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TAX LAW FOCUS

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During 2002, a number of important laws were enacted. On March 9, 2002, President Bush signed the Job Creation and Worker Assistance Act of 2002 (the "***Job Creation Act***"). On July 30, 2002, the President signed the Sarbanes-Oxley Act of 2002 (the "***Sarbanes Act***"). The Job Creation Act represents a final compromise between Democrats and Republicans over the appropriate economic response to the terrorist attacks of September 11, 2001. The Sarbanes Act was enacted in response to the highly publicized financial failures of a number of large publicly traded corporations. The Sarbanes Act is primarily intended to protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the federal securities laws. The Sarbanes Act also contains provisions that impact taxpayers and their advisors. This issue of the Tax Law Focus discusses a number of the changes made by the Job Creation and Sarbanes Acts. Also included in this issue are other selected current tax topics which might be of interest to you. Our Tax Department is ready to help you with specific questions relating to the impact of the Job Creation Act, the Sarbanes Act, the other tax topics discussed below, or any of your tax law needs.

In this issue of the Tax Law Focus we are also pleased to announce that Alan Valade has been named chair of the Tax Department. His predecessor, Roger Cook, is returning to the full time practice of law in the Tax Department. Mr. Cook remains a member of our firm's Board of Directors. We are also pleased to announce that June Summers Haas has joined our firm as a partner in the Tax Department. Ms. Haas has come to us from her position as Commissioner of Revenue for the State of Michigan. Before acting as Commissioner of Revenue for the State of Michigan, she practiced law in San Francisco and served as Director of the National Nexus Program of the Multistate Tax Commission in Washington, D.C.

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THE JOB CREATION AND WORKER ASSISTANCE ACT OF 2002

Special Depreciation Allowance for Qualified Property

Under the Job Creation Act, taxpayers are entitled to an additional first-year depreciation deduction equal to 30% of the adjusted basis of qualified property. The 30% extra depreciation is allowed for regular and alternative minimum tax purposes for the tax year in which the property is placed in service. Taxpayers are allowed to elect out of the 30% additional first-year depreciation for any class of property for any tax year.

Property eligible for this special treatment generally includes: (1) property which has a

recovery period of 20 years or less; (2) depreciable (and not amortizable) computer software; (3) water utility property; and (4) qualified leasehold improvements. A qualified leasehold improvement is any improvement to an interior portion of a building which is nonresidential real property, if: (1) the improvement is made under or pursuant to a lease (as defined under certain provisions of the Internal Revenue Code), either by the lessee, sublessee or the lessor of the building portion; (2) the portion of the building is to be occupied exclusively by the lessee (or any sublessee); and (3) the improvement is placed in service more than three years after the date the building was first placed in service. A qualified leasehold improvement does not include any improvement for which the expenditure is attributable to enlargement of the building, any elevator or escalator, any structural component benefiting a common area or the internal structural framework of the building.

Property must generally be acquired after September 10, 2001, and before September 11, 2004. Original use of the property must begin with the taxpayer after September 10, 2001, and the property must generally be placed in service before January 1, 2005. The basis of the property and the depreciation allowances for the year of purchase and subsequent years must be adjusted to reflect the extra first-year depreciation deduction.

Five-Year Carryback of Net Operating Losses

Taxpayers can generally carry back a net operating loss ("***NOL***") two years and forward 20 years. For certain qualifying losses, such as casualty losses of an individual, the carryback period is three years. Unless the taxpayer elects to forego the carryback, the entire NOL for a tax year is carried back first to the earliest tax year to which, under the carryback rules, it could be carried, then to the next earliest, and so on in chronological order until it is absorbed.

The Job Creation Act temporarily extends the general two-year carryback period to five years for NOLs for tax years ending in 2001 and 2002. This five-year carryback period also applies to qualifying losses eligible for the three-year carryback period.

