2017 CRITICAL LEGAL DEVELOPMENTS

VisTaTech Center, Livonia, Michigan

October 31, 2017

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

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October 31, 2017

Agenda

8:30 - 8:40	Opening Remarks
8:40 - 9:20	Estate Planning - Key Concerns in 2017 .... Mark Landau
9:20 - 9:50	Trusts for All Reasons and Trust Alternatives .... Rebecca Wrock
9:50 - 10:20	Business and Tax Law Matters Concerning Mergers and Acquisitions .... Jeffrey Levine
10:20 - 10:50	Break
10:50 - 11:30	Section 1031 Like Kind Exchanges .... Gregg Nathanson
11:30 - 12:00	When to Tell Your Client to Call A Lawyer..................... Mark Frankel
12:00 - 12:30	Latest Developments in Prenuptial Agreements............ Phil Sternberg

This material does not attempt to give specific legal or tax advice. For advice in particular situations, the services of competent legal, tax or financial planning advisors should be obtained.

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DEPARTMENT OF INSURANCE AND FINANCIAL SERVICES
LANSING

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At every classroom or speech/seminar each instructor or Provider Designated Person or Provider on-site representative shall be required, prior to the commencement of instruction, to read the following statements:

One credit is 50 minutes of instruction with no more than 10 minutes for a break. Fractional credits will not be awarded. Registration, coffee and lunch breaks, or social hours do not qualify for CE credit.

A student that arrives 10 or more minutes late or departs early will not receive CE credit.

All classroom courses must have attendance verified through a sign-in/sign-out sheet with a door monitor. Only students meeting minimum attendance requirements may receive Certificates of Completion.

Students must provide their name, address, license number (not SSN), time-in and time out. Reminders are given by the instructor to sign the attendance forms.

Providers must give Certificates of Completion to all individuals who complete the requirements of a CE course.

Providers should make students aware that licensees cannot receive CE credit for both a self-study (examination) course and a classroom course based on the same published materials.

Providers should make students aware that licensees are not allowed to receive or carry over credit for the same course in the same review period.

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Estate Planning - Key Concerns in 2017

Mark G. Landau

ESTATE PLANNING - KEY CONCERNS, THE TAX LAWS, THE NEW STANDARD

I. KEY CONCERNS IN 2017 - PERSONALIZING DOCUMENTATION

Personalizing estate planning documents is becoming increasingly important. As the estate tax applies to fewer and fewer people, the emphasis has shifted to dealing with special circumstances, concerns and problems involving heirs. "Boilerplate" language or "canned" documents are inadequate. Consider how your own situation differs from those of your business partners, friends or other family members.

A. Asset protection - creditors; spendthrifts; minors.

1. During lifetime.

    a. Adequate insurance, with an umbrella policy.

    b. Emphasize exempt qualified plan assets.

    c. Note ownership of Michigan real estate by husband and wife.

    d. Transfer assets to less risky spouse?

    - Trustee.

    e. Consider LLC and family limited partnership structures.

    f. Use corporate and LLC structure for businesses.

    g. Investigate domestic asset protection trusts.

    h. A Living Trust does not shelter assets from the Settlor's creditors, but can shelter assets from the spouse's creditors.

2. At the first spouse's death.

    a. How great is the concern?

    b. Is another marriage a concern?

    c. Can the survivor manage money?

    d. Do children need funds? What is their relationship with the survivor?

    e. Limit outside gifts to a percentage of the estate.

    f. Should powers of appointment be provided?

3. At the surviving spouse's death.

    a. Do children need protection from a spouse, a creditor or a predator?

    b. Are children minors?

c. Are children spendthrifts?

d. Is generation skipping a goal?

e. Do children have "special needs" considerations?

f. Should beneficiaries be treated differently?

- Advancements.

g. Do beneficiaries need protection of their government benefits?

B. Tax minimization - estate; income.

1. Minimize income and rates.

2. Defer or delay.

C. Privacy - Probate avoidance; minimizing disclosure.

1. Probate applies to personally owned assets, with special exceptions.

2. Probate will not apply to joint assets - consider control and basis issues.

3. Probate will not apply to POD assets - consider intended payout restrictions.

4. Probate will not apply to assets with a beneficiary designation.

5. Fund most other assets to Living Trusts.

6. Note protection of Michigan real estate owned by a married couple.

7. Qualified plan assets need special trust wording to get a tax stretch out.

8. Even trusts have notice and disclosure to beneficiary rules! MCL 700.7814.

D. Retaining flexibility.

1. Consider distributions based on clear standards.

a. Health.

b. Education broadly defined.

c. Welfare.

d. Support - food, clothing, shelter, transportation.

e. Consider "other resources"?

2. Consider special standards.

    a. Maintain standard of living.

    b. Buying a home.

    c. Funding a business.

    d. Paying for a wedding or funeral.

    e. Supporting dependents.

    f. Restrict distributions with specified undesirable behavior?

    g. Contestability clauses?

    h. Prohibited distributions - support, alimony, IRS?

    i. Purely discretionary distributions?

3. Consider detailed powers of appointment.

4. Consider trust protectors.

5. Consider requiring consultation with trusted investment advisors.

6. Consider powers to remove trustees.

7. Consider disclaimers.

E. Estate planning mistakes commonly observed.

1. Having inadequate liquid assets - Use insurance as needed.

2. Inappropriate distribution provisions for the surviving spouse.

    a. Outright versus QTIP?

    b. Which marital formula is desired?

    c. Pay IRAs outright versus in trust?

    d. Include other heirs in the Residuary?

    e. Include available flexibility in the Residuary?

3. Failure to protect heirs from creditors/mismanagement.

4. Failure to simplify with a joint trust when appropriate.

5. Failure to fund trusts.

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6. Inappropriate IRA beneficiary designations.
7. Inappropriate funding formulas for Residuary/Credit Shelter Trusts.
8. Using joint ownership to transfer assets or avoid Probate.
9. Using or preparing deeds without proper advice.
10. Failing to address the distribution of personal property.
11. Failing to provide for charitable gifts.
12. Failing to provide for "final takers".
13. Failing to provide flexibility in documents.
14. Failing to have all needed documents.
15. Failing to update documents.
16. Failing to leverage the use of the lifetime exclusion during life if appropriate.
17. Failing to consider generation skipping provisions if appropriate.
18. Improper operation of Irrevocable Life Insurance Trusts.
19. Failure to provide for family business succession.

II. OVERVIEW OF APPLICABLE TAXES

A. Key estate and gift tax rules.

1. Lifetime exemption.
    a. $5,490,000 - 2017. IRC Section 2010(c).
    b. 2018 - COLA.
    c. The future?
    d. File Form 706 for taxable estates or for portability claims.
    e. Portability preserves deceased spousal unused exclusion amount.
    f. Outright or in trust? Are beneficiaries minors or at risk?
2. Annual exclusion.
    a. $14,000, plus health care and tuition - 2017.
    b. $149,000 - 2017 for gifts to a noncitizen spouse.

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c. 2018 - COLA.

d. File 709 with indirect gifts or gifts over the annual exclusion.

3. Charitable deduction.

   a. Can parent or child best use the deduction?

   b. Would the deduction be best during life or at death?

   c. Is continuing control over the gift desired?

4. Is leveraging of the exemption needed?

5. Count all assets, consider appreciation and consider alternate valuation.

6. Provide beneficiaries with Form 8971 Sch. A basis information. IRC 1014(f).

   a. File with IRS within 30 days after estate tax return is filed.

   b. Not required if 706 is filed only for portability or to elect GST.

   c. Recipient must file Schedule A when making gifts.

   d. IRS penalty for omitted items - $0 basis.

   e. Estate tax value and income tax value must be the same.

   f. Use higher value and elect portability?

   g. Final Regulations expected.

B. Key income tax rules.

1. Applicable ordinary income tax brackets.

   a. Individuals - 39.6% over $418,400 + 3.8% Medicare Tax.

   b. Joint filers - 39.6% over $470,700 + 3.8% Medicare Tax.

   c. Trusts - 39.6% over $12,500 + 3.8% Medicare Tax.

   d. Capital gain - 20% + 3.8% Medicare Tax.

2. Focus on basis.

   a. A Residuary Trust results in one basis step up, only on first death.

   b. A Joint Trust - 50% step up in basis on first death. Second step up in basis on second death.

c. New Structure - 100% to marital (outright or QTIP). Elect portability. Portability can protect both lifetime estate tax exclusions. Double step up in basis.

d. Assets transferred during life have a carryover basis.

3. Focus on deferral.

C. New developments - Stay tuned.

1. Portability election. Rev. Proc. 2017-34, I.R.B. 2017-26, 1279.

a. This procedure provides a simplified method to obtain an extension of time to file a portability election.

b. Applies with death after 12/31/2010.

c. Filing extended to later of January 2, 2018 or 2 years after death.

2. Rollover permitted to spouse. PLR 201736018 (6/9/2017).

a. Estate designated IRA beneficiary.

b. Court Order to spouse.

c. IRS permits rollover.

3. IRS prescribes new IRA rollover relief. Rev. Proc. 2016-47, I.R.B. 2016-37, 346.

a. Self-certification (PLR not necessary) if miss 60 day IRA rollover period.

b. Attach to Form 5498.

4. Court allows piercing LLC. Curci Investments, LLC v Baldwin, Court of Appeals, Fourth District, Div. 3, CA G052764, August 10, 2017.

a. No business purpose.

b. Formalities not respected.

III. THE NEW STANDARD - JOINT TRUSTS?

A. Joint trusts - considerations.

1. Simplicity - like joint ownership in operation and at death.

a. Mimics joint ownership.

b. Provides property management in case of disability.

c. Avoids Probate at death.

d. Covers disposition of assets at death, with successors.

e. May include disclaimer provisions for potential estate tax planning.

(1) See IRC Section 2046.

(2) See MCL 700.2901.

f. May create a separate trust at the first death (Equalizing Trusts).

g. Subject to claims of creditors.

2. Partial step up.

a. 50% first death, 100% second. IRC Sections 1014(a), (b)(9), (e).

b. Basis increase limited to portion contributed with death within 1 year.

3. Lost control?

a. Either spouse can access assets during lifetime.

b. Consider outside gifts during life and at first death?

c. Must both parties consent to amendments?

d. May either party revoke?

4. No creditor protection for the survivor.

5. No tenancy by the entireties creditor protection.

a. Available for real estate, bonds, stock. MCL 554.45, 557.51.

b. Maybe available for brokerage accounts. Shapiro v. Nicoloff, No 01-CV-71591-DT, 2001 U.S.D. LEXIS 26298 (ED Mich. Sept. 25, 2001).

c. Not available for bank accounts.

6. No outside management with surviving spouse in control.

7. Potential loss of first lifetime exclusion, absent a portability election.

8. Some non-testamentary trust is still appropriate to avoid Probate.

a. Testamentary trusts would be subject to Probate.

b. Contractual beneficiary designations may lack detail, successors.

c. Joint ownership with children remains risky.

d. A trust provides management in case of disability.

B. Multiple trusts - considerations.

1. Asset protection maximized.

   a. Assets can be insulated from surviving spouse's creditors.

   b. Assets can be insulated from survivor's new spouse.

   c. Assets can be insulated from children's creditors.

   d. Assets can be excluded if the survivor seeks government assistance.

   e. Separate ownership of business or inherited property can occur.

   f. Allows use of two generation skipping transfer exemptions.

2. Allows separate or non-family trustees and trust protectors.

3. Allows retaining ongoing control over asset disposition.

4. Add flexibility with powers of appointment, trustee removal powers, protectors.

5. Step up and availability of lifetime exemptions depend on funding formulas.

   a. Fund Residuary first sets basis first death, uses exemption.

   b. Fund marital first resets basis at each death, uses second exemption.

   c. A 100% QTIP marital funded first can maximize control.

   d. A 100% marital with a possible disclaimer is flexible.

   e. File a protective 706?

