

University of Mississippi

eGrove

Guides, Handbooks and Manuals

American Institute of Certified Public
Accountants (AICPA) Historical Collection

11-1998

Accountant's business manual, 1998, Volume 1

William H. Behrenfeld

Andrew R. Biebl

Follow this and additional works at: https://egrove.olemiss.edu/aicpa_guides



Part of the [Accounting Commons](#)

**THE
ACCOUNTANT'S
BUSINESS
MANUAL**

HF
5616
.U5
B38
1987
v.1

AICPA

**THE
ACCOUNTANT'S
BUSINESS
MANUAL**

AICPA

American Institute of Certified Public Accountants

ACCOUNTANT'S BUSINESS MANUAL

Supplement 22, November 1998

Copyright © 1998 by

American Institute of Certified Public Accountants, Inc.

Summary of Contents

- | | |
|---|--|
| Obtaining Financing | • Miscellaneous updates throughout plus updated References. |
| Business Valuation | • Revised language for valuation report letters plus updated References section. |
| Investment Vehicles | • Revised material on IRAs (including Roth), new material on the Treasury Direct program, updated References section. |
| Employee Retirement & Deferred Compensation Plans | • Update of discussion of discriminatory contribution rules and addition of new section on the Savings Incentive Match Plan for Employees. Updated References section. |
| Employment Regulations | • Update of addresses and contacts for State Labor, Civil Rights, and Equal Employment Opportunity Agencies. Updated References section. |
| Workers' Compensation | • Update of state-by-state insurance requirements, addresses, and phone numbers. Updated References section. |
| Unemployment Insurance | • Update of addresses and contact phone numbers for state unemployment insurance agencies, plus updated References section. |
| Trusts Estate Planning | • Updated 1998 tax rates for trusts and estates, new material on qualified family-owned business interest; updated References section. |

- Social Security
 - Completely revised contents including new material focusing on issues facing the elderly and disabled: Medicaid planning, arrangements for substitute decision-making, and living wills and health-care surrogates. 1999 Social Security rates and statistics.

- IRS Practice and Procedure
 - Revised to reflect 1998 IRS Restructuring and Reform Act; updated References section.

- Trade and Professional Organizations
 - Updated addresses and phone numbers; updated References section.

- Federal Individual Tax Notes
Federal Corporate Tax Notes
 - Completely new chapters focusing on 1998 IRS Restructuring and Reform Act, 1998 technical corrections, and 1998 case and ruling developments.

- Current-Year Tax Issues
 - Synopsis and analysis of six issues identified as “hot topics” for tax advisers’ attention in 1998 filings, including Roth IRAs.

ACCOUNTANT'S BUSINESS MANUAL

Supplement 21, May 1998

Copyright © 1998 by the
American Institute of Certified Public Accountants, Inc.

Summary of Contents

- | | |
|---|--|
| Sole Proprietorships | <ul style="list-style-type: none">• Health insurance, medical savings accounts, financial liability, self-employment tax, estimated tax payments, personal-property-leasing net income, the <i>Soliman</i> decision, home office insurance, estate planning, conversion to a partnership, tax consequences of incorporation, and conversion to a single-member LLC |
| Partnerships | <ul style="list-style-type: none">• Advantages of partnership taxation over S corporation taxation, large-partnership simplified pass-through election, property basis adjustment upon sale of partnership interest, conversion to an LLC or LLP, use of a corporate general partner, use of appraisals in establishing fair market value, use of two sets of capital accounts, terminations occurring after May 8, 1997 |
| Corporations | <ul style="list-style-type: none">• Disadvantages of operating as a corporation, stock redemptions, fringe benefits, liquidation and double taxation, piercing the corporate veil, owning intangible assets outside of the C corporation |
| S Corporations | <ul style="list-style-type: none">• Subsidiaries, Section 401(a) and 501(c)(3) tax-exempt organizations, "affected" shareholders |
| Business Valuation | <ul style="list-style-type: none">• Revenue Procedure 96-15, updated references |
| Employee Retirement & Deferred Compensation Plans | <ul style="list-style-type: none">• Limitations affected by cost-of-living adjustments |

- Employment Regulations • Minor changes
- Hiring Foreign Nationals • Illegal Immigration Reform and Immigrant Responsibility Act, E-1 treaty traders, H-1A registered nurses, H-1B aliens with specialty occupations, J exchange visitors, L intracompany transferees, O temporary workers, P performing artists and athletes, Q international cultural exchange visitors, special immigrant status, family preferences, and employment, the National Visa Center, adjustment of status, ineligibility, U.S. citizenship, updated references
- Insurance • Group health plans and underwriting
- Trusts • Minor changes
- Estate Planning • Credits for state death taxes and federal estate taxes previously paid
- Social Security • Early retirement, full retirement age for workers born after 1937, Medicare + Choice MSA plan
- Securities Regulation • Exemptions from registration
- Cash Management • Minor changes
- Business Plans • Management consulting services, updated references, updated business planning software
- Trade & Professional Organizations • Minor changes
- IRS Practice & Procedure • Compromise procedures

ACCOUNTANT'S BUSINESS MANUAL

Supplement 20, November 1997

Copyright © 1997 by the
American Institute of Certified Public Accountants, Inc.

Summary of Contents

- | | |
|---|---|
| Sole Proprietorships | <ul style="list-style-type: none">• Changes effected by the Taxpayer Relief Act of 1997 for medical insurance premium deductions |
| Partnerships | <ul style="list-style-type: none">• Changes effected by the Taxpayer Relief Act of 1997 for medical insurance premium deductions |
| Corporations | <ul style="list-style-type: none">• Changes effected by the Taxpayer Relief Act of 1997 for capital gains tax, alternative minimum tax, and medical insurance deductions |
| S Corporations | <ul style="list-style-type: none">• Minor changes |
| Investment Vehicles | <ul style="list-style-type: none">• New information on U.S. Savings Bonds, Inflation-Protection Securities, Inflation-Indexed Debt Securities, and IRA contributions |
| Employee Retirement & Deferred Compensation Plans | <ul style="list-style-type: none">• Changes effected by the Taxpayer Relief Act of 1997 |
| Employment Regulations | <ul style="list-style-type: none">• Update of addresses for State Labor Agencies, State Civil Rights Agencies, and State Equal Employment Opportunity Agencies• Information on the Electronic Federal Tax Payment System for depositing payroll taxes• Updated references |
| Workers' Compensation | <ul style="list-style-type: none">• Update of state-by-state insurance requirements, addresses, and phone numbers• Updated references |

| | |
|------------------------------------|---|
| Unemployment Insurance | <ul style="list-style-type: none"> • Update of addresses and phone numbers for state unemployment insurance agencies • Information on the Electronic Federal Tax Payment System for depositing FUTA tax • Updated references |
| Trusts | <ul style="list-style-type: none"> • Changes reflecting provisions of the Taxpayer Relief Act of 1997 that affect revocable trusts and most domestic trusts |
| Estate Planning | <ul style="list-style-type: none"> • Changes effected by the Taxpayer Relief Act of 1997 including new exclusion from taxable estate of land subject to qualified easement, qualified family-owned business interest, and increases in credit, lower interest rate for paying certain tax liabilities in installments, gift tax exclusion indexed for inflation, generation-skipping transfers expanded to collateral heirs, and new restrictions on charitable remainder trusts |
| Social Security | <ul style="list-style-type: none"> • 1998 Social Security Administration withholding and benefit changes • Updated references |
| Human Resources | <ul style="list-style-type: none"> • Minor changes |
| Federal Individual Tax Notes | <ul style="list-style-type: none"> • Completely new chapter topically integrating 1997 legislation, case law developments, and regulations and rulings affecting individual filings |
| Federal Corporate Tax Notes | <ul style="list-style-type: none"> • Completely new chapter topically integrating 1997 legislation, case law developments, and regulations and rulings affecting corporate filings |
| Current-Year Tax Issues | <ul style="list-style-type: none"> • Synopsis and analysis of ten issues identified as “hot topics” for practitioners’ attention in 1997 filings |
| Trade & Professional Organizations | <ul style="list-style-type: none"> • Updated addresses and phone numbers • Updated references |