A taxpayer may elect to have the carryback period for the loss year determined without regard to the temporary five-year carryback period under the Job Creation Act. The election must be made by the due date (including extensions) for filing the taxpayer's return for the tax year of the NOL. Once the election is made for a tax year, the election is irrevocable for that year.

Cancellation of Indebtedness of an S Corporation

In *Gitlitz v. Commissioner*, 531 U.S. 206 (2001), the U.S. Supreme Court held that excluded cancellation of debt income of an insolvent S corporation is an item of income that passes through to the corporation's shareholders increasing their stock basis, and that the passthrough of that income occurs before the reduction of the S corporation's tax attributes under IRC §108(b). This allowed for the passthrough of otherwise suspended corporate losses to S corporation shareholders.

The Job Creation Act reverses the *Gitlitz* decision by expressly providing that excluded cancellation of debt income is not an item of income to an S corporation shareholder. Consequently, an S corporation shareholder's basis is not increased as a result of excluded cancellation of debt income.

This rule under the Job Creation Act applies to cancellations of debt after October 11, 2001 in tax years ending after that date. This rule, however, does not apply to any cancellation of debt before March 1, 2002 under a reorganization plan filed with a bankruptcy court before October 12, 2001.

IMPACT OF SARBANES-OXLEY ACT OF 2002 ON BROKER-ASSISTED CASHLESS STOCK OPTION EXERCISES

by Jeffrey Hyman

Section 402 of the Sarbanes Act amended section 13 of the Securities Exchange Act of 1934 (the "***Exchange Act***") to generally prohibit any issuer from directly or indirectly, including through any subsidiary, extending credit or arranging for the extension of credit in the form of a personal loan to or for any director or executive officer. There has been substantial concern and uncertainty whether this loan prohibition, which became effective on the July 30, 2002 date of enactment of the Sarbanes Act, precludes broker-assisted cashless exercises of stock options by directors and executive officers. Neither section 402 of the Sarbanes Act nor the underlying legislative history address the issue, and official guidance on the provision is not expected any time soon.[1]

Exercise Mechanics

The mechanics of broker-assisted cashless exercises generally are as follows: The optionee delivers to the issuer a notice of exercise together with instructions that the issuer deliver the option shares to the broker against payment by the broker of the exercise price and the withholding tax due in connection with the exercise. At the same time (commonly referred to as "T"), the optionee instructs the broker to sell at least enough of the option shares to fund payment of the exercise price and withholding tax. When the trade settles (generally three business days later, commonly referred to as "T+3"), the broker delivers the proceeds of sale of the shares to the issuer and the issuer delivers the option shares to the broker.

Depending upon the terms of the option plan and the practices of the parties, there can be and are variations of these mechanics. In some cases, for example, the broker advances the exercise price and withholding tax to the issuer on T, in which case the broker reimburses itself out of the proceeds of sale of the shares on T+3. Sometimes the issuer deposits the option shares with the broker prior to the time it receives payment from the broker of the exercise price and withholding tax. In some cases, moreover, the option shares are held in an account with and not actually sold by the broker, with the exercise price and withholding tax being paid to the issuer by means of a loan by the broker against the security of the shares or other securities of the optionee held at the broker.

Some issuers recommend specific brokerage firms through which optionees can effect the exercise, while other issuers reserve the right to approve brokerage firms selected by optionees, and yet other issuers require the use of one or more brokerage firms selected by the issuer. In order for the broker to execute the transaction in a cash account (or utilize the option shares as collateral in a margin account) and to avoid net capital charges, the broker must verify that the issuer will promptly deliver the option shares.[2] To satisfy this requirement, brokers generally request from the issuer (i) an acknowledgement that it has received from the optionee the notice of exercise and instructions to deliver the shares to the broker, (ii) an agreement to comply with those instructions, and/or (iii) a representation that the notice of exercise and instructions and the overall procedure comply with the terms of the option plan and agreement.