6. Must use with Qualified Domestic Trusts.

C. Funding - considerations.

1. Which assets are protected from creditors, probate or taxation?

2. Which spouse is more "at risk"?

3. Which assets need a basis step up?

4. Which assets need an income tax stretch out?

5. Which assets need not be funded?

6. Which assets should be used to fund charitable gifts?

7. Insurance has a key role to play - asset protection and creation; liquidity.

D. Supporting documents - considerations.

1. Who should be in charge - Will; medical; financial power of attorney?
2. When should documents be effective?
3. Patient Advocate Designations (PAD) and HIPAA waivers for adult children.
4. Is documentation up to date and complete?
5. Do adult children have proper documentation, especially PADs?

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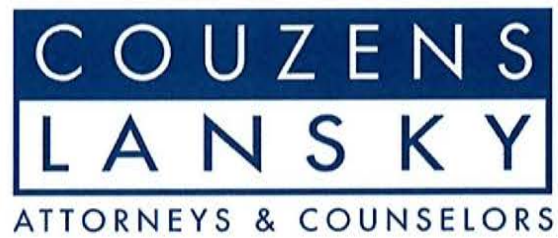

Trusts for All Reasons and Trust Alternatives

Rebecca K. Wrock

TRUSTS FOR ALL REASONS AND TRUST ALTERNATIVES

I. LIVING TRUSTS AND COMMONLY USED SUBTRUSTS

A. Overview.

1. A Trust is a legal relationship where someone is the nominal owner of property (the Trustee) to be held for the benefit of one or more individuals or entities (the Beneficiaries). The person who creates and funds the Trust is called the Settlor or Grantor.

2. Joint Trusts are increasingly common. When appropriate, merge together separate trusts spouses have had.

3. Custom drafting is critical.

4. Periodic review is essential.

5. Creditor protection for heirs via spendthrift provisions is increasingly important, as are discretionary trust provisions under MCL §700.7101 et seq.

6. Careful selection of the Trustee is imperative.

B. Marital/Residuary Trust Combination ("A/B Trusts").

1. Marital Trusts.

   a. Usually funded at the Settlor's death in order to qualify for the unlimited marital deduction, thereby deferring any federal estate taxes to the surviving spouse's death.

   b. The surviving spouse must be the only beneficiary of this Trust.

   c. There are several types of Marital Trusts - choose carefully!

      (1) Cookie Jar - the spouse can withdraw income and/or principal at any time.

      (2) Gift - the Trust property is automatically paid to the spouse, the spouse's written request is not needed.

      (3) Qualified Terminable Interest Property Trust ("QTIP")

         (a) Allows the Settlor to provide for the surviving spouse while maintaining control over how the Trust assets are distributed at the surviving spouse's death.

         (b) The surviving spouse's interest is generally an income interest in the Trust for life.

         (c) The surviving spouse usually has a limited or no power of appointment over principal at death, i.e., no power to specify the heirs.

(d) Often used for blended families in order to provide lifetime income and perhaps principal for the care of the surviving spouse while ensuring the remainder is preserved for the children of the deceased Settlor.

(4) Generation Skipping Transfer QTIP ("GST QTIP" or "Reverse QTIP") - Allows the first spouse to die to remain the transferor for this GST property, while that property still qualifies for the marital deduction and is included in the surviving spouse's estate. The second spouse to die may be the transferor for other GST property.

(5) Estate Trust - The Trust income is paid to the surviving spouse as needed and the remainder, if any, is payable to that spouse's estate at his or her death.

(6) General Power of Appointment Trust - All of the Trust income is paid to the surviving spouse and that spouse must have the power to specify who inherits the remaining property at his or her death.

(7) Qualified Domestic Trust ("QDOT") - This arrangement is required in order for a non-U.S. citizen who is the spouse of a U.S. citizen to qualify for the unlimited marital deduction, to defer any federal estate taxes to the second death.

2. Residuary Trusts.

a. Usually funded at the Settlor's death to take advantage of the Settlor's unused federal estate tax exemption.

b. The property in the Residuary Trust is excluded from the surviving spouse's estate, if the survivor's rights are properly limited.

c. The beneficiary may be the surviving spouse and/or others - be careful!

d. The surviving spouse may have limited rights over the Residuary Trust, which can include:

(1) The right to receive income, automatically or as needed.

(2) The right to receive principal based upon an "ascertainable standard." See IRC §§2041(b)(1)(A), 2514(c)(1); MCL 700.7103.

(3) A "five by five" power, i.e., the right to demand the greater of 5% of the principal each year or $5,000.

(4) A limited power of appointment to specify to whom among a certain class of individuals may receive the remaining property, if any, at the surviving spouse's death. The class must not include the survivor's estate or creditors.

e. Ascertainable standard - Typically distribute as needed for health, education, maintenance and support ("HEMS"). Other resources available may be considered or not, as the document specifies.

3. Allocations.

a. With the federal estate tax exemption being high enough as to only affect less than one percent of the population, the trust allocation formula is crucial. There are several ways to allocate funds between the Marital and Residuary Trusts.

(1) Allocate assets first to the Residuary, in an amount equal to the deceased Settlor's unused federal estate tax exemption; then fund the Marital.

(a) This has been most common.

(b) If the surviving spouse is not a beneficiary of the Residuary Trust and the estate does not exceed the estate tax exemption, the surviving spouse will be left with nothing in the Marital.

(2) Allocate sufficient assets to the Marital to bring the survivor's estate up to his or her federal estate tax exemption; then fund the Residuary up to the decedent's federal estate tax exemption; with the rest to the Marital.

(3) Fund all assets to the Marital, giving the surviving spouse a power to disclaim, with disclaimed assets passing into the Residuary.

(4) Apportion funds to the Marital and Residuary based on percentages.

(5) Apportion funds to the Marital and Residuary Trusts based on specific dollar amounts.

(6) Other formulas.

b. Ensure that the formula would result in the Settlor's desired apportionment, even if the estate were to dramatically increase or decrease or if the federal estate tax exemption amount changes.

C. Children's Trusts.

1. Distribution terms and definitions are critical to carrying out the Settlor's intentions.

2. Protect beneficiaries from others and themselves.

3. Create incentives.

4. Can include other types of Trusts noted herein.

II. SPECIAL NEEDS TRUSTS

A. Provides supplemental benefits, not support or maintenance, to a beneficiary with special needs, while allowing the beneficiary to qualify for or to continue receiving

government benefits such as Supplemental Security Income (SSI), 42 USC 1380 et seq., and Medicaid, 42 USC 1396 et seq.

B. Types.

1. First party (also known as Medicaid Payback Trusts or (d)(4)(A) Trusts).

   a. Funded with the beneficiary's own assets, typically from a court settlement or inheritance. These are not considered for means-tested government benefits qualification. See 42 USC 1396p(c)(2)(B)(IV) and 1382b(c)(1)(C)(ii)(IV).

   b. The beneficiary must be under age 65 and have a disability that meets Social Security standards.

   c. Amounts expended by Medicaid on the beneficiary's behalf must be repaid to the state from the Trust funds at the beneficiary's death ("Estate Recovery").

   d. Federally authorized by Pub. L. 114-255 (December 13, 2016).

2. Third party.

   a. Funded with assets from someone other than the beneficiary.

   b. Typically distributions are made totally in the Trustee's discretion, to provide items not provided by government benefits.

   c. No Estate Recovery.

   d. Commingling first and third party funds can result in all funds being treated as first party, regardless of source.

3. Pooled.

   a. Set up through nonprofit organizations as administrator.

   b. May be first or third party accounts.

   c. Assets of numerous beneficiaries are pooled for investment purposes.

   d. If first party, subject to Estate Recovery.

   e. Check provider agreement - may contain provision that any amounts remaining are retained, whether first or third party funds.

C. The Trustee must control distributions subject to detailed standards. Trust assets cannot be used for expenses payable with public benefits. Trust funds should be payable to providers, not directly to the beneficiary.

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III. GENERATION SKIPPING TRUSTS ("GST Trusts") or DYNASTY TRUSTS

A. A GST Trust or Dynasty Trust is a multi-generational Trust that provides distributions for the benefit of a Settlor's children for life with the remainder continuing for grandchildren or more remote descendants.

B. Typical Application is to pass wealth to successive generations, delaying transfer taxes until the assets are ultimately distributed free of the Trust.

C. Key Concerns:

1. Limits - The Generation Skipping Transfer Tax ("GSTT") exemption is limited to the current federal estate tax exemption, is typically best utilized by opting out of the automatic allocation to direct skips, and can be leveraged, typically using life insurance.

2. Portability - Unlike the unified federal estate and gift tax exemption, the GSTT exemption is not portable. This necessitates either the use of a GST Trust or outright gifts to "skip persons" on the death of the first spouse to die.

3. Clarity - These long term Trusts need clear distribution standards and perhaps flexible provisions or Trust protectors.

4. Trustee selection - Professional or experienced Trustees can be essential since these Trusts continue for extended terms with multiple beneficiaries.

5. Taxable terminations - This occurs when a Trust Beneficiary's interest terminates leaving only "skip persons" with an interest in the Trust.

6. The 37 ½ year rule - The GSTT doesn't just apply to grandchildren. It applies to other related individuals more than a generation removed, and unrelated individuals 37 ½ or more years younger than the Settlor.

7. Tax liability - Responsibility for paying the GSTT can vary depending on whether the transfer causing the GSTT was a direct skip, a taxable termination or a taxable distribution. Income tax on the GSTT can depend on whether the grantor trust rules apply.

8. S-Corporations - Because GST Trusts are designed to be long term, they should be designed to allow ownership of S-Corporation stock.

IV. GIFTING TRUSTS

A. Irrevocable Life Insurance Trusts ("ILIT").

1. An ILIT is an Irrevocable Trust created to be both the owner and beneficiary of a life insurance policy.

2. Typical Application:

    a. Used to keep life insurance proceeds out of the estate of the insured.

    b. Insurance proceeds are often used indirectly to fund estate taxes.

3. Key Concerns:

    a. Premium payments into the ILIT are gifts to the beneficiaries.

    b. *Crummey* provisions should be included and carefully followed.

    c. Trustee selection - The Settlor cannot be the Trustee.

    d. The three (3) year rule - Any gifts made (including through a transfer of ownership or through relinquishment of power over the asset) within three (3) years of the Settlor's death will be included in the Settlor's gross estate for federal estate tax purposes. IRC §2035.

    e. Build flexibility into these non-amendable trusts with powers of appointment, Trustee replacement provisions, Trust protectors, flexible standards, and similar techniques.

B. Qualified Personal Residence Trusts ("QPRT").

1. A QPRT is an Irrevocable Trust into which the Settlor transfers a residence and keeps the right to use the residence for a fixed number of years, giving the remainder interest to others.

2. Typical Application:

    a. By a parent to benefit children or grandchildren.

    b. To achieve a discounted gift - The value of the gift is the present value of the remainder interest under IRS regulations, not the value of the entire residence. See IRC 2702 and Reg. §25-2702-5.

3. Key Concerns:

    a. Survival of the Settlor - The Settlor must survive the Trust term, or the value of the residence is included in the Settlor's Estate. Health and other factors should be considered, in addition to basic life expectancy.

    b. Limitations:

        (1) A single Settlor may have two (2) QPRTs and married Settlors may have a total of three (3).

        (2) In addition to the residence or cost of the residence to be purchased, a QPRT cannot hold amounts in excess of what it will cost to improve and maintain the home (including mortgage payments, if any) beyond six months.

(3) The Settlor(s) may not re-purchase or otherwise reacquire the property after the end of the term. Rental is permitted.

(4) Mortgaged property is not well-suited for a QPRT.

(5) QPRTs are most effective in high interest environments, minimizing the value of the remainder gift.

(6) QPRT gifts do not qualify for the annual gift tax exemption.

c. Compliance reporting, flexibility, and client understanding.