**THE
ACCOUNTANT'S
BUSINESS
MANUAL
Volume 1**

THE ACCOUNTANT'S BUSINESS MANUAL

A Two-Volume Service

Prepared for the AICPA by

WILLIAM H. BEHRENFELD, JD, LL.M., CPA
Sarasota, Florida

and

ANDREW R. BIEBL, CPA
Biebl, Ranweiler, Christiansen, Meyer, Thompson & Co., Chtd.
New Ulm, Minnesota

CONTRIBUTORS

Cathleen L. Bang, JD
Craig E. Behrenfeld, JD, LL.M.
William R. Bischoff, CPA
Jeff Bohm, JD
Barry J. Brinker, CPA
Julie L. Bursik, JD
Michael J. Chapman, MBA
Richard J. Christiansen, CPA
Francis D. Collins, JD
Christopher W. Dungan, CPA, PhD, JD
Yale Kramer, CPA, JD, ASA
Christopher R. Malburg, CPA, MBA
Gregory E. Matthews, CPA
Robert J. Ranweiler, CPA
William L. Reeb, CPA
Eric D. Satre
Robert J. Seifert, CPA
Dean L. Surkin, JD, LL.M.

Editorial Development Marie Bareille
Design and Typography AM Marketing, Inc.
Cover Design J. L. Design Associates, Inc.

Publisher Linda Prentice Cohen

Copyright © 1987, 1988, 1989, 1990, 1991, 1992, 1993, 1994, 1995,
1996, 1997, 1998 by
American Institute of Certified Public Accountants, Inc.,
New York, NY 10036-8773

First edition published May 1987. Twenty-second revision November 1998.

All rights reserved. For information about the procedure for requesting permission to make copies of any part of this work, please call the AICPA Copyright Permissions Hotline at 201-938-3245. A Permissions Request Form for emailing requests is available at www.aicpa.org by clicking on the copyright notice on any page. Otherwise, requests should be written and mailed to the Permissions Department, AICPA, Harborside Financial Center, 201 Plaza Three, Jersey City, NJ 07311-3881.

The *Accountant's Business Manual* has not been approved, disapproved, or otherwise acted upon by any committees, the membership, or the governing body of the American Institute of Certified Public Accountants. Therefore, the content of the *Manual* is not an official pronouncement of the Institute.

Library of Congress Cataloging-in-Publication Data

Behrenfeld, William H.
Accountant's business manual.

Bibliography: p.
Includes index.

1. Accounting—United States. 2. Industrial management—United States. 3. Accounting—Law and legislation—United States. I. Biebl, Andrew R., 1948–

II. American Institute of Certified Public Accountants.

III. Title.

HF5616.U5B38 1987 657 87-992

ISBN 0-87051-000-2 (loose-leaf)

029481

PREFACE TO SUPPLEMENT 22 NOVEMBER 1998

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

With this supplement, we have updated material affected by the IRS Restructuring and Reform Act of 1998 and technical corrections related to IRAs. We have also completely revised and rewritten our chapter on Social Security to include substantial new materials on planning for and advising elderly and disabled clients; as usual, this chapter contains the 1999 SSA rates and statistics released in October.

The fall supplement always includes three tax chapters to assist your compliance work with a round-up summary of legislative and case and ruling developments over the past twelve months. In addition, many of the topical areas from which client and colleague questions arise are covered by this supplement: health insurance deductions, medical savings accounts, estate planning, tax-exempt organizations, and more.

As ever, we encourage readers to offer comments and suggestions for improving the *Manual* and express our thanks to those who have already done so. We appreciate your help.

W.H.B.
A.R.B.

Volume 1

TABLE OF CONTENTS

(See also detailed Tables of Contents with each chapter)

SOLE PROPRIETORSHIPS

| | |
|--|------|
| 1. Introduction | 5 |
| 2. Legal Nature of Proprietorship | 5 |
| 3. Characteristics of a Proprietorship | 6 |
| 4. Advantages of Proprietorship | 8 |
| 5. Disadvantages of Proprietorship | 10 |
| 6. Filing and Compliance Requirements | 12 |
| 7. Proprietorship Name | 14.1 |
| 8. Accounting for Proprietorships | 15 |
| 9. Husband and Wife as Coproprietors | 16 |
| 10. Employment of Spouse and Children | 17 |
| 11. Real Estate in Proprietorship | 19 |
| 12. Contractual Relationships of the Sole Proprietor | 20 |
| 13. The Proprietor and Obligations | 22 |
| 14. Business Liability and Personal Assets | 22 |
| 15. Protection of Proprietary Portions of Business | 23 |
| 16. Change to Partnership | 25 |
| 17. Change to Corporate Form | 26 |
| 18. Change to Single-Member Limited Liability Company | 30 |
| 19. Effect of Proprietor Death | 30 |
| 20. Dissolution of Proprietorship | 32 |
| References | 32.1 |
| <i>Appendix 1:</i> Proprietorship Creation Checklist | 35 |
| <i>Appendix 2:</i> Incorporation Checklists and Examples | 37 |

PARTNERSHIPS

| | |
|--|---|
| 1. Introduction | 5 |
| 2. Partnerships Forms | 5 |
| 3. Legal Status and Characteristics of a Partnership | 8 |

TABLE OF CONTENTS

| | |
|--|------|
| 4. Laws Governing the Partnership | 10 |
| 5. Delegation of Authority for Management Duties Among Partners | 13 |
| 6. Duties of Partners to Each Other | 14 |
| 7. Duties and Liabilities to Third Parties | 16 |
| 8. Advantages and Disadvantages of a Partnership | 18 |
| 9. Creating the Partnership | 20 |
| 10. Funding the Partnership | 24 |
| 11. Accounting Systems and Accounts | 25 |
| 12. Distribution of Profits and Losses | 27 |
| 13. Taxation of Partnerships | 28 |
| 14. Terminating a Partnership | 36.3 |
| References | 39 |
| <i>Appendix 1:</i> Partnership Agreement Checklist | 43 |
| <i>Appendix 2:</i> Partnership Creation Checklist | 45 |
| <i>Appendix 3:</i> Comparison of Entity Attributes—Proprietorships, Partnerships, C Corporations, S Corporations, and LLCs | 47 |

CORPORATIONS

| | |
|--|------|
| 1. Introduction | 3 |
| 2. Incorporation Procedures | 9 |
| 3. Corporate Directors and Officers | 13 |
| 4. Minutes, Meetings, and Seal | 16 |
| 5. Shares | 18 |
| 6. Shareholder Agreements | 21 |
| 7. Shareholder Remedies | 22 |
| 8. Corporate Distributions | 23 |
| 9. Amendments, Mergers, and Dissolutions | 26 |
| 10. Planning Hints for Closely Held Corporations | 28 |
| References | 28.2 |
| <i>Appendix 1:</i> Incorporation Checklist | 29 |
| <i>Appendix 2:</i> Tax Interview Checklist | 31 |

TABLE OF CONTENTS

S CORPORATIONS

1. History 3
2. Eligibility Requirements 7
3. Making an S Corporation Election 14
4. Terminating and Revoking an Election 18
5. Preventing Unwanted Termination of Elections 20
6. Passive Income Problems 21
7. Taxation at the Corporate Level 23
8. Taxation at the Shareholder Level 27
9. Distributions 35
- References 39