Extension of Credit / Arranging

A broker-assisted cashless exercise could be construed to entail an extension of credit by the issuer to the optionee (in violation of the Sarbanes Act section 402 loan prohibition if the optionee is a

director or executive officer). This could be the case where the issuer deposits the option shares with the broker prior to payment by the broker of the exercise price and withholding tax. Moreover, the obligation to withhold tax for deposit on the next withholding tax deposit date may be considered to arise on the date the optionee delivers notice of exercise to the issuer (T), possibly giving rise to an extension of credit by the issuer to the optionee if the broker does not pay the withholding tax to the issuer until T+3. However, the obligation to withhold and deposit tax is actually a direct obligation of the issuer and not an obligation of the optionee being satisfied by the issuer.

Certain variations of the procedure would appear to entail an extension of credit by the broker to the optionee (in violation of the Sarbanes Act section 402 loan prohibition if the issuer is considered to have arranged the extension of credit and if the optionee is a director or executive officer). The broker seems to extend credit where it pays the exercise price and withholding tax to the issuer on T but does not receive the shares and proceeds from their sale until T+3. Even where the broker does not pay the exercise price and withholding tax until it has received the shares and proceeds from their sale on T+3, its execution of the order to sell the shares on T could be viewed as an extension of credit to the optionee because, if the issuer fails to timely deliver the shares, the broker must obtain them from another source in order to settle the trade.

The Sarbanes Act does not define the terms "extension of credit" or "arrange," rendering it uncertain whether broker-assisted cashless option exercises by directors or executive officers violate the Sarbanes Act section 402 loan prohibition. The identical terms appear in Exchange Act sections 7 (relating to margin) and 11(d) (relating to credit on new securities in distribution) and have been interpreted very broadly for purposes of those provisions. However, the policies underlying Exchange Act sections 7 (to protect the securities markets and participants therein from the risks of over-leveraging and speculation) and 11(d) (to deter share pushing) support very broad interpretation of those terms.

By contrast, the transactions motivating enactment of (and the apparent policy underlying) the Sarbanes Act's loan prohibition appear fundamentally different, arguably supporting a more narrow interpretation of the terms "extension of credit" and "arrange." The Sarbanes Act's loan prohibition was in response to very substantial, well-publicized loans to a number of executive officers and directors of certain identified issuers which were made without adequate credit analysis, often forgiven and otherwise not based on arm's-length terms and conditions. These transactions entail inherent conflicts of interest, jeopardizing the issuer and its shareholders.[3] These concerns do not appear present in the case of broker-assisted cashless exercises, which entail little or no risk to the issuer and its shareholders and are generally available to all optionees on the same terms.

Moreover, when and if there is an extension of credit, it is generally for no more than three days, which is the minimum period necessary to consummate a transaction in the ordinary operation of the securities markets. This is arguably analogous to an optionee exercising an option by delivery of a personal check, which is treated as a cash exercise even though the check will take several days to clear and despite the risk that the optionee may have insufficient funds in his bank account to cover the check. In this regard, it should be noted that, notwithstanding their very broad interpretations, the margin rules provide an exception expressly permitting broker-assisted cashless exercises on the same basis as cash transactions not involving an extension of credit.[4]

If there is an extension of credit by the broker, the issuer arguably has not "arrange[d]" it, if the term is given its ordinary meaning. Comfort provided by the issuer to enable the broker to verify prompt delivery of the option shares, in one or more of the ways discussed above, appears to merely entail ministerial action upon which utilization of the exercise procedure is conditioned. Involvement by the issuer in selection of the broker (to ensure selection of a broker administratively competent to handle the exercise procedure, to facilitate compliance with the Sarbanes Act section 403 accelerated reporting requirements, or for other purposes consistent with the policies underlying the Sarbanes Act) ought not to constitute arrangement by the issuer of an extension of credit by the broker. However, there could well be arrangement concerns if the issuer required (or even recommended) use of a broker which performs investment banking services for the issuer, evaluates the performance of the issuer and its stock, or has other involvement with the issuer.