C. Intentionally Defective Grantor Trusts ("IDGT").

1. An IDGT is an Irrevocable Trust in which transferred assets are competed gifts from the Settlor for gift tax purposes, but the Settlor remains taxable on the Trust's income.

   a. The transfer can be structured as a gift or a sale.

      (1) Gifting may cause gift tax and unfavorable basis outcomes.

      (2) A sale of the asset to the IDGT in exchange for a promissory note results in no capital gain because the Settlor is treated as both the transferor and transferee for income tax purposes, and therefore no taxable event results.

   b. By paying the income taxes on future income, the Settlor is further reducing his or her gross estate for federal estate tax purposes, and effectively providing a greater gift to the beneficiaries of the appreciating asset.

2. Typical Application: Used to "freeze" the value of an asset and remove future appreciation from the Settlor's gross estate for federal estate tax purposes.

3. Key Concerns:

   a. Trustee selection - The Settlor cannot be the Trustee.

   b. Basis issues.

      (1) Because the transfer of the asset to the IDGT is treated as complete for gifting purposes, a loss of potential step-up in basis can result.

      (2) Use of substitution power can avoid this result and the potential consequence of substantial capital gain to the beneficiaries on later sale.

   c. Structure of the promissory note.

      (1) The length of time is often 10 years, but avoid exceeding the Settlor's life expectancy if less than 10 years. This can be determined using IRS tables.

(2) The note should pay enough interest for the loan to be classified above market. Therefore, the rate of appreciation on the underlying assets should be higher than the market rate.

(3) Formal IRS guidance in this area is lacking, and sales are sometimes challenged on the basis that the note is a retained equity interest rather than bona fide debt.

d. Timing - The use of two overlapping tax systems to achieve the IDGT benefits is considered by some to be a loophole. People interested in trying to benefit from an IDGT should seek professional assistance before adverse developments occur.

e. There is limited case law or formal guidance to date.

D. Spousal Lifetime Access Trust ("SLAT").

1. A SLAT is an Irrevocable Trust created to benefit the Settlor's spouse, allowing the Settlor to maintain "indirect" access to the funds via the spouse. The spouse receives income and principal as needed on an ascertainable standard, and may also be given a five by five power and/or a limited power of appointment.

2. Typical Application: Used to make a completed gift to a Settlor's spouse, which may be covered by the Settlor spouse's federal estate tax exemption at the time the gift is made.

3. Key Concerns:

a. Divorce.

b. Loss of the Settlor spouse's stepped-up date of death basis.

c. If the Trust Beneficiary spouse dies first, loss of access for the Settlor spouse. The Trust Beneficiary spouse can provide for the Settlor spouse with an ILIT to replace these funds.

d. Reciprocal Trust Doctrine - Spouses should not create substantially identical trusts for each other's benefit, or the IRS may assert that each spouse created the trust for his or her own benefit, resulting in estate inclusion of the trust property for each spouse.

E. Grantor Retained Trusts ("GRT").

1. A GRT is a Trust into which the Settlor transfers property, while retaining the right to an annual income amount for a specified number of years.

a. Grantor Retained Income Trust ("GRIT") - Restricted in the family setting by IRC 2702 since 1990.

b. Grantor Retained Annuity Trust ("GRAT") - Payout is a fixed annuity amount.

c. Grantor Retained Unitrust ("GRUT") - Payout is a fixed percentage of the Trust property annually.

2. Typical Application: Providing a discounted gift to the remainder beneficiaries, typically children or grandchildren.

3. Key Concern: Compliance with technical regulations. To be effective, the assets must appreciate at a rate greater than the expected rate of return mandated by the IRS.

F. Charitable Trusts.

1. A Charitable Trust can be used to reduce or eliminate entirely any applicable estate taxes, while benefitting charitable beneficiaries.

a. Charitable Remainder Trust ("CRT").

(1) A CRT provides income to a non-charitable beneficiary for a period of time, such as a term of years or for life, with the remainder passing to charity.

(2) The value of the remainder can be deducted from the Settlor's estate.

(3) The income amount may be a fixed annual amount or a fixed percentage of the annual fair market value of the Trust.

b. Charitable Lead Trust ("CLT").

(1) A CLT provides income to a charity for a period of time, with the remainder passing to the Settlor's non-charitable beneficiaries.

(2) The present value of the remainder to be received by non-charitable beneficiaries as part of the Settlor's estate, but can be reduced depending on the charitable payout.

c. Alternatives.

(1) Private foundations.

(2) Charitable gift annuities.

(3) Charitable gifts of IRA or other retirement plan assets. IRC §408(d)(8).

(4) Sale of a residence to a charity while retaining life use.

(5) Bargain sales.

(6) Other.

2. Typical Applications:

   a. Charitable Trusts:

      (1) Reducing or eliminating estate taxes after taking advantage of the benefits of Living Trusts, ILITs, annual gifting and discounted gifts.

      (2) Combine a Charitable Trust with an ILIT used to provide a tax free inheritance to children and grandchildren.

      (3) Paying out to a private foundation, keeping assets dedicated to charitable use under the control of the Settlor or the Settlor's family.

   b. Alternatives: Reduce taxes via related tax deductions.

3. Key Concerns: Compliance with technical regulations, compliance reporting and client understanding.

G. IRC 2503(b) and 2503(c) Trusts.

1. A 2503(b) Trust is an irrevocable gifting Trust. Income must be distributed at least annually. These Trusts may extend beyond age 21 and would typically be used for adult beneficiaries, which could be numerous. Detailed distribution provisions may be included.

2. A 2503(c) Minor's Trust is an irrevocable Trust established to hold property for one minor until the minor reaches age 21. Income may be accumulated. Principal must be distributed to the minor at age 21, unless the minor consents to an extension.

3. Typical Application: To make a gift to which the beneficiary does not presently have access, while simultaneously qualifying for the annual gift tax exemption.

4. Alternatives:

   a. Uniform Transfers to Minors Act ("UTMA").

   b. Uniform Gift to Minors Act ("UGMA").

   c. 529 Plans.

5. Key Concerns:

   a. Setup and administration cost - Less costly alternatives exist.

   b. Income Taxation.

   c. Financial Aid - The Trust is treated as an asset of the minor for financial aid purposes (as are UTMA and UGMA Accounts).

   d. Estate Taxes - If the donor and Trustee are the same, the Trust is included in the donor's gross estate (same with UTMA and UGMA Accounts). If estate taxes are

a concern, the Trustee should be someone other than the donor and the donor's spouse.

H. Health and Education Exemption Trusts ("HEET").

1. A HEET is a Trust created to provide for the health and/or education of one or more beneficiaries more than a generation removed from the Settlor, and for a charitable co-beneficiary. The transfer is not subject to the GSTT because of the charitable co-beneficiary. See IRC 2611(b)(1).

   a. A lifetime transfer uses gifts qualifying for application of the Settlor's annual exemption or lifetime federal estate tax exemption, removing future appreciation and income from the Settlor's estate. There is no current income or gift tax charitable deduction for the charitable interest.

   b. A testamentary transfer, unless an ILIT is used, results in the transferred assets being included in the Settlor's estate for estate tax purposes. There is no estate tax charitable deduction, unlike a direct bequest to a charity.

2. Typical application: HEETs are best suited for those who have estates in excess of the federal estate tax exemption and have exhausted their GSTT exemptions, who want to provide for health and education of beneficiaries more than a generation removed, and who have charitable goals.

3. Key Concerns:

   a. Qualified Transfers - Distributions to the non-charitable beneficiaries must be made directly to health and education providers to be considered "qualified transfers" within the meaning of IRC 2503(e).

      (1) Books, room and board are not qualified transfers. However, 529 Plans can be used for such expenses.

      (2) Elective surgeries or medical procedures are not qualified transfers.

   b. Uncertainty over significance of charitable beneficiary's interest - The charity's interest must be significant, or can be ignored as being used "primarily to postpone or avoid" the GSTT. See IRC 2652(c)(2). There is little guidance as to what qualifies as "significant", but the greater the amount, the greater likelihood that the transaction will be respected by the IRS.

   c. The Separate Share Rule - The Separate Share Rule requires that separate and independent shares of different beneficiaries be treated as separate shares or trusts in determining Distributable Net Income ("DNI") allocable to the beneficiaries. See IRC 663(c) and 2654(b). The Trustee should have discretion to distribute between charitable and non-charitable beneficiaries in order to avoid application of the Separate Share Rule. However, the charitable beneficiary should receive a minimum amount that is determined to be significant in accordance with IRC 2652(c)(2).

d. Choice of Tax Treatment - If the Settlor is living, the Settlor can elect grantor trust treatment or non-grantor trust treatment.

(1) Grantor Trusts entitle the Settlor to a charitable income tax deduction for distributions to the charitable beneficiary, but the Settlor must report and pay income tax on the Trust income during the Settlor's lifetime.

(2) Non-grantor Trusts deduct distributions of income to the charitable beneficiary, up to 100% of the trust income (rather than up to 50% of the Settlor's AGI). Income is taxed at the Trust level, using the complex trust rates.

V. SPECIAL PURPOSE TRUSTS

A. Domestic Asset Protection Trusts ("DAPT").

1. A DAPT is an Irrevocable Trust created to provide for the Settlor and using the Settlor's own assets while making the underlying assets unavailable to the Settlor's creditors under state law. Michigan became the 17th state to enact such legislation on March 8, 2017. See MCL 700.1041 et seq.

2. Typical Application:

a. Clients with both substantial wealth and a high risk of creditors.

(1) Carefully assess insurance coverage - sufficient insurance will often render a DAPT superfluous.

(2) Carefully review umbrella policies.

(3) Employer provided malpractice liability insurance is often sufficient to cover professional clients who have a high risk of creditors.

b. Alternative or supplement to a Prenuptial agreement, if done more than 30 days prior to the marriage or if both parties consent.

c. Critically, the Settlor may retain:

(1) Power to direct investments.

(2) Power to veto distributions.

(3) Power to remove and appoint Trustees and advisors.

(4) Right to receive income.

(5) Right to receive principal under a discretionary trust provision or support provision, or under the direction of an advisor with respect to either.

(6) Right to receive distributions to pay taxes.

(7) After death, to have debts and estate administration expenses paid.

3. Key Concerns:

    a. Control - The Settlor can be a beneficiary, but may only receive income and principal in the complete discretion of the Trustee - the Settlor must give up control over the assets.

    b. Trustee selection - The Settlor cannot be the Trustee, and must be an individual or corporate Trustee residing in Michigan.

    c. Compliance.

        (1) With the statute, including having the Trust have a "spendthrift" clause.

        (2) With the Affidavit requirement, including stating the transfer will not render the Settlor insolvent or is intended to defraud creditors.

        (3) With tax reporting requirements.

    d. Risks.

        (1) Though technically authorized under the statute, numerous DAPT features may result in possible challenges from creditors. For example, while anyone but the Settlor can technically be the Trustee, an appearance of influence might cause a transfer to be set aside.

        (2) While there are a number of powers the Settlor is authorized to retain under the statute, the more powers that are retained, the more likely a transfer is to be set aside.

    e. Bankruptcy - Under the federal bankruptcy code, the normal 10 year bankruptcy lookback period will apply.

    f. Fraudulent intentions - If there is evidence of an intention to hinder or defraud a creditor, the transfer will be set aside.

        (1) Absent evidence of intent to hinder or defraud a creditor, the statute of limitations on a transfer is reduced from six (6) years to two (2) years.

        (2) Absent evidence of intent to hinder or defraud a creditor, the burden of proof on the creditor is raised from preponderance of the evidence to clear and convincing.

    g. Undeveloped law - Michigan is the most recent state to adopt a DAPT statute. There is little case law or regulatory guidance to date.