LIMITED LIABILITY COMPANIES

1. Introduction 3
2. Defining an LLC 3
3. LLC Operations and Management 4
4. Classification of LLCs for Tax Purposes 9
5. Taxation of Multi-member LLCs 11
6. Tax Aspects of Converting Existing Entities into LLCs 16
7. Conclusion 19
- References 20

OBTAINING FINANCING

1. Introduction 3
2. Preliminary Considerations 3
3. Short-Term Financing 7
4. Intermediate-Term Financing 17
5. Long-Term Debt Financing 23
6. Employee Stock Ownership Plans (ESOPs) 26
7. Venture Capitalists 28
8. The Economics of Refinancing 29
9. The Importance of Financial Statements 30
10. The Financing Proposal Package 34
- References 35

TABLE OF CONTENTS

BUSINESS VALUATION

| | |
|---|----|
| 1. Introduction | 5 |
| 2. Definitions | 6 |
| 3. Valuation Purposes | 7 |
| 4. Important Valuation Concepts | 11 |
| 5. Common Methods of Valuation | 17 |
| 6. Applying Discounts | 23 |
| 7. Reaching Conclusions | 28 |
| 8. The Internal Revenue Service Approach | 29 |
| 9. Valuation of Selected Items | 33 |
| 10. Special Valuation Considerations | 36 |
| 11. AICPA Guidance | 38 |
| 12. Other Professional Guidance | 41 |
| 13. Research Sources | 43 |
| 14. Report Writing | 47 |
| References | 54 |
| <i>Appendix 1:</i> Illustrative Letters | 57 |
| <i>Appendix 2:</i> Valuation Checklist | 65 |
| <i>Appendix 3:</i> Research Checklist and Sources | 67 |

INVESTMENT VEHICLES

| | |
|--|------|
| 1. Introduction | 5 |
| 2. Definitions | 10 |
| 3. Bank Investments | 12 |
| 4. Bonds | 14 |
| 5. Common Stock | 28 |
| 6. Options and Warrants | 32.2 |
| 7. Preferred Stock | 35 |
| 8. Mutual Funds | 39 |
| 9. Commodities | 43 |
| 10. Life Insurance | 45 |
| 11. Tax-Sheltered Retirement Plans | 47 |
| 12. Tax-Deferred Income Plans | 49 |
| 13. Investment Administration and Strategies | 51 |
| References | 55 |

BANKRUPTCY/INSOLVENCY

| | |
|---|----|
| 1. Introduction | 7 |
| 2. Bankruptcy Overview | 7 |
| 3. Alternatives to Bankruptcy | 8 |
| 4. Typical Accountants' Roles in Bankruptcy | 13 |
| 5. The Ins-and-Outs of Working in Bankruptcy | 19 |
| 6. Organization of the Bankruptcy System | 25 |
| 7. Terminology and Definitions | 26 |
| 8. Chapter 7: Liquidation | 29 |
| 9. Chapter 13: Adjustment of Debts of an Individual with Regular Income | 33 |
| 10. Chapter 11: Reorganization | 38 |
| 11. Chapter 12: Adjustment of Debts of a Family Farmer with Regular Annual Income | 43 |
| 12. Exemptions | 46 |
| 13. Conversion of Cases | 49 |
| 14. Dismissal of Cases | 50 |
| 15. Transfers of Property | 52 |
| 16. Creditors' Rights and Protections | 58 |
| 17. Income Tax Implications | 65 |
| References | 67 |

EMPLOYEE RETIREMENT AND DEFERRED COMPENSATION PLANS

| | |
|---|----|
| 1. Overview of Retirement Planning | 5 |
| 2. Choosing a Plan: Kinds of Qualified Plans | 7 |
| 3. Statutory Requirements for Qualified Plans | 10 |
| 4. Deduction Limits | 49 |
| 5. Taxation of Distributions | 56 |
| 6. Fiduciary Responsibilities | 70 |
| 7. Plan Adoption and Reporting | 75 |
| 8. Simplified Employee Pension Plans and SIMPLE Plans | 84 |
| 9. Other Kinds of Plans | 88 |
| 10. Accounting for Pension Plans | 91 |

TABLE OF CONTENTS

11. Nonqualified Plans 94
References 98
Appendix 1: Selected ERISA Pension Plan Reporting and
Disclosure Requirements 101
Appendix 2: Limitations Affected by Cost-of-Living
Adjustments 103

EMPLOYMENT REGULATIONS

1. Introduction 5
2. Sources 5
3. Definitions 6
4. Federal Wage and Hour Requirements 10
5. Discrimination 20.2
6. National Labor Relations Board 24
7. Payroll Requirements 26
8. Postemployment Issues 29
References 30
Appendix 1: State Labor Agencies 34
Appendix 2: State Civil Rights Agencies 37
Appendix 3: State Equal Employment Opportunity
Agencies 40

WORKERS' COMPENSATION

1. Introduction 3
2. Definitions 3
3. Federal Regulations 4
4. Occupational Safety and Health 9
5. State Information and Offices 11
References 32
Appendix: Occupational Safety—
State Agencies and Addresses 35

UNEMPLOYMENT INSURANCE

1. Introduction 3
2. Definitions 3

TABLE OF CONTENTS

| | |
|--|----|
| 3. Federal Unemployment Tax Act (FUTA) | 4 |
| 4. Reporting Requirements Under FUTA | 10 |
| 5. FUTA and State Unemployment Insurance | 13 |
| 6. State Unemployment Insurance | 15 |
| 7. Factors Affecting Employer's Experience Rating | 18 |
| References | 21 |
| <i>Appendix:</i> State Unemployment Insurance Agencies | 23 |

HIRING FOREIGN NATIONALS

| | |
|--|----|
| 1. Basic Premises | 5 |
| 2. Nonimmigrant Visas | 6 |
| 3. Lawful Permanent Residence | 23 |
| 4. Labor Certification | 36 |
| 5. Ineligibility for Visas—Exclusion | 45 |
| 6. Applying for U.S. Citizenship | 46 |
| 7. Employer Responsibilities | 48 |
| 8. Penalties | 50 |
| 9. Illegal Immigration Reform and Immigrant Responsibility Act of 1996 | 51 |
| References | 52 |
| <i>Appendix 1:</i> Addresses of Government Offices | 53 |
| Department of Labor Regional Offices | |
| Immigration and Naturalization Service Offices | |
| <i>Appendix 2:</i> Visa Symbols | 55 |
| <i>Appendix 3:</i> Immigration and Naturalization Form I-9 | 57 |
| <i>Appendix 4:</i> Summary of Changes in Immigration Law After the Illegal Immigration Reform and Immigrant Responsibility Act of September 30, 1996 | 59 |

INSURANCE

| | |
|-----------------------|------|
| 1. Background | 5 |
| 2. Types of Insurers | 7 |
| 3. Agents and Brokers | 11 |
| 4. Health Insurance | 12 |
| 5. Life Insurance | 20.2 |

TABLE OF CONTENTS

- 6. Property Insurance 29
- 7. Liability Insurance 34
- 8. Employee Bonding 38
- 9. Social Security 39
- References 40

TRUSTS

- 1. Trust Formation 3
- 2. Types of Personal Trust 4
- 3. Specific Uses of Trusts 6
- 4. Trust Administration 13
- 5. Income Taxation 17
- 6. Gift Taxation 24
- 7. Estate Taxation 26
- References 30