Conclusion

Based on the above discussion, there appear to be convincing reasons why broker-assisted cashless stock option exercises by directors and executive officers should not violate the loan prohibition imposed by section 402 of the Sarbanes Act. Nevertheless, until official guidance is available and uncertainties relating to the prohibition are resolved, it would be prudent for issuers desiring to continue making this exercise procedure available to directors and executive officers to structure it in a manner least likely to run afoul of the prohibition. In this regard, structuring the procedure so that the issuer does not deliver the option shares to the broker until T+3, against simultaneous payment by the broker of the exercise price and withholding tax from proceeds of sale of the shares, appears least likely to constitute an extension of credit. Moreover, the issuer is least likely to be considered to arrange any extension of credit if its involvement in selection of the broker is limited to recommending several administratively competent brokers with whom the issuer had no other relationship. As a final point, this type of distinguishing between the technical variations of broker-assisted cashless exercises further supports treating all variations as permissible because they all serve the same purpose of enabling optionees to realize the value of their options by bridging the practical problems of attempting to settle two transactions at or about the same time.

[1] There are, of course, forms of cashless option exercise other than the broker-assisted exercises discussed herein, such as payment of the exercise price and withholding tax (i) by the optionee turning in already-owned shares or issuance by the issuer of a net number of shares (which should not violate the Sarbanes Act's loan prohibition), and (ii) by the optionee issuing a promissory note to the issuer (which would appear to violate the Sarbanes Act's loan prohibition).

[2] Section 220.3(e)(4) of Regulation T, and Rule 15c3-1 as interpreted by the Commission.

[3] That avoiding such conflicts of interest is a fundamental policy underlying the Sarbanes Act section 402 loan prohibition is evidenced by the fact that the provision is entitled "Enhanced Conflict of Interest Provisions" and that Senator Feinstein, a principal drafter of the provision, discussed conflicts of interest in the deliberations over the provision on the Senate floor.

[4] As indicated above, Sarbanes Act section 402 prohibits an issuer from making or arranging an extension of credit "in the form of a personal loan" to or for a director or executive officer, indicating that not all extensions of credit made or arranged by an issuer to or for a director or executive officer are prohibited.

OTHER SELECTED CURRENT TAX TOPICS

Michigan State Tax Legislation Enacted in 2002

by June Summers Haas

For a year in which there was no budget surplus, a surprising number of tax bills moved through the Michigan legislature and were signed by Governor Engler before his departure on December 31, 2002. This year twenty-five state tax bills became law. The vast majority of the bills make administrative or procedural changes. However, a number of new tax exemptions, incentives and budget enhancements were enacted. This article reviews the major state tax bills that were enacted in 2002.

Budget Enhancements. In late spring 2002, the State found itself in budgetary troubles again. General fund revenues were approximately $353 million behind target. The State's tax solutions were the enactment of Public Acts ("***P.A.***") 243 and 244, which moved up the collection date of the state education tax from December 2002 to August 2002. The summer 2002 tax levy effectively moved the tax revenues into the State's 2002 fiscal year. Also enacted was a 75¢ increase on cigarettes. This gave Michigan the 15th highest cigarette tax rate in the country.

<u>Single Business Tax</u>

Acceleration of SBT Phase-Out. As part of the agreement to resolve the budget crisis in late July 2002, the phase-out of the Single Business Tax ("***SBT***") was accelerated from its prior end date of 2020 to December 31, 2009. The gross receipts filing threshold for the SBT was also increased to $350,000 from $250,000 effective for tax years beginning after December 31, 2002.