B. Qualified Retirement Account Trusts.

1. Qualified Retirement Account Trusts are used to maintain Trust controls over Qualified Retirement Account assets while meeting the requirements to qualify as a "look through" Trust. With a "look through" Trust, income recognition on the Qualified Retirement Account assets may be "stretched out" based on the life

expectancy of the oldest beneficiary via annual required minimum distributions (RMDs).

2. Typical Application: To maintain control over Qualified Retirement Account assets in many situations:

    a. Minor or young adult beneficiaries.

    b. Spendthrift beneficiaries.

    c. Beneficiaries with a high risk of creditors or predators.

    d. In a blended family situation where Qualified Retirement Accounts are the main asset, to ensure that children from a prior relationship are not cut out; however, the spousal rollover tax benefit would be lost.

    e. These can be subtrusts of a typical Living Trust.

3. Key Concerns:

    a. Taxation - There are two types of taxation structures.

        (1) Conduit - A conduit Trust pays annually all net income to the beneficiary, and distributions are taxed to the beneficiary.

        (2) Accumulation - An accumulation Trust is authorized to accumulate income and does not have to distribute it.

            (a) RMDs and other distributions are taxed to the beneficiary.

            (b) Accumulated income is taxed at the compressed Trust level.

            (c) Accumulation Trusts offer flexibility to withhold income at the expense of potentially higher taxation.

    b. Compliance - Strict compliance is necessary with IRS rules and deadlines.

        (1) For determining beneficiaries (and who the measuring life will be for purposes of RMD calculations).

        (2) For withdrawing the decedent's RMD.

    c. Beneficiaries -

        (1) Young beneficiaries may be disadvantaged by a beneficiary who is significantly older (and therefore the measuring life for RMDs). By naming designated subtrusts for each individual as beneficiary, each beneficiary may use his or her own life expectancy.

        (2) Charitable beneficiaries can be problematic in this context. They are not considered "designated beneficiaries", so the IRA would need to be

distributed within five (5) years of the Settlor's death (if under age 70 ½), or the Settlor's remaining life expectancy (if 70 ½ or older).

(a) If charitable beneficiaries are paid their entire distributions in advance of relevant deadlines, the charitable beneficiary is then ignored for RMD purposes. Careful compliance here is critical.

(b) Alternative plans for charitable beneficiaries are another option.

C. Pet Trusts.

1. A Pet Trust provides for the care of the Settlor's pets. Funds are set aside to be managed by the Trustee and distributed to the caregiver who cares for the pet. Authorized by MCL 700.2722.

2. Typical Application: To care for one or more pets after the Settlor's death, ensuring financial means for the pet's care for life, maintaining control over a succession of caregivers and making the transition to life without the Settlor easier on the pet.

3. Key Concerns:

   a. Conflicts of interest - Conflicts can arise in several areas of Pet Trust planning. Choice of caregivers, Trustees, and remainder beneficiaries is important.

   b. Incentives - An improperly drafted Pet Trust can incentivize the pet's early death or can incentivize the pet being kept alive when the pet is only suffering.

   c. Contests - It is not uncommon for a Pet Trust to be challenged by would-be heirs. Employ typical estate plan contest avoidance strategies.

   d. Taxation - Since a pet cannot be a taxpayer, income is taxed at the Trust level.

D. Trusts for Incarcerated Individuals.

1. A Trust for an incarcerated individual is a discretionary Trust drafted in light of the State Correctional Facility Reimbursement Act ("SCFRA"), MCL 800.401a et seq. See also *Miller v. Dep't of Mental Health.* 432 Mich 426, 429; 442 NW2d 617 (1989) and *In re Darrell V. Wright Trust Agreement.* No. 319832. Macomb Probate Court LC No. 2013-210763-TV (March 17, 2015).

2. Typical Application: To ensure that funds intended for a Trust Beneficiary are not at risk to repay the State under the SCFRA for its cost of care for the Trust Beneficiary.

3. Key Concerns:

   a. Flexibility - Flexibility to allow for suspension of any Trust Beneficiary's rights in case of incarceration can be valuable.

   b. Control - The Trustee must have complete discretion as to any distributions. This should extend beyond incarceration and parole, since the State's claim survives that time. To avoid remaining amounts, if any, from being paid to the Trust Beneficiary's estate where the State would be considered a creditor, the interest

should not be vested in the Trust Beneficiary. See *Coverston v. Kellogg.* 136 Mich App 504, 510. 357 NW2d 705 (1984).

c. Notice - Trustees are not currently required to provide notice to the State. Prisoners must periodically complete asset disclosure forms for property belonging to or due to the prisoner.

E. Gun Trusts.

1. Gun Trusts are typically used to own weapons regulated by the National Firearms Act of 1934 ("NFA") and Title II of the Gun Control Act of 1968. These weapons are often called NFA or Title II firearms and must be registered with the Bureau of Alcohol, Tobacco, Firearms and Explosives.

   a. NFA Trusts are designed to own, possess and transfer the Settlor's NFA firearms.

   b. A Gun Trust may be drafted to own both NFA firearms and Title I firearms (standard rifles, shotguns and handguns), or one category exclusively.

2. Typical Application:

   a. NFA Trust:

      (1) To own the Settlor's NFA firearms and allow each Trustee and Trust Beneficiary to possess or use the firearm.

      (2) To keep the guns in trust after the Settlor's death, avoiding the usual transfer requirements.

      (3) To prevent an "accidental felony" when the registered owner of the firearm leaves the firearm at home, even if locked in a gun safe, when any unregistered non-owner has access.

   b. In general:

      (1) To provide for the transfer of the Settlor's firearms and related accessories to the Settlor's intended Trust Beneficiaries, avoiding probate.

      (2) With the exception of NFA firearms and handguns required to be registered with the State of Michigan, to keep the Settlor's inventory of firearm ownership from the government's records.

3. Key Concerns:

   a. Prohibited Persons - A "prohibited person" cannot be a Trustee or a Beneficiary of a Gun Trust. If a prohibited person is a Trustee or Beneficiary, the Trust can be invalidated, causing the firearms to be rendered contraband. Anyone associated with the Trust as Trustee or Beneficiary or anyone in possession of firearms could be subject to a fine of $250,000, imprisonment of up to 10 years, or both.

b. Compliance requirements, including notice and Trust state registration, must be followed. Transfers into an NFA Gun Trust must be registered.

F. IRC 682 Trusts for special divorce situations.

1. An IRC 682 Trust (a "Section 682 Trust" or "Alimony and Maintenance Trust") allows the paying ex-spouse to transfer sufficient income producing assets or property into a trust for the benefit of the receiving ex-spouse, and the income generated is used to pay the receiving ex-spouse for the term specified in the divorce agreement.

2. Typical Application:

   a. To protect the receiving ex-spouse from the death, financial insolvency or a decrease in income of the paying ex-spouse prior to the expiration of the term specified in the divorce agreement.

   b. To assure that the marital children will continue receiving the income payments if the receiving ex-spouse dies (which would otherwise be unavailable in a typical spousal support arrangement).

   c. To avoid the paying ex-spouse's need to sell a family business or liquidate other assets to satisfy a support obligation.

   d. To avoid contentious relationships by administering payments through a neutral third party.

3. Key Concern: The resulting Trust could end up being underfunded or overfunded depending on the market, resulting in the receiving spouse getting more or less than what was intended.

G. Other.

Business and Tax Law Matters Concerning Mergers and Acquisitions

Jeffrey A. Levine

KEY BUSINESS AND TAX CONSIDERATIONS IN

MERGER & ACQUISITION TRANSACTIONS

I. KEY PROVISIONS IN TRANSACTION DOCUMENTS

A. Definitions.

1. A well-structured purchase agreement will have a detailed definition section.

2. Depending on the transaction's terms, some key definitions may include:

   a. Accounting principles. For example, various transactions will have "working capital adjustments", "balance sheet adjustments", "earnouts." It will be important in the definitions or in a disclosure schedule to the purchase agreement to specify any desired exceptions to GAAP or other accounting principles which will guide the parties' economic agreement.

   b. Current Assets and Current Liabilities. How are these defined for purposes of the purchase price adjustments? Are there any typical current assets (including cash) which are excluded from the definition of current assets, and are there any current liabilities (such as accrued vacation and personal time off) which are excluded from current liabilities.

   c. Debt. In a "cash-free, debt-free" transaction, defining what obligations the seller(s) will be responsible for is key. Are there any "carve-outs" from the debt definition, such as accounts payable, and other forms of debt?

   d. Assumed Liabilities. Is only "interest-bearing debt" an assumed liability?

   e. Earnout definitions. Examples include "net income", "profits", etc., if there will be an earnout in the transaction.

   f. Environmental definitions. Examples include environmental laws, hazardous materials, releases and the like which will govern environmental representations, warranties and indemnification obligations.

   g. GAAP.

   h. Intellectual Property ("IP"). What is included in the IP which is being transferred to the buyer?

   i. Knowledge. Is knowledge "actual knowledge without a duty of inquiry" by the seller(s) or are the seller(s) required to make "due inquiry" of the facts outlined in a particular representation and warranty?

   j. Lien. Assets of the seller/target are typically transferred free of "Liens." What "permitted encumbrances" will the buyer take over (such as particular title defects in real estate being acquired)?

   k. Special Damages. What damages will be "carved-out" of damages for which sellers will be liable, such as special, punitive, exemplary, speculative, indirect,

incidental and/or consequential damages, any damage based upon lost profits or a multiple of earnings, or any diminution of value.

B. What is Being Acquired?

1. In an asset form of transaction, what assets are being sold by the seller?

2. What assets are "excluded assets?" Some typically excluded assets are:

   a. Cash;

   b. Accounts receivable;

   c. Prepaid expenses;

   d. Insurance; and

   e. Personal effects.

3. If the seller is selling equity, what assets will be distributed out to the selling shareholders at/prior to closing, and what tax at the corporate level (and the receiving shareholder level) will be triggered?

4. What contracts will the buyer assume and what contracts will the seller get "stuck with." These might include "golden handcuffs", "change of control" or other agreements with key employees.

5. What liabilities will buyer take over and what obligations will seller have for pre-existing liabilities?

C. What is the Purchase Price and What Purchase Price Adjustments Apply?

1. Is the purchase price "fixed" regardless of the status of working capital, the balance sheet, debts, etc., or is the purchase price sensitive to those items?

2. As noted in the definition section above, will there be a working capital adjustment, a balance sheet adjustment or any other form of adjustments to the purchase price?

   a. If so, how are these measured?

   b. What if there are disagreements? Who will "arbitrate" these matters?

3. If earnouts apply, for how long, and what are the measuring criteria (net earnings, gross sales, etc.)? Make sure to have access to the books and records of the company to verify earnouts.

4. Will "obsolete", "slow-moving" or other problematic inventory reduce the purchase price?

5. Will uncollected receivables reduce the purchase price? Who bears the risk? Will uncollected receivables be "turned-back" to the seller after a period of time to collect (via threatening letters, lawsuits, etc.)?

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D. Allocations.

1. How will the tax allocation among the sold assets be determined? What impact will those allocations have on the respective parties? How will recapture items be handled?

2. Should "personal goodwill" be considered when determining allocations?

   a. Can allocations to personal goodwill be justified?

   b. What is the nature of the business in question?

   c. Will there be an appraisal of the personal goodwill to justify an allocation to it?

   d. Some factors to consider for allocations to goodwill include:

      (1) What personality and personal qualities attract customers or otherwise generate business success?

      (2) Reputation for judgment, knowledge, and skill.

      (3) Expertise, specialized knowledge, and know-how.

      (4) Comparative professional success.

      (5) Demonstrated earning power.

      (6) Personal business, industry, and customer contacts/relationships.

      (7) Close relationships with key decision-makers at referral sources, suppliers, or customers.

      (8) How dependent is the seller/target on an individual for its financial success?

      (9) How would that individual's loss negatively impact the revenue and/or profitability of the seller/target?