ESTATE PLANNING

- 1. Fundamental Estate Planning Concepts 5
- 2. The Conventional Will 8
- 3. Will Components 11
- 4. Federal Estate 17
- 5. Gift Tax 34
- 6. Tax on Generation-Skipping Transfers (GST) 36
- 7. Income Tax 36.1
- 8. Special Estate Planning Situations 37
- 9. Postmortem Estate Planning 40.6
- References 40.8
- Appendix:* Estate Planning Practice Aids 40.11

SOCIAL SECURITY AND OTHER ISSUES FACING ELDERLY OR DISABLED CLIENTS

- 1. Introduction 5
- 2. Social Security 5

TABLE OF CONTENTS

| | |
|--|----|
| 3. Supplemental Security Income | 22 |
| 4. Medicare | 24 |
| 5. Medicaid | 32 |
| 6. Planning for Substitute Decision Making | 37 |
| References | 39 |

HUMAN RESOURCES

| | |
|--|------|
| 1. Recruitment | 5 |
| 2. Recruitment Sources | 8 |
| 3. Interviewing | 11 |
| 4. Reference Checking and Testing | 15 |
| 5. Communication With Applicants | 16 |
| 6. New Employee Orientation | 17 |
| 7. Performance Evaluations | 17 |
| 8. Compensation | 18 |
| 9. Benefit Programs | 26.2 |
| 10. Termination | 26.4 |
| References | 26.9 |
| <i>Appendix 1:</i> Sample Firm Hiring Policy | 27 |
| <i>Appendix 2:</i> Sample Personnel Requisition | 31 |
| <i>Appendix 3:</i> Sample Job Descriptions | 32 |
| <i>Appendix 4:</i> Sample Job Posting Request | 36 |
| <i>Appendix 5:</i> Sample Application for Employment | 37 |
| <i>Appendix 6:</i> Standard Interview Questions Form | 41 |
| <i>Appendix 7:</i> Interview Rating Reports | 42 |
| <i>Appendix 8:</i> Reference Check | 46 |
| <i>Appendix 9:</i> Job Offers and Rejections | 47 |
| <i>Appendix 10:</i> Orientation Checklist | 49 |
| <i>Appendix 11:</i> Job Description Outline | 51 |
| <i>Appendix 12:</i> Predischarge Checklist | 55 |
| <i>Appendix 13:</i> Exit Interview Form | 57 |
| <i>Appendix 14:</i> Separation Interview Checklist | 59 |
| <i>Appendix 15:</i> Termination Checklist | 60 |

TABLE OF CONTENTS

SECURITIES REGULATION

| | |
|---|------|
| 1. Introduction | 3 |
| 2. Definitions | 4 |
| 3. Federal Securities Regulation: Overview | 14.1 |
| 4. The Securities Act of 1933 | 15 |
| 5. The Securities Exchange Act of 1934 | 26.2 |
| 6. Other Federal Securities-Related Acts | 30 |
| 7. State Securities Regulation | 38.3 |
| 8. Accountants' Liability Under the Federal Securities Acts | 41 |
| 9. Going Public | 43 |
| References | 54 |
| <i>Appendix 1:</i> Common 1933 Act Forms for Registration of Securities | 57 |
| <i>Appendix 2:</i> Commonly-Used 1934 Act Forms for Registration of Securities | 59 |
| <i>Appendix 3:</i> SEC Accounting and Reporting Requirements | 60 |
| <i>Appendix 4:</i> SEC Industry Guides | 66 |
| <i>Appendix 5:</i> State Securities Regulators | 67 |
| <i>Appendix 6:</i> SEC Regulations S-X (Excerpts on Accountants' reports and general instructions regarding financial statements) | 70 |
| <i>Appendix 7:</i> Solicitation of Proxies | 75 |

Volume 2 TABLE OF CONTENTS

(See also detailed Tables of Contents with each chapter)

FEDERAL INDIVIDUAL TAX NOTES

| | |
|--|----|
| 1. Income Issues | 5 |
| 2. Deductions and Losses | 8 |
| 3. Tax Calculations and Credits | 16 |
| 4. Restructuring and Reform of the IRS | 23 |

FEDERAL CORPORATE TAX NOTES

1. Income and Accounting Method Issues 3
2. Deductions and Losses 8
3. Credits and Tax Calculations 11
4. Corporate-Shareholder Transactions 17
5. S Corporations 19

CURRENT-YEAR TAX ISSUES—1998

1. Introduction 3
2. Education Tax Credits 3
3. Other Education Tax Incentives 7
4. Dependency Exemptions in Divorce and Separation Situations
and for College-Bound Children—More Important Than
Ever 10
5. Per Diem Amounts 13
6. Principal Residence Exclusion 16
7. Roth IRAs 21

CASH MANAGEMENT

1. Introduction 3
2. Definition and Objectives 4
3. Accelerating Cash Inflows 6
4. Decelerating Cash Outflows 16
5. Use of Banks 19
6. Cash Management Reports 24
7. Cash Planning Techniques 27
8. Interest Rate Risk 35
- References 45

BUSINESS PLANS

1. Introduction 3
2. What Is a Business Plan? 4
3. Contents of a Business Plan 6

TABLE OF CONTENTS

| | |
|--|------|
| 4. Financing | 21 |
| 5. The Accountant's Role | 23 |
| References | 29 |
| <i>Appendix 1:</i> Sample Business Plan Outline | 31 |
| <i>Appendix 2:</i> Sample Format for Financial Statement Projections | 32.2 |
| <i>Appendix 3:</i> Business Planning Software | 35 |
| <i>Appendix 4:</i> Sample Cash Flow Statement Format | 37 |
| <i>Appendix 5:</i> Sample Business Plan | 38 |

TRADE AND PROFESSIONAL ORGANIZATIONS

| | |
|--|----|
| Bankruptcy/Insolvency | 3 |
| Business/Economic Statistics | 3 |
| Business Entities/General Information | 3 |
| Employment Regulations and Insurance/Workers' Compensation | 5 |
| Employment of Foreign Nationals | 5 |
| Estates and Trusts | 5 |
| Insurance | 6 |
| Investment | 7 |
| Obtaining Financing | 7 |
| Pensions/Social Security | 8 |
| Securities | 8 |
| Small Business | 9 |
| State Boards of Accountancy | 10 |
| State Society Executive Directors | 12 |
| Taxation | 14 |
| References | 16 |

IRS PRACTICE AND PROCEDURE

| | |
|---|----|
| 1. Organization of the Internal Revenue Service | 5 |
| 2. Practice Before the IRS | 6 |
| 3. IRS Procedure for Examining Returns | 22 |
| 4. Types of Examinations | 26 |

TABLE OF CONTENTS

| | |
|---|------|
| 5. How to Prepare for an Examination | 32 |
| 6. Criminal and Civil Tax Fraud | 35 |
| 7. Results of the Examination | 38 |
| 8. Assessment and Collection of Tax | 40 |
| 9. Appeals Process | 46.2 |
| 10. Obtaining a Refund | 48 |
| 11. Rulings, Determinations, Technical Advice | 50 |
| 12. Problem Resolution: Taxpayer Advocate | 54 |
| References | 56 |
| <i>Appendix 1:</i> Where to Obtain Out-of-State Tax Forms | 58 |
| <i>Appendix 2:</i> Record Retention | 60 |
| <i>Appendix 3:</i> Recognition and Authorization Requirements for Persons Appearing Before the IRS | 64 |

FINANCIAL MATHEMATICS

| | |
|-----------------------------|----|
| 1. Compound Interest Theory | 3 |
| 2. Elementary Statistics | 9 |
| 3. Tables | 21 |
| 4. Financial Ratios | 51 |
| References | 59 |

INDEX

Dear Subscriber:

The *Accountant's Business Manual* is intended to be a practical, efficient, up-to-date desk reference for use by professional accountants and business advisers. Semiannual supplements will be issued to keep the *Manual* abreast of current developments. However, we believe the *Manual* should also be responsive to user needs, with updates containing additional materials identified by readers. Thus, we would appreciate your taking a few minutes to tell us what you think of the *Manual* and how it can better serve your purposes. Please use the reverse of this form as necessary.