Gross Receipts Redefined. In late 2000 the Michigan Department of Treasury backed a bill redefining "gross receipts" from its fairly narrow "sales" definition to an expansive definition covering the entire income of a taxpayer unless specifically exempted. The change was effective for tax years beginning on or after January 1, 2001 and many gross receipts taxpayers were shocked at the increases in their SBT tax bills. Because of the concerns of business taxpayers, in late 2002 the legislature, in P.A. 606, rewrote the definition of "gross receipts" to include new exemptions. However, because the Department of Treasury believes that the changes will decrease SBT revenues, the changes are not effective until October 1, 2003 (the start of the 2004 fiscal year for the State). Under P.A. 606, gross receipts will exclude the following: (1) proceeds from a transfer of accounts receivables if the underlying sale was included in gross receipts for federal purposes (Dealers in receivables do not get this exemption); (2) proceeds from original issue of stock or equity; (3) proceeds from an original issue of debt instruments; (4) proceeds from returned merchandise; (5) proceeds from cash, in-kind or trade discounts; (6) proceeds from federal, state or local tax refunds; (7) proceeds from security deposits; (8) proceeds from the principal portion of loans; (9) the value of property received in a like-kind exchange; (10) proceeds from a sale, transaction, exchange, involuntary conversion or other disposition of a capital asset or land other than the gain included in federal taxable income (The federal taxable gain is still included in gross receipts); and (11) proceeds from an insurance policy, claim settlement or civil action judgment other than those amounts included in federal taxable income.

These changes mean that many gross receipts taxpayers (who have increased tax bills for 2001 and 2002) will see a substantial decrease in their SBT tax liability for 2003. In addition, the change

in the definition may make the difference between exceeding the SBT filing threshold or not for many taxpayers.

Leased Officers and Employees. Effective December 31, 2003, the salaries of officers and employees leased from a professional employer organization ("***PEO***") no longer need to be included in the SBT base of the operating entity. Such salaries are appropriately reported in the tax base of the PEO. P.A. 603 reversed the decision in the *Bandit Industries* case and the Department of Treasury's published position in Letter Ruling 2002-4. Under the new law, a PEO is defined as "an organization that provides the management and administration of the human resources and employer risk of another entity" by entering a professional employer agreement under which the PEO becomes the employer of the officers or employees and (1) maintains the right of direction and control of the employee (although this may be a shared responsibility), (2) pays wages and employment taxes of the employees out of its own accounts, (3) reports, collects and deposits state and federal employment taxes on behalf of the employees, and (4) retains the right to hire and fire. This legislation ends a longstanding dispute between the Department of Treasury and the employee leasing community. PEOs and the entities to which they lease employees wanted the officers' and employees' salaries included in the PEO's SBT tax base and excluded from the operating entity's SBT tax base. Typically, the PEO is a "gross receipts" taxpayer so the inclusion of the officers' and employees' salaries in its SBT base does not affect its resulting SBT tax liability. The exclusion of officers' and employees' salaries dramatically decreases the operating entity's SBT tax base and often allows the entity to be eligible for the SBT small business credit. P.A. 603 may provide planning opportunities for holding companies that provide leased officers or employees to their subsidiaries.

Foreign SBT Tax Filers. Canadian and other foreign businesses filing Michigan SBT returns, but not required to file federal income tax returns, can now use "reasonable approximations" to calculate their SBT tax liability. Canadian federal income tax calculations may be used as reasonable approximations of items of business income.

State Tax Incentives

Brownfields. The sunset date for the Brownfield Redevelopment Act and the SBT Brownfield Credit were extended from January 1, 2003 to January 1, 2008. Additional technical and clarifying corrections were also made, but no guidance was given on how SBT Brownfield credits may be assigned. The Department of Treasury has indicated that it will discuss SBT Brownfield credit assignments further, but has made no commitments to issue guidance or support clarifying legislation.

Next Energy Credit. Michigan created a new alternative energy credit called the Next Energy Credit. Taxpayers may claim a credit for tax years after 2002 against SBT for certain qualified business activity if certified under the Michigan Next Energy Authority.

Renaissance Zones. The Renaissance Zone Credit and Next Energy Credit were limited to 10% of adjusted payroll for services performed in a Renaissance Zone for tax years beginning January 1, 2003. The Department of Treasury was concerned about perceived sheltering of their Michigan tax liabilities by companies locating sales offices within Renaissance Zones.