E. What is Payable at Closing and to Whom?

1. Will there be "seller paper", escrows, holdbacks or other forms of deferred payments to be made to the seller?

2. If so, care needs to be taken to define the payout terms and conditions.

3. If "seller paper" is involved, the installment sale rules will apply, and is there immediate taxation on depreciation recapture or other forms of disqualified installment sale property?

F. If there are deferred payments, what security will the sellers receive?

1. Will stock be held in escrow?

2. Will there be a security interest in the target company's assets, and what will the agreement terms be?

3. Will there be life insurance on the life/lives of key buyer/target owners or employees?

4. Will there be personal guarantees?

G. Closing.

1. Will the transaction be a "sign-and-close" or "sign now/close later?"

2. Will the closing take place in person (unusual these days) or via electronic mail?

3. If a deferred sign and close is used, specify clearly when one party or the other can walk.

H. Representations and Warranties.

1. Due diligence will allow for the buyer to learn more about the business, and to frame representations and warranties to protect the buyer.

2. Sellers need to review representations and warranties carefully with owners, key employees, accountants, and counsel in order to confirm that they are true, correct and complete.

3. Disclosure schedules often provide "get-out-of-jail" free cards to sellers.

4. Will assets be "as is" or will there be condition/sufficiency of asset representations and warranties?

I. What non-compete, non-solicitation and confidentiality provisions will apply?

1. Will different owners have differing provisions? For example, a minority owner may need to be able to continue to work after no longer being employed by the buyer/target company.

2. Will there be liquidated damages for violations?

J. Real Estate Matters.

1. If real estate is involved, an entire separate set of considerations will apply including title work, survey, environmental condition, etc.

2. If a lease is involved, what consents may be required to assign the lease(s)?

K. Indemnification.

1. What "survival", "deductible"/"basket", "cap" provisions will apply?

2. As noted above, will the sellers be liable for Special Damages?

3. Are there separate tax indemnifications?

L. Tax Matters.

1. In an equity sale, who prepares the final tax returns for the target entity?

2. Who is liable for pre-closing taxes?

3. What taxes will arise out of the closing itself, such as a forward IRC 338 election, an IRC 338(h)(10) election, or IRC 754 election if a "partnership" entity?

4. How will post-closing audits by governmental authorities be handled?

5. Will prior accounting firms and law firms be able to represent the target, and will conflict of interest issues be waived in the definitive transaction agreement?

M. Employees.

1. What employees will be hired by buyer, retained in the target?

2. Will some employees be terminated and by whom?

3. Do WARN Act issues apply?

4. How will health and other benefits be handled (including COBRA)?

5. Are there any IRC 409A issues to consider?

6. Will there be employment agreements for one or more key employees?

II. GETTING EQUITY IN THE ACQUIRING COMPANY OR RETAINING EQUITY IN THE TARGET COMPANY

A. There are many ways to provide ongoing equity in the buyer/target, including:

1. Paying for it with cash or on a deferred basis;

2. Contributing equity into the buyer under an IRC 351 form or IRC 721 form of transaction; or

3. Contributing assets, in exchange for equity.

B. When will the key employees/former owners be allowed to cash out? On a "change of control", when leaving the company, etc.?

C. How will the price be determined if not on a change of control?

D. There are many complicated structures, particularly involving partnerships, with borrowing at the target level and post-closing distributions potentially having tax advantages.

III. TAX CONSIDERATIONS

A. Overview. A corporate or partnership (LLC) acquisition can be arranged as a purchase and sale of assets, a purchase and sale of stock/equity or as a tax-free reorganization. Regardless of which is chosen, the parties have the further option to structure the transaction as an immediate payment or deferred payment transaction. The transaction can be structured to be taxable, tax-free or a combination depending on the desired result.

B. Taxable or Tax-Free.

1. Seller's Considerations.

a. In a tax-free transaction, the consideration paid will be primarily stock of the acquiring corporation or its parent, which will often be illiquid for at least a period of time.

b. If non-stock consideration is paid in an otherwise tax-free transaction, the resulting gain may be taxed as capital gain and/or ordinary income, depending on the form of the transaction. In a taxable transaction, gain normally is taxable at capital gain rates.

2. Buyer's Considerations.

a. In a tax-free acquisition, since the consideration paid will be predominantly stock of the acquiring corporation or its parent, the purchase will not drain cash resources, but may result in the dilution of shareholder's earnings. Further, any dividends subsequently paid to the acquired corporation's shareholders will be non-deductible, while in a taxable transaction, interest paid on a promissory note or other debt instrument normally would be deductible.

b. If the transaction is structured as an asset purchase, the tax-free acquisition generally results in a carryover of existing basis of the acquired assets, whereas a taxable acquisition will cause the basis to step up or down to the current fair market value of the assets.

c. Favorable tax attributes of the acquired corporation, such as net operating loss carryovers, can be utilized by the acquiring corporation (subject to applicable limitations) in an asset acquisition, generally, only if it is structured as a tax-free transaction.

C. Stock or Asset Acquisition.

1. Seller's Considerations.

a. If the acquisition is a tax-free transaction, generally it is irrelevant to the seller whether the transaction is an asset purchase or stock purchase. In either case,

the shareholders of the acquired corporation will wind up with stock having the same basis and holding period as their old shares and no gain or loss will be recognized, unless cash or other non-stock consideration is also received.

b. If the acquisition is a taxable transaction, the seller may prefer a stock transaction in which the buyer purchases the seller's stock for cash or cash equivalents, in which case the seller is generally eligible for capital gain treatment. Further, if the consideration is paid in installments, the seller may be able to report the gain as the installments are received, subject to the installment reporting rules.

c. While capital gain treatment and installment reporting may also be available to the acquired corporation's shareholders in an asset transaction, because of the potential recognition of gain by the acquired corporation, which will ultimately be paid by the shareholders, the shareholders generally will prefer a stock transaction.

2. Buyer's Considerations.

a. A stock purchase, whether taxable or tax-free, generally causes the acquiring corporation to retain the acquired corporation's basis in its assets. IRC 338 may, however, change this result.

b. A taxable asset transaction generally steps the basis of the acquired corporation's assets up or down to the purchase price.

c. In a stock purchase, whether taxable or tax free, the purchaser acquires and assumes all of the liabilities of the acquired corporation. The parties, however, typically have representations, warranties and indemnities in the stock purchase agreement which may cause the selling shareholders to remain economically liable for certain liabilities of the acquired corporation. Escrow agreements are often used in these transactions. In an asset purchase, some or all of the liabilities can be excluded by contract; state law may, however, cause the purchaser to be treated as a successor entity, causing the acquirer to become liable for the seller's obligations notwithstanding the contract language to the contrary.

d. In a stock purchase transaction, minority stockholder status may result if certain shareholders of the acquired corporation retain some of the acquired corporation's stock. In an asset purchase transaction, this does not occur. The acquired corporation normally liquidates after the transaction has closed, although this is not always the case. Special tax consequences apply depending on whether the acquired corporation liquidates or stays in existence after the sale. Installment notes and other aspects of the transaction need to be carefully considered.

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IV. TAXABLE CORPORATE ACQUISITIONS

A. Stock Purchase.

1. Seller.

a. Character of gain - Generally, the sale of stock, assuming it is a capital asset, will result in a capital gain or loss, long or short term, depending on whether the stock has been held for more than one year.

b. Reporting of gain.

(1) Cash Sale. If the consideration is paid in full in the year of sale, the seller's gain or loss will be reported in the year of sale, regardless of whether the seller is a cash or accrual basis taxpayer. However, if part of the purchase price is deferred, then the reporting of the gain or loss is considerably more complex.

(2) Deferred payments.

General Installment Reporting Rules.

(a) IRC 453 generally provides that if any part of the sales price is deferred, installment reporting of the gain will apply automatically unless otherwise elected. For a transaction to qualify under IRC 453, at least one payment of the purchase price must be received after the year of sale. It is however permissible for 100% of the purchase price to be paid in a single installment so long as that installment is received after the year of sale. Each year the seller includes in income the percentage of principal payments received during the year which equals the seller's gross profit divided by the total contract price (Gross Profit Percentage).

(b) Installment reporting is not available for or to:

i. Sales of inventory (unless the sale is all of the seller's inventory in bulk to one purchaser).

ii. Losses.

(c) With dealers in real and personal property, all amounts owing on a dealer installment note are taxable in the year of sale, as opposed to the year payments are received.

(d) All notes received, where the sales price is in excess of $150,000, are subject to special rules. To the extent the face amount of all applicable installment obligations exceeds $5,000,000 at the end of the taxable year, interest is charged on the tax which is deferred under the installment method to the extent of the face amount of the deferred payments. Further, to the extent that any debt is secured directly by an installment obligation that arises out of applicable sales, the net proceeds of the secured debt are treated as payments with respect to the other

obligations. Thus, if a seller receives a promissory note at closing, and then pledges that note as collateral for a post-closing new loan, the seller loses installment reporting on the closing note to the extent of post-closing borrowing.

(e) Certain exceptions apply to personal use and farm property, time shares and residential lots.

(3) Imputed interest.

(a) When an installment sale is utilized, the sales price exceeds $3,000 and payments are received more than one (1) year after the date of the sale, generally, the imputed interest rules of IRC 483 and IRC 1271-1275 must be taken into account. If not, the Internal Revenue Service will impute or restructure the transaction at the applicable federal rate. The net effect of these rules on the seller is to decrease gain or increase loss while creating interest income and on the buyer to decrease the cost basis of the purchased stock (or assets) while generating an interest deduction.

(b) The current rules establish a so-called "testing rate" which is equal to 100% of the applicable federal rate ("AFR") under IRC 1274, which is the lowest of the rates for either the month in which the contract is signed or the two (2) preceding months, against which the interest rate charged on the transaction is tested. If it is less than the testing rate, then interest is imputed at the AFR. The AFR for a debt instrument with a term of less than three (3) years is the federal short term rate, for a term of three (3) years to nine (9) years is the federal mid-term rate and for a term of over nine (9) years is the federal long term rate.

(c) If the amount of the seller financing is $2.8 million or less, the "imputed rate" is the lesser of 9% or 100% of the AFR. If the amount of seller financing is more than $2.8 million, the imputed rate is 100% of the AFR.

(d) Exceptions - see IRC 483 and 1274.

2. Buyer.

Basis of assets of acquired corporation.

General rule. Since the buyer is acquiring the stock of the corporation and not the assets, the basis of the assets of the acquired corporation will remain the same after the acquisition. Therefore, if the purchase price for the stock exceeds the basis of the assets of the seller, the buyer would prefer an asset acquisition to step up the basis of the assets to the purchase price of the stock. If the buyer wants the purchase of stock to be treated in effect as a purchase of assets, the requirements of IRC 338 must be satisfied. The general rules of IRC 338 are as follows:

(1) The buyer (which must be a corporation) must acquire at least 80% of the total combined voting power of all classes of stock of the seller and at least 80% of the total number of shares of all other classes of stock of the seller within a 12-month period (a "qualified stock purchase").

(2) If a qualified stock purchase occurs, then the buyer may elect to treat the stock purchase as a purchase of the seller's assets. This is accomplished without the necessity of actually liquidating the seller. Rather, the seller is deemed to have sold all of its assets in a single transaction in a fully taxable transaction. The seller is then treated as a new corporation which purchases all of the assets of the seller as of the beginning of the succeeding day. The deemed purchase price is the fair market value of the seller's assets on the acquisition date. Careful valuation and allocation among assets is very important. The rules of IRC 1060 and 197 apply to this deemed sale.

(3) The election under IRC 338 must be made on Form 8023 by the 15th day of the 9th month beginning after the month in which the buyer acquires the requisite 80% stock ownership in the seller (the "acquisition date"). The election once made is irrevocable.

(4) If the selling corporation was an S corporation, any recapture tax will not be paid by the S Corporation shareholders; rather the seller is required to file a one day return as a C corporation in which it will report any income or loss resulting from the election under IRC 338. IRC 338(h)(10) elections are typically used where the seller is an S corporation (where that seller-S corporation is not subject to tax on built-in gains under IRC 1374-the "10-year rule").

