must demonstrate there was no willful neglect, as well as significant mitigating factors or events that exist beyond its control.

   b. Tax practitioners must demonstrate they had reasonable cause and acted in good faith.

   c. Taxpayers must demonstrate reasonable cause and they acted in good faith under the circumstances. A key element in the IRS's analysis is whether the taxpayer knew or should have known that the information conveyed was incorrect.

H. Little Details Matter.

1. Business entities must be in good standing with their respective state of organization at the time a petition is filed with the United States Tax Court. *Hom & Associates v. Comm'r.*, 140 TC No. 11 (May 7, 2013).

2. The statute of limitations remains open if returns are not appropriately signed. *Chapman Glen Limited v. Comm'r.*, 140 TC No. 15 (May 28, 2013).

II. MICHIGAN TAX ISSUES

A. Pending legislation limiting responsible officer liability.

1. Currently MCL 205.27a(5) imposes personal liability on all responsible officers, managers, members, and partners of a corporation, limited liability company, limited liability partnership, partnership, or limited partnership liable for taxes that fails for any reason to file the required returns or to pay the tax due.

2. S.B. 0064 (2013) proposes to limit exposure to only those taxes "collected from another person". This reduces the tax exposure to employee withholding taxes and sales taxes collected.

3. The bill also proposes to:

   a. Apportion the liability among all responsible officers. If there are 2 responsible officers, Treasury can only collect one-half of the liability from each person.

   b. Require disclosure of all other responsible officers being pursued and other information.

   c. Limit the time of assessment to four years from assessment of the tax to the business.

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4. The Senate unanimously passed the bill on May 22. The House Committee on Tax Policy recommended the bill without amendment on June 12.

B. Individuals may combine flow-through income and loss with unitary relationships.

In *Malpass v. Department of Treasury* and *Wheeler Estate v. Department of Treasury*, 494 Mich. 237; 833 N.W. 2d 272 (2013), the Michigan Supreme Court in an unanimous decision held that individual taxpayers could combine the profits and losses from unitary flow-through businesses and apportion the income on the basis of the businesses' combined apportionment factors for purposes of the Michigan Individual Income Tax. The holding also included the ability to apportion to a foreign entity if that entity and the individual taxpayer's in-state business were unitary.

1. The court considered the following factors in determining the existence of a unitary business: economic realities, functional integration, centralized management, economies of scale, and substantial mutual interdependence.

2. The decision allows both separate reporting and combined reporting. Until the statute is changed, taxpayers appear to have a choice.

3. This decision creates opportunities not only for current returns, but amended returns for open prior years.

C. Updated Form 151, Power of Attorney.

The Department of Treasury has issued revised Power of Attorney forms, clarifying that notices only have to be sent to the taxpayer to be effective, not the representative as well.

This is in response to cases where the Department failed to timely send the representatives notice and the Court of Appeals held in favor of the taxpayers. *SMK, LLC v. Dept. of Treasury*, 298 Mich. App. 302 (2012), and *Fradco v. Dept. of Treasury*, 298 Mich. App. 292 (2012), leave for appeal and immediate consideration granted, 493 Mich. 948 (March 27, 2013).

D. Potential Changes to Litigation of Tax Issues.

Legislative proposals are pending to remove the Michigan Court of Claims from a circuit court to a division of the Michigan Appeals Court, and to remove the Michigan Tax Tribunal from an administrative panel under the Michigan Administrative Hearing System to the Michigan Judiciary as a court of general jurisdiction with judges appointed by the Supreme Court.

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III. SELECT 2014 FIGURES AND AMOUNTS

A. Retirement Plans.

1. Defined benefit plans. The limitation on the annual benefit under a defined benefit plan under Code Section 415(b)(1)(A) is increased from $205,000 to $210,000. For participants who separated from service before January 1, 2014, the 100% of average high-three-years' compensation under Code Section 415(b)(1)(B) is computed by multiplying the participant's compensation limitation, as adjusted through 2013, by 1.0155.

2. Defined contribution plans. The limit on the annual additions to a participant's defined contribution account under Code Section 415(c)(1)(A) is increased from $51,000 to $52,000.

3. Annual compensation limit. The maximum amount of annual compensation that can be taken into account for various qualified plan purposes, including Code Section 401(a)(17), Code Section 404(l), Code Section 408(k)(3)(C), and Code Section 408(k)(6)(D)(ii), is increased from $255,000 to $260,000.

4. Key employee in top-heavy plan. The dollar limit under Code Section 416(i)(1)(A)(i) relating to the definition of a key employee in a top-heavy plan is increased from $165,000 to $170,000.

5. ESOP five-year distribution period. The dollar amount under Code Section 409(o)(1)(C)(ii) for determining the maximum account balance in an employee stock ownership plan (ESOP) subject to a five-year distribution period is increased from $1,035,000 to $1,050,000, while the dollar amount used to determine the lengthening of the five-year distribution period is increased from $205,000 to $210,000.