1. In general, do you find the *Accountant's Business Manual* useful?
Very useful Somewhat useful Not useful
2. Are the topics covered in sufficient depth? Yes No
3. What topics or chapter elements would you like to see expanded or added?

Conversely, are there topics that could remain as they are or be eliminated?

4. Are there changes you would like to see made in the presentation or format of the material? Yes No

Comments: _____

Please return this form to
AICPA/Publications Administration, 2d Floor
Harborside Financial Center, 201 Plaza Three
Jersey City, NJ 07311-3881

MOVING?

Please let us know so that we can ensure prompt delivery of future orders and updates to the *Accountant's Business Manual*. We need advance notice and your old as well as new address and ZIP code.

Name _____

OLD ADDRESS

Telephone _____

NEW ADDRESS

Telephone _____

Please send this form to
AICPA
Order Department
P.O. Box 2209
Jersey City, N.J. 07303-2209

SOLE PROPRIETORSHIPS

1. INTRODUCTION

2. LEGAL NATURE OF PROPRIETORSHIP

- 2.1 Formalities
- 2.2 Duration
- 2.3 Business Purposes
- 2.4 Size

3. CHARACTERISTICS OF A PROPRIETORSHIP

- 3.1 Unlimited Liability
- 3.2 Commingling of Personal/Business Assets/Liabilities
- 3.3 Term
- 3.4 Exercising Control and Independence

4. ADVANTAGES OF PROPRIETORSHIP

- 4.1 Simplicity
- 4.2 Owner Control
- 4.3 Commingling of Assets, Income, and Deductions
- 4.4 No Double Taxation
- 4.5 Ease of Converting to Another Entity
- 4.6 Employment of Spouse/Children
- 4.7 Health Insurance Costs

5. DISADVANTAGES OF PROPRIETORSHIP

- 5.1 Individual Liability
- 5.2 Lack of Continuity
- 5.3 Limitations on Employee Benefit and Ownership Programs
- 5.4 Social Security Taxes
- 5.5 Income Tax Rates

6. FILING AND COMPLIANCE REQUIREMENTS

- 6.1 Certificate of Assumed Name
- 6.2 Local Licensing and Permits
- 6.3 Professional Licensing
- 6.4 Sales Tax Permits
- 6.5 Federal Employer Identification Number (FEIN)
- 6.6 Workers' Compensation
- 6.7 Unemployment Compensation
- 6.8 Withholding Taxes

- 6.9 Other Employment Regulations
- 6.10 Income Tax Reporting

7. PROPRIETORSHIP NAME

8. ACCOUNTING FOR PROPRIETORSHIPS

- 8.1 Accounting Methods and Consistency
- 8.2 Minimum Requirements
- 8.3 Accounting Periods

9. HUSBAND AND WIFE AS COPROPRIETORS

- 9.1 Propriety
- 9.2 Divorce

10. EMPLOYMENT OF SPOUSE AND CHILDREN

- 10.1 IRA Deduction
- 10.2 Keogh/HR 10 Plan Contribution
- 10.3 Estate Planning
- 10.4 Child Care Credit
- 10.5 Social Security Tax
- 10.6 Earned Income Credit and Business Loss
- 10.7 Employee Benefit Plans
- 10.8 Salary to Children and Tax Bracket

11. REAL ESTATE IN PROPRIETORSHIP

- 11.1 Held in Proprietor's Name
- 11.2 Documentation
- 11.3 Property Used Both Personally and for Business

12. CONTRACTUAL RELATIONSHIPS OF THE SOLE PROPRIETOR

- 12.1 Nonbinding Contracts
- 12.2 Verbal Contracts
- 12.3 Written Contracts
- 12.4 Breach of Contract
- 12.5 Uniform Commercial Code (UCC)

13. THE PROPRIETOR AND OBLIGATIONS

- 13.1 Unlimited Authority
- 13.2 Financial Instability or Bankruptcy

14. BUSINESS LIABILITY AND PERSONAL ASSETS

- 14.1 Personal Guarantees
- 14.2 Liability Insurance

15. PROTECTION OF PROPRIETARY PORTIONS OF BUSINESS

- 15.1 Unique Knowledge
- 15.2 Name
- 15.3 Goodwill
- 15.4 Personal Property
- 15.5 Intellectual Property
- 15.6 Estate Planning for Proprietorship

16. CHANGE TO PARTNERSHIP

- 16.1 Partners' Contribution
- 16.2 Partnership Agreement
- 16.3 Tax Consequences
- 16.4 Notice to Creditors and Debtors

17. CHANGE TO CORPORATE FORM

- 17.1 Reasons for Incorporating
- 17.2 Valuation
- 17.3 Items for Transfer to Corporation
- 17.4 Filings
- 17.5 Issuance of Stock
- 17.6 Tax Consequences
- 17.7 Liabilities in Excess of Basis

18. CHANGE TO SINGLE-MEMBER LIMITED LIABILITY COMPANY

19. EFFECT OF PROPRIETOR DEATH

- 19.1 Intestate Death
- 19.2 Strategies for Preserving the Business
 - 19.2.1 Conveyance by will
 - 19.2.2 Sale or conversion to partnership
 - 19.2.3 Joint tenancy

20. DISSOLUTION OF PROPRIETORSHIP

- 20.1 Bankruptcy
- 20.2 Sale of Business
- 20.3 Sale of Individual Assets
- 20.4 Noncompete Agreements
- 20.5 Complete Termination

REFERENCES

APPENDIX 1: Proprietorship Creation Checklist

APPENDIX 2: Incorporation Checklists and Examples

1. INTRODUCTION

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

A proprietorship is a business enterprise in which a single individual—not a partnership or corporation—engages in that enterprise for profit as an owner-operator. The one owner bears all the liability that may be incurred. In the chapter on Partnerships, see appendix 3, “Comparison of Entity Attributes—Proprietorships, Partnerships, C Corporation, S Corporations, and LLCs.

2. LEGAL NATURE OF PROPRIETORSHIP

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

2.1 Formalities

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

2.2 Duration

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

2.3 Business Purposes

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

2.4 Size

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

3. CHARACTERISTICS OF A PROPRIETORSHIP

3.1 Unlimited Liability

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

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

3.2 Commingling of Personal/Business Assets/Liabilities

Proprietorships frequently commingle personal and business moneys and other property within the business accounts. The business account

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

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

3.3 Term

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

3.4 Exercising Control and Independence

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

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

4. ADVANTAGES OF PROPRIETORSHIP

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

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

4.1 Simplicity

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

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

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

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

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

4.2 Owner Control

Another significant advantage of a sole proprietorship is the owner’s exclusive control of the enterprise. Subject to necessary guarantees of

creditors or financing parties, a proprietor is able to make the appropriate decisions and to operate the business as he or she chooses.

4.3 Commingling of Assets, Income, and Deductions

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

4.4 No Double Taxation

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

4.5 Ease of Converting to Another Entity

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

4.6 Employment of Spouse/Children

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

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

4.7 Health Insurance Costs

For 1998 and 1999, self-employed individuals can deduct on their individual income tax returns 45 percent of the amount they pay for medical insurance and eligible long-term care insurance for themselves and their families. The percentage increases to 50 percent in 2000 and 2001, with additional increases to 100 percent scheduled by the year 2007. The deduction is limited to the income on the individual's Schedule C or F, after deducting one-half of the self-employment tax and the Keogh or SEP contribution. The deduction is allowed even if the individual does not itemize deductions.