(5) All acquisitions of stock or assets must be treated consistently as either asset purchases or stock purchases if they occur within the period beginning one (1) year before and ending one (1) year after the 12-month acquisition period (the "Consistency Rule").

B. Asset Purchase.

1. General. As discussed above, if the purchase price exceeds the basis of the seller's assets and to avoid assuming unwanted liabilities of the seller, the buyer usually will opt for a direct purchase of assets rather than the indirect method under IRC 338. From the seller's standpoint, such a transaction is more complex and, if the seller decides not to continue the sales proceeds in corporate form, the selling corporation must be liquidated. As a general rule, this results in double taxation, first to the corporation, and again to the shareholders when the net proceeds are distributed to the shareholders. Alternative forms of payment should be considered, such as payments to stockholders for covenants not to compete, rent on retained real estate leased to the acquirer and employment agreements.

2. Liquidating Sales and Distributions.

   a. General Rule - IRC 336 requires gain or loss generally to be recognized to the liquidating corporation on distributions in liquidation, as if the property were sold to the recipient shareholder at fair market value, and also on sales of assets after adoption of a plan of liquidation. Gain, but not loss, will also be recognized to the corporation on non-liquidating distributions (as if the property were sold to the distributee at its fair market value). In addition, a purchaser's election to step up the basis of an acquired corporation's assets under IRC 338 will, as discussed above, also trigger recognition of gain or loss.

b. Gain at Corporate Level.

(1) Gain or loss is recognized to a corporation on a distribution of its property in complete liquidation. The distributing corporation is treated as if it had sold the property at fair market value to the distributee-shareholders.

(2) IRC 1239 may apply, triggering ordinary income to the corporation if the distribution is to a related person. The corporation may be able to avoid ordinary income by making distributions of ordinary income producing property to non-related shareholders.

(3) Since the corporation is treated as having sold its property at fair market value, valuation becomes very important. IRC 1060 requires use of the residual method, in which all asset value, including goodwill, is taken into consideration.

(4) Liabilities.

(a) If the distributed property is subject to a liability, the fair market value of the property for this purpose is deemed to be no less than the amount of the liability. IRC 336(b).

(b) If the amount of the liability exceeds the value of the property that secures it, the distributing corporation will recognize gain in an amount equal to the excess of the liability over the adjusted basis of the property. Similarly, if the shareholders of the liquidating corporation assume liabilities of the corporation and the amount of liabilities assumed exceeds the fair market value of the distributed property, the corporation will recognize gain to the extent the assumed liabilities exceed the adjusted basis of the property. This rule may apply on a property-by-property basis which can result in gain on some property even if the overall corporate assets do not have liabilities in excess of fair market value.

(c) The rule is not intended to require that liabilities incurred by reason of the acquisition of the property that were not taken into account in determining the corporation's basis for that property be taken into account in determining the amount of gain or loss under IRC 336.

(d) IRC 336 does not necessarily affect the amount realized by, or basis of property received by, the shareholders of the liquidating corporation. IRC 331 continues to apply to the shareholders, triggering a net fair market value amount realized to those shareholders.

c. Exceptions to Recognition Treatment on Liquidating Sales and Distributions.

(1) Tax-Free Reorganizations - A liquidating corporation is not required to recognize gain or loss on distributions of property in connection with a tax-free corporate reorganization, to the extent that there is nonrecognition of gain or loss to the distributee with respect to such property. However, to the extent boot is received by the distributee-shareholders, IRC Section 336 may

require gain or loss recognition, unless some other exception applies (e.g., IRC 361). These rules need to be carefully considered.

(2) Liquidations of Controlled Subsidiaries - A liquidating corporation is not required to recognize gain or loss on distributions of property to an 80% corporate shareholder, but must recognize gain, but not loss, with respect to property distributed to a minority shareholder. However, the distributing corporation must recognize gain or loss with respect to property distributed to an 80% corporate shareholder which is a tax-exempt organization, unless the property is used by the organization in an unrelated trade or business immediately after the distribution. The distributing corporation will generally recognize gain or loss with respect to property distributed to an 80% shareholder which is a foreign corporation.

d. S Corporations.

(1) Generally, a corporate-level tax is imposed on any gain that arose prior to the conversion of a C corporation to an S corporation ("built-in" gain) and is recognized by the S corporation, through sale, distribution or other disposition within five (formerly ten) years after the date on which the S election took effect. IRC 1374(a).

(2) For purposes of the built-in gain rule, the term "disposition of any asset" includes not only sales or exchanges but other income-recognition events that effectively dispose of or relinquish the taxpayer's right to claim or receive income, including the collection of accounts receivable by a cash method taxpayer and the completion of a long-term contract performed by a taxpayer using the completed contract method of accounting.

(3) The total amount of gain that must be recognized by the corporation is limited to the lower of the recognized built-in gain of the corporation at the time of conversion to S corporation status or the amount which would be the taxable income of the corporation if the corporation were not an S corporation. Recognized net built-in gain for purposes of the built-in gain tax cannot be reduced by post-conversion, non-built-in losses. Built-in losses (pre S losses), however, reduce net built-in gains.

(4) Net unrealized built-in gain equals the fair market value of the corporation's assets at conversion over the basis of those assets at conversion. The amount of built-in gain is determined asset by asset. Valuation is extremely important at the time of conversion.

(5) Recognized gains on sales or distributions of assets by an S corporation are presumed to be built-in gains, except to the extent the taxpayer establishes that the appreciation accrued after the conversion, such as where the asset was acquired by the corporation in a taxable acquisition after the conversion or if the asset was not held by the corporation at the time of conversion. Recognized built-in losses are generally defined in the same manner as recognized built-in gains, but may be recognized only if the asset was held on the date of conversion and as of that date, fair market value of the asset was less than the adjusted basis of the asset.

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(6) Built-in gains are taxed at the maximum corporate rate applicable to the particular type of income (i.e., the maximum rate on ordinary income under IRC 11 or, if applicable, the alternative rate on capital gain income under IRC 1201) for the year in which the disposition occurs.

3. Buyer's Basis. The buyer generally has a cost basis for the acquired assets regardless of the amount of gain recognized by the Seller. Allocation of the purchase price to the various assets acquired in the transaction should be set forth in the purchase agreement. The failure to allocate may result in the disallowance of the allocation to one or both parties by the Internal Revenue Service. Such allocation will have to take into account the conflicting positions of the seller and buyer, in particular, with respect to goodwill and a covenant not to compete. Goodwill is taxable at capital gain rates and amortizable to the purchaser under IRC 197 over 15 years, while a covenant not to compete is taxable at ordinary income rates to the recipient of those payments and amortizable to the purchaser over the same 15 year period as goodwill.

a. Allocation of Purchase Price in Acquisitions of Assets.

(1) IRC 1060 requires the purchase price in an asset acquisition to be allocated among assets. In essence, to the extent that the purchase price paid exceeds the fair market value of the assets acquired, such excess will be characterized as purchase price for the acquisition of goodwill or going concern value (i.e., Residual Allocation Method).

(2) The residual method of allocation requires the purchase price for the assets to be allocated to four classes of assets in descending order as follows:

(a) First to Class I assets which consist of cash, demand deposits and similar accounts in banks and savings and loan associations.

(b) The price which exceeds the Class I allocation is allocated to Class II assets which are certificates of deposit, U.S. government securities, readily marketable stock or securities, and foreign currency in proportion to their fair market values at the beginning of the day after the acquisition date.

(c) The price which exceeds the Class I and Class II allocation is allocated to Class III assets in proportion to their fair market values at the beginning of the day after the acquisition date. Class III assets are all assets, both tangible and intangible, that are not included in Class I, II or IV assets, including account receivables and covenants not to compete.

(d) The remaining amount of the price is allocated to Class IV assets which are intangible assets in the nature of goodwill and going concern values. Thus, if a trade or business is purchased for a premium, the premium is allocated to goodwill. However, if the trade or business is purchased at a bargain price, no allocation is made to goodwill.

(3) Form 8594 must be filed by both buyer and seller.

4. IRC 197 provides that the adjusted basis of certain intangible property is amortized ratably over 15 years, beginning with the month in which such property is acquired by the taxpayer. Special Rules apply to acquisitions of covenants not to compete agreements and partnership interests (where an IRC 754 election to step up the basis of its assets is in effect).

V. TAX-FREE CORPORATE ACQUISITIONS (REORGANIZATIONS)

A. Overview. A corporate acquisition can be tax-free only if it is structured to fit within the reorganization provisions of IRC 368. IRC Section 368 is a definitional section only and the tax consequences of a reorganization are in turn governed by several other provisions of the IRC.

B. The details of a tax-free form of transaction will be deferred to another seminar program.

Section 1031 Like Kind Exchanges

Gregg A. Nathanson

U.S. INTERNAL REVENUE CODE
SECTION 1031 TAX DEFERRED LIKE KIND EXCHANGES

I. SECTION 1031 LIKE KIND EXCHANGE

A. What is a 1031 tax deferred like kind exchange under IRC 1031 (hereinafter a "1031 Exchange" or "Section 1031 Exchange)?

1. Transaction where property owner (the "Taxpayer") exchanges one property for another without incurring income tax on the gain.

2. Must structure transaction as "exchange" of one property for another, as opposed to the sale of one property and the purchase of another.

3. Tax on the transaction is ***deferred*** until some future date (i.e., when the newly acquired property is sold).

B. Why is the exchange "tax deferred"?

1. IRC 1031 authorizes tax deferred exchanges.

2. IRS says so and has provided detailed regulations.

C. What are advantages of a 1031 Exchange?

1. Dispose of property without incurring immediate tax liability.

2. Use tax deferred dollars in another investment.

3. "Interest free loan" from the IRS.

4. Tax deferred exchange becomes tax free exchange upon Taxpayer's death, since at death, Taxpayer's heirs receive property with basis "stepped up" to fair market value at time of death.

D. Are there any disadvantages of tax deferred exchanges?

1. Reduced basis in newly acquired property will result in more taxable gain when that property is sold.

2. Increased transactional costs, such as attorney fees, escrow fees and intermediary fees.

3. Taxpayer must apply proceeds from disposition of old property to acquisition of new property.

4. The IRC and IRS Regulations must be followed or the transaction will be subject to tax.

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E. What are the elements of a tax deferred exchange?

1. Both the "Relinquished Property" (the old property being disposed of) and the "Replacement Property" (the new property being acquired) must be either:

    a. Held for productive use in a trade or business, or

    b. Held for investment; and

2. The Relinquished Property and Replacement Property must be of "like kind"; and

3. The exchange must be a reciprocal transfer of properties as opposed to a sale and purchase.

F. Must both properties be held either for productive use in a trade or business or for investment?

1. Yes.

2. Consider the use of each property by the Taxpayer, not other parties to transaction.

3. Apply test at time of exchange (prior motives not controlling).

4. Note: 1031 is not available for property held "primarily for sale" by a Taxpayer who is a "dealer" in real estate. Whether property is held by that Taxpayer primarily for sale is a question of fact.

G. How long must Taxpayer hold Replacement Property?

1. The answer here, too, is a question of fact: did the Taxpayer intend to hold the Replacement Property for use in a trade or business or for investment, or merely resell it?

2. Two (2) years is generally a safe holding period.

3. Shorter holding periods may be acceptable, depending upon the Taxpayer's true intent at the time of the exchange.

4. Be careful on transfers to limited liability companies or S corporations after the exchange if Relinquished Property was not held in that entity.

H. What is "like kind"?

1. All real estate.

2. May trade improved real estate for unimproved real estate.

3. Personal property of the same kind or class.

4. May not trade real estate for personal property or personal property for a different kind of personal property.

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I. Must exchange occur at the same time?