Administration and Procedure

Elimination of Revenue Commissioner and Penalty Reductions. P.A. 657 eliminates the position of Michigan Revenue Commissioner and the Revenue Division in the Department of Treasury.

Now the Michigan State Treasurer is in charge of all responsibilities previously assigned to the Revenue Commissioner. P.A. 657 also provides much needed penalty relief. Under P.A. 657, the penalty for failure to pay taxes and the failure to file a tax return is reduced to 5% after two months up to a maximum of 25% from the current penalty maximum of 50%. The current 50% maximum was put in place after the 1987 Michigan Tax Amnesty Program and was never reduced. The new penalty reduction is effective for assessments issued after February 28, 2003.

Qualified Tuition Programs: Section 529 Plans

by Debra Hedges

Recent tax legislation has enhanced the tax benefits available to participants in Qualified Tuition Programs, also commonly referred to as Section 529 Plans. These plans allow a donor to make gifts to a Section 529 Plan for the college or vocational education of a designated beneficiary. Because of the important tax benefits, funding a Section 529 account may be one of the best college savings plans available today and an effective way for individuals to use their annual gift tax exclusion, which is $11,000 for the year 2003.

Funds deposited in a Section 529 Plan are invested in an account for a designated beneficiary in a state-sponsored savings plan with the expectation that the funds and the earnings will be withdrawn by the beneficiary for the costs of higher education. There is no income limitation that prohibits participation by a donor or a beneficiary. Additionally, while the beneficiary is often the donor's child or grandchild, there is no requirement that the beneficiary be related to the donor. Typically, the contributions to these state-sponsored Section 529 Plans are invested in mutual funds administered by professional money managers. Although federal law does not impose total contribution limits, most state plans impose limitations on total contributions. Michigan prohibits contributions for a designated beneficiary once his or her account balance reaches $235,000. Other states allow contributions up to an aggregate account value of as much as $260,000. The Michigan plan is administered by TIAA-CREF. Numerous differences exist among the 30-plus state-sponsored Section 529 Plans, which makes the selection process important, as most plans are open to non-residents.

Some of the favorable aspects of the Section 529 Plan are as follows:

- *Tax Free Growth*. The most important tax benefit of a Section 529 Plan is that any earnings on the funds deposited in the Section 529 Plan will be distributed to the beneficiary free from federal income tax, provided that the funds are used for Qualified Higher Education Expenses. Qualified Higher Education Expenses include tuition, room and board (for at least half-time students), fees, books, supplies, and equipment necessary for attendance at an eligible institution (typically any accredited post-secondary educational or vocational institution).

- *Gift Tax Exclusion*. Gifts to a Section 529 Plan may qualify for the $11,000 annual gift tax exclusion. A special feature allows a donor to apply both the current annual gift tax exclusion and the subsequent four years' annual exclusion to contribute up to $55,000 tax-free in one year.

- *State Income Tax Deductions*. Some states, including Michigan, allow a limited state income tax deduction for contributions made to the State's Section 529 Plan. Currently, Michigan offers an annual state income tax deduction for contributions made to a Michigan plan of up to $5,000 for single filers, or $10,000 for joint filers. There is no income limitation on this deduction.

- *Flexibility of Beneficiary Designation.* Donors may change beneficiaries without any tax consequences at any time by withdrawing the funds and rolling them over to another Section 529 account established for a different individual, so long as the individual is a member of the original beneficiary's family. This allows a donor to make adjustments, for example, if the original beneficiary does not need all of the funds for education (due to a scholarship, death or disability), by designating another family member as a beneficiary.

- *Choice of Investment Strategy*. Most state plans offer a choice of investment strategies ranging from high to low risk. Many plans offer a mix of investments that change over time as the beneficiary becomes closer to college age. If the donor is not satisfied with the investment performance of a chosen fund, a donor may roll over the Section 529 account once a year, to either another Section 529 fund within the same state or to another state's Section 529 Plan, without changing beneficiaries.