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

Medical savings accounts (MSAs) are available to self-employed individuals and employees of a small employer who are covered under an employer-sponsored high-deductible health plan. An MSA is a trust or custodial account, similar to an IRA, to cover out-of-pocket medical expenses. (See Insurance chapter, herein, for more details.)

5. DISADVANTAGES OF PROPRIETORSHIP

5.1 Individual Liability

The chief disadvantage of a proprietorship is the lack of a shield from liability. While liability may be mitigated by insurance coverage, the

proprietor will, as a rule, retain ultimate personal liability—including exposure of nonbusiness assets to proprietorship liabilities. Legal or financial risk cannot be spread among a number of individuals or entities and thus mitigated. The proprietor's responsibility is total.

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

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

5.2 Lack of Continuity

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

5.3 Limitations on Employee Benefit and Ownership Programs

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

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

5.4 Social Security Taxes

With the taxable earnings base continuing to rise and the elimination of the Medicare earnings base, more income may become subject to Social Security taxation than is available to be drawn as salary, particularly when the proprietorship operates in a capital-intensive business. Self-employment tax is calculated on the net income of the proprietorship, although a portion of the profit generated is often used to retire

debt, purchase inventory or fixed assets, or is contained in accounts receivable. This results in self-employment tax being calculated on income that is not able to be withdrawn by the proprietor as cash.

The self-employment tax is computed on a base that is not reduced by the proprietor's contributions to his or her own qualified retirement plan or simplified employee pension (SEP) plan, or by the deductible percentage of medical insurance premiums. Therefore, the self-employment tax is likely to be higher than the FICA tax on the owner's salary when the same business is operated as a corporation.

5.5 Income Tax Rates

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

6. FILING AND COMPLIANCE REQUIREMENTS

6.1 Certificate of Assumed Name

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

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

Conducting business under an assumed name does not in any way limit the personal liability of the sole proprietorship for the obligations incurred by the business as discussed in section 5.1.¹

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

6.2 Local Licensing and Permits

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

6.3 Professional Licensing

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

6.4 Sales Tax Permits

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

6.5 Federal Employer Identification Number (FEIN)

A Federal Employer Identification Number must be obtained for Social Security and withholding purposes if additional persons will be employed, with application made to the Internal Revenue Service on Form SS-4. The Internal Revenue Service provides a procedure to obtain the FEIN by telephone. The service is called TELE-TIN and is used in connection with filing the SS-4. The proprietor should complete Form SS-4 prior to calling the IRS. A representative may obtain the number for the proprietor, but should have a signed power of attorney on Form 2848 to authorize representation before the IRS. Further details may be obtained by contacting your local IRS center. Some jurisdictions also require a state tax identification number for withholding and sales tax purposes.

6.6 Workers' Compensation

Suitable contact must be made with the local authority administering workers' compensation statutes to determine if the enterprise is subject

to mandatory coverage and to provide any necessary proof of compliance. (See the Workers' Compensation chapter for additional information on this subject.)

6.7 Unemployment Compensation

Appropriate filings with, and periodic deposits to, the agency administering unemployment compensation programs must be made if the number and type of employees necessitate such arrangements under federal and state laws. State and federal unemployment taxes may be involved. Federal unemployment (FUTA) tax must be paid on a quarterly basis, using a Federal Tax Deposit (FTD) coupon, if the liability exceeds \$100. Annual reporting is required on IRS Form 940 by January 31 of the following year. Some employees are exempt from federal employment taxes: Consult Circular E, *Employer's Tax Guide*, to determine necessary coverage. (See also the Unemployment Insurance chapter, herein, for further guidance.)

6.8 Withholding Taxes

Periodic payments and informational filings are required for employee withholding, income, and employee Social Security tax obligations. Since 1993, the IRS annually notifies employers of their specific payroll tax deposit requirement for the coming year. IRS Form 941 or Form 943 for agricultural employers is used to report federal income and Social Security taxes. The proprietor's self-employment Social Security tax liability is computed on the proprietor's U.S. individual income tax return as described in section 6.10. The proprietor's income and self-employment tax liabilities are normally paid in via quarterly estimated tax payments.

6.9 Other Employment Regulations

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

6.10 Income Tax Reporting

Proprietorship income is reported annually to the IRS on either Schedule C, Profit or Loss from Business, or Schedule F, Farm Income and

Expenses, and included in the individual's Form 1040. This income must also be considered in calculating self-employment Social Security tax on Schedule SE and possibly on other tax forms included in Form 1040. For more information, see IRS Publication 334, *Tax Guide for Small Business*. Personal-property-leasing net income is subject to self-employment tax only when it rises to the level of a business, as described in the instructions to Schedule E of Form 1040.

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

7. PROPRIETORSHIP NAME

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

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

(Text continued on page 15)

8. ACCOUNTING FOR PROPRIETORSHIPS

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

8.1 Accounting Methods and Consistency

The accounting method chosen should allow determination of profit and loss under generally accepted accounting principles (GAAP) or an other comprehensive basis of accounting (OCBOA). The cash basis of accounting is generally the simplest and can be used by many small businesses. If inventories exist, the regulations in IRC Sections 446 and 471 require that the accrual basis be used. Any method used must be consistently followed from period to period.

In filing the first Schedule C or Schedule F, an owner can choose the appropriate method of accounting without the consent of the IRS. Subsequently, if the owner wants to change the method of accounting, the owner must get the consent of the IRS—usually by filing Form 3115, Application for Change in Accounting Method, and paying the required user fee. Each separate business should be reported on its own schedule C or F. Accordingly, each business may make separate tax method elections.

Start-up expenses incurred in the formation of a proprietorship must be capitalized for tax purposes. An election may be made under IRC Section 195 to amortize such expenses over a sixty-month period.

8.2 Minimum Requirements

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

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

8.3 Accounting Periods

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

9. HUSBAND AND WIFE AS COPROPRIETORS

9.1 Propriety

While a proprietorship enterprise is generally viewed as the responsibility and characteristic of a single person, a determination must be made whether a coproprietorship partnership exists between husband and wife. In absence of a partnership, a proprietorship exists, which by definition can have only one proprietor—the spouse who “substantially controls” based on the facts. The net business income of the proprietor is subject to self-employment tax. Accordingly, the remaining spouse is relegated to employee status, which should be documented by payment of a salary. The salary paid to the spouse/employee is subject to Social Security tax at both the employer and employee levels.

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

9.2 Divorce

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

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

10. EMPLOYMENT OF SPOUSE AND CHILDREN

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

10.1 IRA Deduction

Salaries paid to a child may create a source of earned income to support a contribution to an individual retirement account, subject to current limitations and restrictions.

10.2 Keogh/HR 10 Plan Contribution

Spousal salary creates a source of earned income to allow Keogh/HR 10 plan contribution after the spouse has met participation requirements.

10.3 Estate Planning

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

10.4 Child Care Credit

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

10.5 Social Security Tax

Wages paid to a proprietor's child under age eighteen (including a foster or stepchild) are exempt from Social Security taxation (see IRS Publication 51). Prior to 1988, wages paid to a spouse were also exempt.

Whether it is still advantageous to pay spousal wages subject to FICA tax needs to be determined on a case-by-case basis. Prior to 1988 a spousal salary permanently exempted a portion of the couple's earned income from Social Security tax, assuming the proprietor's income was under the Social Security maximum taxable wage base. After 1987, spousal wages could actually increase the couple's Social Security tax liability beyond what it would be if no spousal wages were paid.