   1. No.

   2. Delayed exchanges are acceptable ***IF*** all IRS requirements are satisfied.

J. What are the basic 1031 delayed exchange requirements?

   1. Use of Qualified (Exchange) Intermediary.

   2. 45 day identification period.

   3. 180 day completion period.

   4. Appropriate identification of properties.

   5. Appropriate documentation and implementation of exchange.

K. What is a Qualified Intermediary?

   1. An organization or individual that facilitates deferred exchange by contracting with Taxpayer to do the following:

      a. Acquire Relinquished Property from Taxpayer.

      b. Transfer Relinquished Property to Purchaser (IRC and IRS regulations permit Taxpayer to deed property directly to Purchaser).

      c. Receive and hold "sale" proceeds from Purchaser.

      d. Acquire Replacement Property from Seller.

      e. Disburse "purchase" proceeds to Seller.

      f. Transfer Replacement Property to Taxpayer.

   2. Taxpayer does not receive proceeds from the disposition of Relinquished Property; proceeds are paid directly to Qualified Intermediary, which uses proceeds to acquire Replacement Property.

   3. Most title companies have affiliates who act as exchange intermediaries, for a fee.

L. What is the 45 day identification period?

   1. Taxpayer has 45 days from disposition of Relinquished Property to identify Replacement Property.

   2. May identify up to three (potential) Replacement Properties without regard to fair market value ("Three-Property Rule") or any number of (potential) Replacement Properties as long as their aggregate fair market value does not exceed 200% of the fair market value of the Relinquished Property ("200% Rule").

3. Notice must be signed by Taxpayer and hand delivered, sent by certified mail, faxed or emailed to, and received by, Qualified Intermediary before end of 45 day period.

M. What is 180 day completion period?

1. Taxpayer must receive Replacement Property within 180 days of surrendering control of Relinquished Property, OR the date (including extensions) Taxpayer's tax return is due, whichever occurs first.

2. If exchange begins (i.e. Taxpayer surrenders Relinquished Property) after October 17, Taxpayer must extend tax return filing date beyond April 15 to avoid shortening 180 day period to complete exchange.

N. Generally, what type of documentation is required to satisfy 1031 requirements?

1. Purchase Agreement for Relinquished Property should reference the parties' intent to make transaction part of 1031 Exchange.

2. Purchase Agreement for Replacement Property should reference the parties intent to make transaction part of 1031 Exchange.

3. For deferred exchange, need Exchange Agreement with Qualified Intermediary.

4. Assignment of Purchase Agreement whereby Taxpayer assigns interest in Relinquished Property Purchase Agreement to Qualified Intermediary, and Purchaser of that property must consent to assignment.

5. Assignment of Purchase Agreement whereby Taxpayer assigns interest in Replacement Property Purchase Agreement to same Qualified Intermediary, and Seller of that property must consent to assignment.

6. Other documentation may be required, depending upon the specifics of the particular transaction.

O. Could exchange result in immediate recognition of gain?

1. Yes.

2. To avoid gain, Taxpayer must "trade even or up in equity and even or up in value."

3. To the extent Taxpayer receives money or other property, Taxpayer will have "recognized gain" or "boot".

4. Any errors in structuring, documenting or implementing the exchange could also cause the Taxpayer to recognize gain.

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II. NEW CONSTRUCTION EXCHANGE

A. What is a New Construction Exchange?

A New Construction Exchange is when a Taxpayer uses an intermediary to acquire title to Replacement Property, and the Replacement Property is improved before the Taxpayer takes title.

B. What is an example of a New Construction Exchange?

1. Taxpayer disposes of Relinquished Property for $1,000,000.

2. At closing, funds are paid to Qualified Intermediary.

3. Taxpayer identifies and uses Qualified Intermediary or Exchange Accommodation Titleholder (EAT) to acquire title to pre-improved Replacement Property, using $600,000 of the $1,000,000 of exchange proceeds.

4. IRS Rev. Proc. 2000-37, 2000-2 C.B. 308 and related rules permit EAT to acquire and hold title to Replacement Property, lease Replacement Property to Taxpayer and hire Taxpayer to manage construction of improvements.

5. Taxpayer, as construction manager, supervises improvement of Replacement Property. All $400,000 of exchange proceeds are used to pay contractors to make improvements.

6. EAT deeds improved Replacement Property to Taxpayer within 180 days after Taxpayer closes on disposition of Relinquished Property.

7. If EAT takes title to Replacement Property using single member limited liability company, Taxpayer can acquire title to the Replacement Property indirectly by acquiring 100% of the membership interests of EAT.

C. The 45 day notice should identify the Replacement Property together with all anticipated newly constructed improvements.

D. The key date is when the Taxpayer takes title to Improved Replacement Property. Therefore, look to the value in place on the date the Taxpayer acquires title to improved Replacement Property.

III. REVERSE EXCHANGE

A. What is a 1031 "Reverse" Exchange?

1. Transaction where property owner (Taxpayer), in effect, acquires "Replacement" Property before disposing of "Relinquished" Property.

2. In other words, the Taxpayer can buy first, then sell.

B. How does taxpayer do a Reverse Exchange?

1. IRS Rev. Proc. 2000-37 provides safe harbor for Reverse Exchanges to qualify under Section 1031. Taxpayer must comply with its technical requirements.

2. Taxpayer must contract with an Exchange Accommodation Titleholder ("EAT") by entering into a Qualified Exchange Accommodation Arrangement ("QEAA") for purposes of holding the property and meeting other requirements of Rev. Proc. 2000-37.

C. What are the requirements of a QEAA?

1. The EAT must hold qualified indicia of ownership of the property at all times from the date of acquisition by the EAT until the property is transferred to the Taxpayer. Qualified indicia of ownership means legal title to the property, or other indicia of ownership so that the EAT is treated as beneficial owner of the property for legal and tax purposes.

2. When the EAT acquires title, it must be the Taxpayer's bona fide intent that the property be held by the EAT as either Replacement Property or Relinquished Property in a transaction intended to qualify as a Section 1031 Exchange.

3. Within 5 business days after the EAT acquires the property, the Taxpayer and the EAT must enter into a written agreement (QEAA) confirming that the EAT is holding the property for the benefit of the Taxpayer in order to facilitate a Section 1031 Exchange under Rev. Proc. 2000-37 and that the Taxpayer and EAT will report the acquisition, holding and disposition of the property accordingly.

4. The Taxpayer must identify the Relinquished Property within 45 days after the EAT acquires the Replacement Property. The Taxpayer may identify alternative and multiple properties, just like with a "straight" Section 1031 Exchange.

5. Within 180 days after the EAT acquires the property:

    a. The property must be transferred to the Taxpayer as Replacement Property; or

    b. The property must be transferred to an unrelated person as the Relinquished Property.

D. What permissible arrangements fall within the safe harbor?

1. Rev. Proc. 2000-37 provides for a number of permissible agreements which will not, in and of themselves, defeat the exchange.

2. The EAT may enter into an exchange agreement with the Taxpayer and serve as the Qualified Intermediary in a simultaneous or tax-deferred exchange.

3. The Taxpayer may guarantee some or all of the obligations of the EAT, including secured or unsecured debt incurred to acquire the property.

4. The Taxpayer may indemnify the EAT against costs and expenses.

5. The Taxpayer may loan funds to the EAT.

6. The Taxpayer may guarantee repayment of a third party loan to the EAT.

7. The Taxpayer may lease the property from the EAT.

8. The Taxpayer may manage the property, supervise improvements of the property, act as a contractor, or otherwise provide services to the EAT with respect to the property.

9. The Taxpayer and the EAT may enter into agreements relating to the purchase or sale of the property, including puts and calls at fixed or formula prices, for a period not exceeding 185 days from the date the EAT acquires the property.

E. Can there ever be a reverse, New Construction Exchange?

Yes, with proper planning.

IV. <u>SECOND OR VACATION HOMES</u>

Can a second or vacation home ever qualify for 1031 Exchange treatment?

A. IRS Rev. Proc. 2008-16, 2008-1 C.B. 547 provides a safe harbor for determining when a second or vacation home qualifies as property held for productive use in a trade or business or for investment, for purposes of a Section 1031 Exchange.

1. IRC 1031 provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment (Relinquished Property), if the property is exchanged solely for property of like kind that is to be held either for productive use in a trade or business or for investment (Replacement Property).

2. The IRS has made clear that a "personal residence" is not property held for productive use in a trade or business or for investment and, therefore, cannot qualify as part of a Section 1031 Exchange. Rev. Proc. 2005-14, 2005-7 I.R.B. 528; *Starker v United States*, 602 F.2d 1341, 1350 (9th Cir. 1979); and *Moore v Commissioner*, T.C. Memo. 2007-134.

3. Rev. Proc. 2008-16 provides Taxpayers with a safe harbor under which a dwelling unit will qualify as property held for productive use in a trade or business or for investment under Section 1031 even though a Taxpayer occasionally uses the dwelling for personal purposes.

B. What are Qualifying Use Standards for "Relinquished Property"?

1. The dwelling unit must be owned by the Taxpayer at least 24 months immediately before the exchange (the "qualifying use period"); and

2. Within the qualifying use period, in each of the two 12-month periods immediately preceding the exchange:

   a. The Taxpayer rents the dwelling unit to another person(s) at a "fair rental" for 14 days or more, and

   b. The period of the Taxpayer's personal use of the dwelling does not exceed the greater of 14 days or 10% of the number of days during the 12-month period that the dwelling unit is rented at a fair rental.

C. What are Qualifying Use Standards for "Replacement Property"?

1. The dwelling unit must be owned by the Taxpayer for at least 24 months immediately after the exchange (the "qualifying use period"); and

2. Within the qualifying use period, in each of the two 12-month periods immediately after the exchange:

   a. The Taxpayer rents the dwelling unit to another person(s) at a fair rental for 14 days or more, and

   b. The period of the Taxpayer's personal use of the dwelling does not exceed the greater of 14 days or 10% of the number of days during the 12-month period that the dwelling unit is rented at a fair rental.

D. How is personal use defined?

Personal use is defined in IRC 280A(d)(2) and includes use by the Taxpayer, the Taxpayer's family or a co-owner. Family includes Taxpayer's spouse, brothers, sisters, ancestors and lineal descendants. There is an exception if a family member rents the property at fair market value *and* the family member uses the property as his or her principal residence.

E. How is fair rental value determined?

Fair rental is determined based on all the facts and circumstances that exist when the rental agreement is entered into.

F. Any other considerations?

A Taxpayer utilizing this safe harbor must also satisfy all other requirements for a Section 1031 Exchange.

G. Even if a vacation property does not fall squarely within the safe harbor provided by Rev. Proc. 2008-16, it is still possible for a Taxpayer to establish that the property qualifies under Section 1031 as property held for productive use in a trade or business or for an investment.

When to Tell Your Client to Call A Lawyer

Mark S. Frankel

WHEN TO TELL YOUR CLIENT TO CALL A LAWYER

I. AN OUNCE OF PREVENTION

Clients are often their own worst enemies. They come to you to help them build wealth, and often because of their success, they think they can solve their own problems. In an attempt to save a few hundred dollars, they fail to consult an attorney when doing so could save tens of thousands of dollars later. A client may think the only time one needs a lawyer's help is if they are being sued or they need to sue someone, but that is not the case. Sometimes a lawyer's expertise can also come in handy if they are trying to protect their rights. As you are often a friend and confessor, you have the opportunity to advise a client when to call for help.

II. WHEN TO REFER YOUR CLIENT TO COUZENS LANSKY

A. Any time it might involve handcuffs.

An incident of driving under the influence or domestic violence; accusations of any kind of criminal behavior, including white collar crime or tax fraud, should send your client straight to a lawyer.

B. When the client has been threatened or sued.

Some telltale signs you need to engage a lawyer are when someone is threatening to sue you (like a neighbor or a business contact), when you are being asked to sign something where you are giving up your rights or accepting money (other than an iTunes agreement), when you receive something official in the mail from a law office or court, or when you want to change the terms of something that is already written down (like a contract to do business, or the terms of a custody agreement, etc.).