Section 529 Plans are not without their drawbacks. Most significantly, while funds not needed for education expenses may be withdrawn from a Section 529 Plan, a penalty will be imposed on all or a portion of the withdrawal and income taxes will be due on the withdrawn income. The donor cannot control investments except by rolling over to a new Section 529 Plan (which can only be done once a year). Although the donor retains the right to change the beneficiary, if the new beneficiary is in a lower generation than the original beneficiary (for example, the first beneficiary is a child and the new beneficiary is a grandchild), the original beneficiary (the child) may be treated as making a gift. Lastly, you should be aware that brokers and banks are marketing different state programs and often charge additional commissions for their services. These commissions can be avoided by applying directly to a state's Section 529 Plan administrator.

Final Regulations for Retirement Plans Arrive, Finally!

by Marguerite Munson Lentz

More than ten years (!) after the U.S. Treasury Department first issued its proposed regulations, the Treasury Department has issued final regulations which govern the required minimum distributions from tax-qualified plans and IRA's. The new final regulations provide rules for when a plan participant must start withdrawing assets from the tax-qualified plan or IRA (the "required beginning date") and how much must be withdrawn each year (the "required minimum distribution"). (Different rules apply to Roth IRA's while the Roth IRA owner is alive.) The regulations also provide rules for the required minimum distribution for beneficiaries after the plan participant or IRA owner dies. The final regulations are to be used for all required minimum distributions after January 1, 2003 (even for plans which were in existence prior to that date).

A few highlights of the new regulations:

- To compute required minimum distributions during the plan participant or IRA owner's lifetime, the final regulations use a uniform table. This uniform table assumes that the required minimum distributions for most plan participants and IRA owners are calculated on the basis of a joint and survivor life expectancy of the plan participant or IRA owner and a beneficiary who is 10 years younger, regardless of who is actually named as the beneficiary. This change, introduced in 2001, was a major simplification over the 1987 proposed regulations and gave new freedom to change the beneficiary without worrying about whether or not that changed the required minimum distribution amount. It also computed the required minimum distribution

amount in the most favorable manner to the taxpayer (that is, the smallest required amount, leaving the most in the plan or IRA to grow tax-deferred). The final regulations revised the uniform table to reflect current life expectancies. The result is that required minimum distributions are smaller than under the 2001 proposed regulations, and more may be left in the retirement plan or IRA to grow and compound tax-deferred.

- The 2001 proposed regulations introduced the concept of creating separate shares for separate beneficiaries after the death of the plan participant or the IRA owner. However, the 2001 proposed regulations did not expressly allow this option if the plan participant or IRA owner died after the required beginning date. The new regulations appear to fix this glitch.

- If the plan participant or the IRA owner dies before the required beginning date, the required minimum distributions may be distributed over the life expectancy of the beneficiary or beneficiaries if all beneficiaries are individuals (and not charities, the estate, or other entities). If the life expectancy rule does not apply, the assets must be distributed within five years. The 2001 proposed regulations introduced the concept of a delayed date for determining whether the beneficiaries were individuals or entities. The final regulations kept this concept but changed the date: the date for determining who the beneficiaries are for purposes of using the life expectancy rule (and not the five year rule) is September 30 of the calendar year after the year of death. This change in date may be helpful for trusts who are named as beneficiaries and want to use the life expectancy of some but not all of the trust beneficiaries, as it gives the trustee more time to make distributions after the determination date (but less time for planning prior to the determination date).

Despite the Treasury Department's valiant effort to simplify the required minimum distribution rules, this remains an extremely complex area of law, with numerous exceptions and nuances. In addition, although the rules for determining the required minimum distributions have been liberalized substantially, the beneficiary designation should still be coordinated with your overall estate plan. Please call any member of the Tax Department if you have any questions concerning how these rules apply to you. We would be happy to help you determine the best approach for you and your tax-qualified plans and IRA's.