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

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

Besides the Social Security retirement benefits issue, it may be appropriate to pay spousal wages to allow contributions to retirement plans, claim the child care or earned income credits, or participate in employee benefit plans. In addition, payment of a small amount of spousal wages—\$2,500 to \$3,000 per year—would keep the spouse eligible under Social Security death and disability coverage and may be used

to provide survivor benefits. The possibility of a marriage dissolution at some point in the future also needs to be considered. A decision not to pay spousal wages to save Social Security taxes may leave the ex-spouse with no Social Security earnings history on which to eventually draw benefits, even after years of legitimate service to the former spouse's proprietorship.

10.6 Earned Income Credit and Business Loss

If there are qualifying children and a taxable loss from the business exists, a spousal salary can enhance the earned income credit by combining the salary with an optional self-employment tax election under IRC Section 1402 (a) (12) (ii). Limitations exist on how frequently the non-farm optional self-employment tax election may be used. For further information, see IRS Publication 533, *Self-Employment Tax*.

10.7 Employee Benefit Plans

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

(Text continued on page 19)

10.8 Salary to Children and Tax Bracket

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

11. REAL ESTATE IN PROPRIETORSHIP

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

11.1 Held in Proprietor's Name

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

11.2 Documentation

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

11.3 Property Used Both Personally and for Business

Property owned by the proprietor and used both for business and personal reasons must be prorated between the business and personal

use based on the business-use percentage. The business portion of any depreciation and related expenses are allowed as business deductions:

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

For tax purposes, business use of the home is deductible in limited circumstances. Following the Supreme Court's *Soliman* decision, deductions are disallowed if the relative importance of work and time spent in other locations exceeds that incurred at the residence (U.S. 168, 174 (1993)). The Taxpayer Relief Act of 1997 changes this provision, but not until 1999. However, the *Soliman* decision and the principal-place-of-business test are not applicable if the home office is a separate structure or is regularly used to meet with patients, clients, or customers.

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

12. CONTRACTUAL RELATIONSHIPS OF THE SOLE PROPRIETOR

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

12.1 Nonbinding Contracts

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

12.2 Verbal Contracts

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

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

12.3 Written Contracts

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

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

12.4 Breach of Contract

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

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

12.5 Uniform Commercial Code (UCC)

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

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

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

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

13. THE PROPRIETOR AND OBLIGATIONS

13.1 Unlimited Authority

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

13.2 Financial Instability or Bankruptcy

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

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

14. BUSINESS LIABILITY AND PERSONAL ASSETS

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

14.1 Personal Guarantees

The proprietor is often required to provide personal guarantees of payment, secured by nonbusiness assets. One of the risks assumed by the owner for choosing to do business in a proprietorship is the fact that the public dealing with the sole proprietor is generally entitled to reach the deeper pocket (if available) of the proprietor's additional

personal assets. The proprietor's waiver or disclaimer of liability is generally not sufficient to protect personal assets.

14.2 Liability Insurance

Insurance coverage for every type of potential liability is of particular significance for the sole proprietor. The amounts and nature of protection will, of course, depend on the nature of the enterprise. (See the chapter on Insurance, herein, along with section 11.3 of this chapter on home office liability insurance.)

15. PROTECTION OF PROPRIETARY PORTIONS OF BUSINESS

15.1 Unique Knowledge

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

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

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

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

15.2 Name

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

15.3 Goodwill

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

15.4 Personal Property

Personal property can be protected by insuring against foreseeable risks. (See the chapter on Insurance, herein, along with section 11.3 of this chapter on home office property insurance.)

15.5 Intellectual Property

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

15.6 Estate Planning for Proprietorship

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

A decedent's business may be continued under limited circumstances in some jurisdictions; however, in most instances, the business

will be liquidated following the death of the owner either by selling the separate assets of the business or by a sale of the business as a going concern.²

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

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

16. CHANGE TO PARTNERSHIP

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

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

16.1 Partners' Contribution

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

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

Decisions on how to bring the assets and liabilities of the proprietorship enterprise into the new partnership will normally require negotiation. The newly created entity may assume the obligations and liabilities

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

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

16.2 Partnership Agreement

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

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

16.3 Tax Consequences

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

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

16.4 Notice to Creditors and Debtors

A change in form of the business enterprise requires notices to creditors and other obligees of the business. Without timely notice, the proprietor may be retaining sole liability for obligations rightfully shared by partners and the partnership itself.

17. CHANGE TO CORPORATE FORM

Incorporating a sole proprietorship entails considerably greater formality than change to a partnership. (See also the chapters on Corporations

and S Corporations and appendix 2 following this chapter.) Because of the many formalities required and pitfalls that can occur in incorporating, competent professional personnel should always be consulted.

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

17.1 Reasons for Incorporating

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

— *Income tax.* Corporate tax rates are equal to the lowest individual rates on the first \$50,000 of corporate income. This allows for splitting income between individual and corporate tax returns to achieve full use of lower tax brackets. At income levels above \$335,000, corporate rates are significantly lower than the highest individual rate. However, other factors, such as the tax cost upon liquidation of the corporation, must also be considered.

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

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

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

17.2 Valuation

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

17.3 Items for Transfer to Corporation

Assets

| | |
|-------------------------|--|
| Cash | Amount needed for operation. |
| Receivables | Identify on balance sheet, even if no tax basis (i.e., cash basis proprietorship). |
| Inventory | Identify on balance sheet, even if no tax basis, to prevent “assignment of income” attack under IRC Section 482. |
| Machinery and equipment | Generally automatic to include. May retain and lease to corporation, but watch passive-loss rules and possible self-employment tax. |
| Real estate | May transfer to allow land debt to be repaid with corporate after-tax dollars. Could also retain and lease to create retirement income. Real estate rent creates a hedge against inflation and does not reduce Social Security benefits under earnings limit test. Real estate, however, may be subject to double taxation if the corporation is liquidated. For this reason, real estate is often held out of the corporation. |

Liabilities

| | |
|------------------|--|
| Accounts payable | If the proprietorship was on a cash basis, the operating expense payables will be deducted when paid by the corporation. |
|------------------|--|

Liabilities

Other liabilities

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

17.4 Filings

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

17.5 Issuance of Stock

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

17.6 Tax Consequences

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

Step 1. Property (tangible or intangible) is transferred to a corporation.

Step 2. The transfer is solely in exchange for stock of the newly formed corporation.

Step 3. The transferors have at least 80 percent control of the corporation immediately after the exchange.

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

Incorporation should be viewed as a long-term commitment, because double taxation will generally occur upon the liquidation or

dissolution of the corporation, unless the corporation is an S corporation at all times. Even with an S corporation, tax ramifications result upon the liquidation of the corporation.

17.7 Liabilities in Excess of Basis

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

18. CHANGE TO SINGLE-MEMBER LIMITED LIABILITY COMPANY

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

19. EFFECT OF PROPRIETOR DEATH

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

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

19.1 Intestate Death

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

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

19.2 Strategies for Preserving the Business

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

19.2.1 Conveyance by will

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

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

19.2.2 Sale or conversion to partnership

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

19.2.3 Joint tenancy

Where permitted by law, joint tenancy may be considered as a preservation alternative. Local law must be consulted as to whether such a

method of holding the business would render the enterprise something other than a sole proprietorship.

20. DISSOLUTION OF PROPRIETORSHIP

20.1 Bankruptcy

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

20.2 Sale of Business

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

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

20.3 Sale of Individual Assets

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

20.4 Noncompete Agreements

Covenants or agreements not to compete in the same form of business for a specified time and place may be negotiated separately in the sale of a proprietorship or its assets. Such covenants are governed by relevant state laws and are generally strictly construed in favor of free competition. Although a noncompete covenant may cover a relatively short

period, the Internal Revenue Code requires that noncompetes (as well as most acquired intangible assets) be amortized over a 15-year period for tax purposes.