6. Government plans. The annual compensation limitation under Code Section 401(a)(17) for eligible participants in certain governmental plans that, under the plan as in effect on July 1, 1993, allowed COLAs to the plan's compensation limit under Code Section 401(a)(17) to be taken into account, is increased from $380,000 to $385,000.

7. Control employee. The employee compensation amount used in the definition of "control employee" for fringe benefit calculation under Reg. § 1.61-21(f)(5)(i) increases from $100,000 to $105,000. The compensation amount under Reg. § 1.61-21(f)(5)(iii) increases from $205,000 to $210,000.

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8. Notable Unchanged Items.

a. The elective deferral (contribution) limit for employees who participate in 401(k), 403(b), most 457 plans, and the federal government's Thrift Savings Plan remains unchanged at $17,500.

b. The catch-up contribution limit for employees aged 50 and over who participate in 401(k), 403(b), most 457 plans, and the federal government's Thrift Savings Plan remains unchanged at $5,500.

c. The limit on annual contributions to an Individual Retirement Account remains unchanged at $5,500. The additional catch-up contribution limit for individuals aged 50 and over is not subject to an annual cost-of-living adjustment and remains $1,000.

B. Social Security wage base.

1. The wage base for computing the Social Security tax (OASDI) in 2014 increases to $117,000 from $113,700. The $3,300 increase, about 2.9%, is due to an increase in average total wages.

For 2014, the FICA tax rate for employers is 7.65%—6.2% for OASDI and 1.45% for Medicare. For 2014, an employee pays:

6.2% Social Security tax on the first $117,000 of wages (maximum tax is $7,254.00 [6.2% of $117,000]), plus

1.45% Medicare tax on the first $200,000 of wages ($250,000 for joint returns; $125,000 for married taxpayers filing a separate return), plus

2.35% Medicare tax (regular 1.45% Medicare tax + 0.9% additional Medicare tax) on all wages in excess of $200,000 ($250,000 for joint returns; $125,000 for married taxpayers filing a separate return). Code Sec. 3101(b)(2).

2. For 2014, the self-employment tax imposed on self-employed people is:

12.4% OASDI on the first $117,000 of self-employment income, for a maximum tax of $14,508.00 (12.40% of $117,000); plus

2.90% Medicare tax on the first $200,000 of self-employment income ($250,000 of combined self-employment income on a joint return, $125,000 on a separate return), (Code Sec. 1401(a), Code Sec. 1401(b)); plus

3.8% (2.90% regular Medicare tax + 0.9% additional Medicare tax) on all self-employment income in excess of $200,000 ($250,000 of combined self-employment income on a joint return, $125,000 for married taxpayers filing a separate return). Code Sec. 1401(b)(2).

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C. Annual gift tax exclusion.

1. For calendar year 2014, the first $14,000 of gifts to any person (other than gifts of future interests in property) are not included in the total amount of taxable gifts under Code Section 2503 made during that year.

2. For calendar year 2014, the first $145,000 of gifts to a spouse who is not a citizen of the United States (other than gifts of future interests in property) are not included in the total amount of taxable gifts under Code Sections 2503 and 2523(i)(2) made during that year.

D. Unified credit.

For an estate of any decedent dying during calendar year 2014, the basic exclusion amount is $5,340,000 for determining the amount of the unified credit against estate tax under Code Section 2010.

E. Foreign Earned Income Exclusion.

For taxable years beginning in 2014, the foreign earned income exclusion amount under Code Section 911(b)(2)(D)(i) is $99,200.

F. Interest on Education Loans.

For taxable years beginning in 2014, the $2,500 maximum deduction for interest paid on qualified education loans under Code Section 221 begins to phase out under Code Section 221(b)(2)(B) for taxpayers with modified adjusted gross income in excess of $65,000 ($130,000 for joint returns), and is completely phased out for taxpayers with modified adjusted gross income of $80,000 or more ($160,000 or more for joint returns).

G. Personal Exemption.

1. For taxable years beginning in 2014, the personal exemption amount under Code Section 151(d) is $3,950.

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2. For taxable years beginning in 2014, the personal exemption phases out for taxpayers with the following adjusted gross income amounts:

Filing Status	AGI - Beginning of Phaseout	AGI - Completed Phaseout
Married Individuals Filing Joint Returns and Surviving Spouses (Code Section 1(a))	$305,050	$427,550
Heads of Households (Code Section 1(b))	$279,650	$402,150
Unmarried Individuals (other than Surviving Spouses and Heads of Households) (Code Section 1(c))	$254,200	$376,700
Married Individuals Filing Separate Returns (Code Section 1(d))	$152,525	$213,775

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