C. Personal injury.

You may have bought a house that is causing you asthma from hidden mold, been in a car accident, or had a child's friend seriously injured playing on your backyard trampoline. Don't depend on your insurance company to fight your battle, unless they are hiring a lawyer for you. Even then, you may need a separate lawyer.

D. Employment issues.

1. As employer.

An employer should have a good relationship with an employment lawyer from the date the employer first hires someone not related to the employer. Having the right procedures in place, including employee manuals, etc., is good business. When an employee is not working out, it is a good idea to consult with an employment lawyer to be sure that any separation is handled properly.

2. As employee or former employee.

If there has been a long standing employment relationship which has been suddenly terminated, particularly just before a large bonus or stock options become due, call a lawyer. If your client's work place is uncomfortable and your client is feeling harassed, the client should call a lawyer.

E. Estate planning.

No estate plan is simple enough to do over the Internet, as much as those late night TV ads would like to convince you otherwise. Your clients typically have no idea what they do not know when it comes to drafting enforceable and effective estate planning documents. I have spent too much of my career fixing what people thought were simple estate plans that they did using a form or the Internet. The financial well-being of your client's heirs, especially minor children, is too important to risk simply to save a few dollars. This will be money well spent, even if your client will not be alive to appreciate it.

F. Estate and trust administration.

There are websites that purport to be able to walk you through the steps to administer an estate. Again, your clients have no way of knowing what the website is not telling them. There may be federal estate tax returns; trust or estate income tax returns; and various notices to file. Money saving tax elections may need to be filed. Not handling them properly could open your client to personal liability. Call an expert.

G. Contract formation.

Where long-term commitments and large sums of money are involved, such as buying or selling a house, a business, a book, a screenplay, or an idea, call a lawyer who specializes in that kind of contract.

III. WHO SHOULD YOUR CLIENT CALL?

Couzens Lansky, of course. While you may not realize it, Couzens Lansky is a full service law firm. We have lawyers who can address nearly every legal need your clients are likely to encounter. Aside from the estate and tax planning attorneys you are familiar with, Couzens Lansky has a complete array of corporate, banking, tax, real estate, intellectual property, estate, commercial litigation, personal injury and divorce lawyers. We also maintain relationships with trusted attorneys outside the firm to address issues outside our area of expertise.

IV. BE PREPARED

Clients are sensitive to fees. Attorneys bill by the hour. Litigators want to focus on salient issues.

A. Be honest and bring everything to the table.

Lay all your cards on the table. Rule number one is to be honest and truthful. Conversations with lawyers are legally protected, which means now is not the time to hold back. When your lawyer says "tell me everything," the lawyer means it.

B. What your lawyer needs to hear from you.

Make sure to tell your story chronologically, completing every thought before moving on to the next. Your lawyer needs to understand the events you are describing or your situation as close to how they happened as possible. Jumping forward and back in time or going off on tangents is confusing, and may lead to an important detail being overlooked. Be specific, but avoid using legal terminology unless you absolutely know what you are talking about (for example, don't call something a "contract" or a "deed" unless you are certain it was, legally).

C. Communicate effectively: It saves you both time and money.

It is critical to come prepared as well. After all, you are likely paying for the lawyer's time, so it is important to make the most of it. Your lawyer will understand this too. If you have been sued, or subpoenaed, or searched, or arrested, you have almost certainly received some papers. What court is this in? Is it civil or criminal (that means are you being charged with a crime by the government or sued by someone for money)? Does it say "Circuit Court" or "United States District Court" or what? Be as familiar as you possibly can with the papers, and have them in front of you when you call. If you do not have the ability to fax or scan documents to get them to the lawyer, figure out ahead of time how you will do so, by going to Kinko's or a friend's house or something. Make an outline of what you want to discuss with your lawyer before you meet with them, and what information you would like to get out of the conversation by the time it is over. Send it to your lawyer ahead of time so you are both on the same page, and if you have any relevant documents, scan and email those too.

V. <u>WHEN TO CHILL INSTEAD</u>

A. When it is "a matter of principle."

B. When a neighbor has planted a hedge on the property line or has a tree hanging over the fence.

C. When a client has been fired for no apparent reason after a brief stint on the job.

D. When a contractor goes over budget.

E. When someone has written something about the client that the client finds offensive.

Latest Developments in Prenuptial Agreements

Phillip L. Sternberg

MARRIAGE FROM BEGINNING TO END
PRENUPTIAL AGREEMENTS, DIVORCE LITIGATION,
POST DIVORCE ISSUES

I. INTRODUCTION

Over half of all marriages end in divorce. People are living longer and the old-time stigma of divorce is, for the most part, gone. More than ever, people are marrying with hopes for the best, but recognizing the possibility of the worst. With these realizations, planning, not only for a life together, but for divorce and a life apart, is becoming a commonplace occurrence. Everyone involved in these areas will need increasing assistance from professional planners, C.P.A.s and attorneys.

II. PRENUPTIAL AGREEMENTS ARE ENFORCEABLE IN DIVORCE (sort of)

A. Prenuptial Agreements have been around forever, but only recently have been recognized as enforceable in divorce. By statute, they have been recognized in Michigan since at least 1855.

1. Michigan Compiled Laws ("MCL") §557.28 provides: "A contract relating to property made between persons in contemplation of marriage shall remain in full force after marriage takes place."

2. A Prenuptial is generally enforceable by statute for estate planning purposes.

3. Public policy changed in 1991 when the Michigan Court of Appeals ruled Prenuptial Agreements are enforceable in the event of divorce.

B. Michigan is a "No-Fault" divorce state:

1. This simply means, "if you want a divorce, you can get one, regardless of whether or not there is fault."

2. When dealing with issues of property division and spousal support, traditional notions continue to control. Nine factors must be considered by the trial judge (*Sparks v Sparks,* 440 Mich 141 (1992)):

a. Duration of the marriage;

b. Contribution of parties to marital estate;

c. Age of the parties;

d. Health;

e. Life status of the parties;

f. Necessities and circumstances of the parties;

g. Earning abilities;

h. Past relationships and conduct; and

i. General principals of equity.

C. In 1991 the Michigan Court of Appeals, in the case of *Rinvelt vs. Rinvelt,* 190 Mich App 372 (1991), adopted a test for determining the validity of a Prenuptial Agreement which was first set down in a case before the Alaska Supreme Court, *Brooks v Brooks*, 677 P.2d 1230, 1231, 1234 (Alaska 1984). If a Prenuptial Agreement meets the requirements of the test, it will be honored by a divorce court.

Three part test for validity.

1. Was the agreement obtained through fraud, duress, mistake, misrepresentation or nondisclosure of a material fact?

2. Was the agreement unconscionable when executed?

3. Have the facts and circumstances changed since the agreement was executed, so as to make its enforcement unfair and unreasonable?

D. Disclosures must be thorough, complete and accurate.

1. This will be the most challenged aspect.

2. Financial disclosures should be made with the same degree of detail as any other business transaction. If possible, C.P.A.s and financial consultants should assist. Consider the use of professional, impartial appraisers for business interests, real estate and any other assets without a readily ascertainable fair market value.

3. Disclosures should be compatible with financial disclosures and valuations contained in applications for financing, buy-sell agreements and others which are relevant and contemporaneous.

4. More is generally better. If there is doubt as to value, the Prenuptial Agreement is less likely to be set aside if the value of an asset has been overstated rather than understated. However, in some cases the Prenuptial Agreement was challenged on the basis that the assets were overstated.

E. The execution of the Prenuptial Agreement must be free from duress.

1. Avoid, whenever possible, last minute signings.

2. It is strongly recommended that parties be represented by separate counsel.

3. For those who refuse to use an attorney, strong written warnings should be given.

4. Other than time, are there any other circumstances involved which a court could consider as duress? Is the woman pregnant? What are the relative ages of the parties? What is the health of the parties?

F. Fairness at the time of the divorce is viewed from a standpoint of foreseeability. ". . . the benefit accruing to one party from the disparate growth of his assets is simply not a

changed circumstance rendering the agreement unfair and unreasonable to enforce." *Reed vs Reed* 265 Mich App 131 (2005).

G. If a Prenuptial Agreement is thrown out by a court, traditional divorce considerations will determine property distribution and spousal support.

H. *Allard v Allard*, 318 Mich. App. 583 (2017) decided this year by the Court of Appeals impacts the protections of Prenuptial Agreements.

  1. The Court cannot be divested of its equitable power to determine whether spousal support should be awarded.

  2. The Court cannot be divested of its equitable power to invade the separate property of the parties.

  3. Does not mean the terms of a Prenuptial Agreement won't be followed, but definitely empowers the Court to make a determination as to whether the terms should be followed, regardless of whether there were unforeseeable changes in circumstances.

  4. Legislation is being introduced which if passed, may reverse *Allard.*

III. <u>ESTATE PLANNING AND THE PRENUPTIAL AGREEMENT</u>

A. Prenuptial Agreements have traditionally been enforceable for estate planning purposes.

B. Generally, a Prenuptial Agreement will set forth estate planning minimums which each spouse is entitled to receive in the event of the other's death.

  1. A Prenuptial Agreement is not an estate plan itself, but will be viewed as a contract to make or change an estate plan or Will.

  2. The planning process involving a Prenuptial Agreement is an appropriate time to have the parties review, update and change existing estate planning documents.

  3. A Prenuptial Agreement can be disregarded as to eligibility for Medicaid.

  4. Consider insurance.

C. A word of warning - The same tests for validity might be applied by a court when considering the enforcement of the terms of a Prenuptial Agreement upon death as with divorce. Attempting to completely disinherit a spouse could result in an unenforceable agreement and distribution through statutory election (IRC 682 Trusts for special divorce situations).

IV. DIVORCE: THE ODDS PREVAIL, NOW WHAT?

A. Once divorce is inevitable, in all but the simplest cases, the assistance of knowledgeable, experienced attorneys, C.P.A.s and financial planners is essential.

1. Experts are needed to provide information and opinions regarding all assets in the marital estate:

a. Real property;

b. Personal property;

c. Business interests;

d. Stocks, bonds, pension and profit sharing plans; and

e. Licenses and degrees are even being given values for determining issues of property settlement and support.

2. The tax consequences and tax impact on values of property and rights to be received in a divorce settlement or judgment need analysis.

B. C.P.A.s and financial planners who have worked throughout the marriage for both parties can expect to be subpoenaed to provide records and/or testimony, including validating disclosures made on Prenuptial Agreements.

C. Personal Financial Strategies.

1. What should it take to maintain this person's reasonable lifestyle after divorce?

2. Developing a financial strategy for the nonearning spouse is important.

3. How can an income stream be provided, without consuming the principal assets awarded?

a. Income generating asset.

b. Spousal support in addition to non-income producing assets.

c. Annuities?

V. DIVORCE JUDGMENTS--INSURING FOR THE FUTURE

Every judgment of divorce is required, by its terms, to extinguish all existing beneficiary rights to insurance, testamentary, decedent and trust distributions of the now ex-spouse.

A. Distributions upon death designated to the ex-spouse will lapse and the property can go into a probate estate.

B. All previously executed estate planning documents must be reviewed and amended.

   1. New beneficiary designations are necessary.

   2. Rethinking tax consequences due to a change in marital status is appropriate.

C. Extinguishment of insurance rights created during the marriage does not bar creation of new rights post judgment.

D. Whether provided for in the judgment or not, life and disability insurance should be considered to continue income flow in the event of the payor spouse's death or disability while obligated to provide child and/or spousal support.

E. Annuities and other devices utilized traditionally for structured settlements may be viable options to provide for automatic and continued payments of child support and spousal support. However, child support always remains modifiable depending on circumstances and modifications in spousal support are dependent on the terms of the judgment.