Automatic Allocation of GST Tax Exemption

by Debra Hedges

Much of the attention given to the Economic Growth and Tax Relief Reconciliation Act of 2001 has focused on the reduction of individual income tax rates, increases in pension and IRA limits, and the anticipated estate tax repeal. One of the provisions that has been given less attention is the automatic allocation of the generation-skipping transfer ("***GST***") tax exemption. Since this provision may result in the inefficient use of the GST tax exemption, individuals who make lifetime gifts to trusts should consider opting out of the automatic allocation of the GST tax exemption to these gifts.

The GST tax is a separate tax that is in addition to the gift and estate tax and is imposed on transfers to beneficiaries who are more than one generation below the transferor's generation. Every individual, however, has a GST tax exemption (currently $1,120,000) which may be allocated to lifetime gifts or to transfers upon death. Under the deemed allocation rules, if an individual makes a completed gift during his or her lifetime to a person who is more than one generation below the transferor (a "skip person"), any unused GST tax exemption of the transferor will be automatically allocated to the property transferred. Similarly, GST tax exemption

automatically will be allocated to a trust if a skip person is even a remote potential beneficiary of the trust.

While the intent behind the new automatic allocation rules was to protect taxpayers who might incur GST tax by failing to allocate available GST tax exemption to lifetime transfers, there are reasons why a transferor might not want the automatic GST tax exemption to apply. For example, if a taxpayer creates a trust to benefit his or her children but the trust property could pass to grandchildren in the event of a child's death, then the GST tax exemption would be allocated to the trust under the automatic allocation rules. The purpose of the trust, however, was not to benefit any grandchildren directly but rather the transferor's own children. As a result of the automatic allocation of the GST tax exemption to this trust, the remaining GST tax exemption may be insufficient if the transferor later decides to create a trust for a grandchild, resulting in an unnecessary GST tax liability.

The transferor can prevent the automatic allocation of his or her GST tax exemption by making an election on a Form 709 (the Gift and GST Tax Return). This return is filed for the year the transfer is made (even if no gift tax is due). The taxpayer must describe the transfer and the extent to which the automatic allocation is not to apply. A taxpayer may also file a Form 709 along with a payment of the GST tax due to prevent the automatic allocation of the GST tax exemption to the transferred property.

Please contact us if you are considering lifetime gifts and want to discuss how the automatic allocation of the GST tax exemption may affect your specific situation.

Disturbing Attack on Entireties Property

by Marguerite Munson Lentz

In Michigan, property which is held by a husband and wife as "tenants by the entireties" is subject to special treatment. Only a married couple may jointly own property as tenants by the entireties, and only certain kinds of property may be held in a tenancy by the entireties (such as real estate). Not all property held by a husband and wife jointly with rights of survivorship is entireties property. Importantly for creditor protection purposes, the entireties property generally is not subject to the sole debts of the husband or the sole debts of the wife, but is only subject to the joint debts of both husband and wife.

The Supreme Court of the United States has rejected this special treatment in *United States v. Craft*, 122 S. Ct. 1414 (2002). In that case, a husband and wife, Mr. and Mrs. Craft, owned real estate in Michigan as tenants by the entireties. Mr. Craft, but not Mrs. Craft, owed income taxes. The IRS attached a lien on Mr. Craft's interest in the entireties property when he failed to pay his income taxes. The Crafts sued to remove the IRS lien from the real estate (and permit the real estate to be sold) claiming that, under Michigan law, the entireties property was not subject to Mr. Craft's sole debts. The Supreme Court held that, as a matter of federal law, the tax lien could attach to the entireties property.

This case depends upon federal law and does not change Michigan law dealing with entireties property. However, it does provide a troublesome exception to the creditor protection that entireties property formerly provided.

Honigman Miller Schwartz and Cohn LLP is a general practice law firm with over 190 attorneys at its three offices in Michigan. Our Tax, Employee Benefit and Property Tax Appeal Departments include the twenty-nine attorneys listed below. Except as indicated below, the attorneys are licensed to practice law in the state of Michigan only.

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