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

20.5 Complete Termination

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

All parties dealing with a proprietorship must be informed of a change of ownership in order to prevent ongoing liability to the original proprietor beyond the date of transfer.

REFERENCES

- Aronoff, Craig E., and John L. Ward. *Family Business Sourcebook: A Guide for Families Who Own Businesses and the Professionals Who Serve Them*. Detroit: Omnigraphics, 1991.
- Bautista, Veltisezar B. *How to Build a Successful One-Person Business: A Common-Sense Guide to Starting and Growing*, 2d ed. Farmington Hills, MI: Bookhaus Publishers, 1995.
- Burstiner, Irving. *The Small Business Handbook*. New York: Simon & Schuster Trade, 1994.
- Carmichael, Douglas R., et al. *Guide to Small Business Consulting Engagements*. Fort Worth, Tex: Practitioners Publishing Company, 1994.

(Text continued on page 33)

- Davidson, Robert L. *Small Business Incorporation Kit*. New York: John Wiley & Sons, Inc., 1992.
- De Young, John. *Cases in Small Business Management: A Strategic Problems Approach*, 3d ed. Dover, NH: Upstart Publishing Company, Inc., 1994.
- Eckert, Lee A. *Small Business: An Entrepreneur's Plan*. Orlando, Fla.: Dryden Press, 1993.
- English, Robert J., et al. *Business Contracts: Forms and Tax Analysis, 1995 Supplement*. 2 vols., 2d ed. New York: John Wiley & Sons, Inc., 1995.
- Faris, S. Jackson, ed. *Small Business in the Clinton Years: What Your Company Must Do to Survive and Succeed*. Nashville, Tenn.: Hammock Publishing, Inc., 1993.
- Fleury, Robert E. *Small Business Barriers and Battlefields: Adding Reality to the American Dream*. Saint Charles, Ill.: Matahari Publishing, 1995.
- . *The Small Business Survival Guide: How to Manage Your Cash, Profits and Taxes*, 3d ed. Naperville, Ill.: Sourcebooks, Inc., 1992.
- Gottry, Steven R. *Common Sense Business in a Nonsense Economy: The Entrepreneur's Guide to Avoiding Pitfalls and Maximizing Assets—In Good Times and Bad*. San Diego: Pfeiffer & Company, 1994.
- Harroch, Richard D. ed. *Start-Up Companies: Planning, Financing and Operating the Successful Business*. New York: New York Law Publishing Company, 1985. Looseleaf.
- Haynsworth, Harry J. *Organizational Forms for the Closely Held Corporation: Selecting the Form of a Small Business Entity*, New York: American Law Institute, 1989. Looseleaf.
- Hiam, Alexander, and Karen Olander. *Prentice Hall Small Business Survival Guide: A Blueprint for Success*. New York: Prentice Hall, 1996.
- Jenkins, Michael D. *Starting and Operating a Business*. 11 vols. Grants Pass, Ore.: Oasis Press, 1994.
- Karlson, David. *Avoiding Mistakes in Your New Business*. Menlo Park, Calif.: Crisp Publications, Inc., 1994.
- Lamming, Richard. *Beyond Partnership: Strategies for Innovations and Lean Supply*. New York: Prentice Hall, 1993.
- J.K. Lasser Tax Institute Staff. *How to Run a Small Business*, 7th ed. New York: McGraw-Hill, 1993.
- Lewis, Jerre G. *How to Manage Your Business for the 21st Century*. Interlochen, Mich.: Lewis & Renn Publishing, 1995.

- Longenecker, Justin G., and Carlos W. Moore. *Small Business Management*, 10th ed. Cincinnati: South-Western Publishing Co., 1997.
- Maki, Kathleen, ed. *Small Business Sourcebook*. Detroit, Mich.: Gale Research, 1994.
- Marsh, Carole. *The Big Instruction Book of Small Business* (by state). Atlanta: Gallopade Publishing Group, 1994.
- Nunes, Morris A. *Basic Legal Forms for Business*. New York: John Wiley & Sons, Inc., 1993.
- Pickle, Hal B., and Royce L. Abrahamson. *Small Business Management*, 5th ed. New York: John Wiley & Sons, Inc., 1990.
- Schell, Jim. *Small Business Management Guide: Advice from the Brass-Tacks Entrepreneur*. New York: Henry Holt and Co., 1994.
- Schneeman, Angela. *The Law of Corporations, Partnerships, and Sole Proprietorships*. Albany, N.Y.: Delmar Publishers, 1996.
- Siegel, Joel. *Keys to Starting a Small Business*. Hauppauge, N.Y.: Barron's Educational Series, Inc., 1991.
- Small Business Innovation Research: Program Solicitation*. Upland, Penn.: Diane Publishing Company, 1996.
- Solomon, Lewis D. *Business Workout Strategies: Tax and Legal Aspects*. New York: John Wiley & Sons, Inc., 1992.
- Steinhoff, Daniel. *Small Business Management Fundamentals*, 6th ed. New York: McGraw-Hill, Inc., 1993.
- Tepper, Ron. *Fail-Safe Strategies for Small Businesses*. New York: John Wiley & Sons, Inc., 1994.
- U.S. Small Business Administration, Office of Advocacy Staff. *Handbook of Small Business Data*. Washington, D.C.: United States Government Printing Office, 1994.
- White, Jane, and Bruce Pyenson. *J.K. Lasser's Employee Benefits for Small Business*, 2d ed. New York: Prentice Hall, 1993.
- Williams, Bruce. *In Business for Yourself*. Lanham, Md.: Madison Books, 1991.
- Zimmerer, Thomas, and Norman M. Scarborough. *Effective Small Business Management*. New York: Prentice Hall, 1995.

13.16 Self-Employed Health Insurance Deduction

A partner cannot deduct as a business expense his or her health insurance premiums. If the partner or spouse is not eligible to participate in a subsidized health plan, 40 percent (45 percent for tax years beginning in 1998) of the amount paid for health insurance can be deducted as an adjustment to income on Form 1040.

13.17 Retirement Plans

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

14. TERMINATING A PARTNERSHIP

14.1 Dissolution

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

Partnerships may dissolve when any of the following events occur:

- When the business of the partnership or the carrying on of the particular business in the form of a partnership becomes illegal
- When the partnership acts for an illegal purpose
- Expulsion of a partner
- Withdrawal or addition of a partner
- Upon the expiration of the term of the partnership agreement and the mutual agreement of the partners to dissolve the business
- Upon fulfillment of the partnership purpose as stated in the partnership agreement
- When any partner or partners declare(s) that they no longer wish to continue the partnership arrangement

- Upon the death of any partner
- Upon the bankruptcy of any partner or of the partnership itself
- When a partner acts to defraud the partnership or otherwise breaks a partner's fiduciary duty
- When a court grants the petition of a partner (or someone acting in the partner's behalf) or of a local or state regulatory authority to dissolve the partnership. Such petition may be granted if—
 - A partner cannot perform his obligations to the partnership.
 - A partner has been judicially declared mentally incompetent.
 - A partner has prejudiced the carrying on of the partnership business or prejudiced the continuing partnership form of the business.
 - The business of the partnership can only be carried on at a loss.
 - The court finds other circumstances that make dissolution a fair or equitable result.

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

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

14.2 Termination

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

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

APPENDIX 2: Incorporation Checklists and Examples

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

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

Contents

Part I—Initial Checklist of Duties and Accountant Responsibilities

Part II—Checklist of Advantages and Disadvantages of Incorporation

Part III—New Corporation Information Sheet

Part IV—Checklist of Client Responsibilities

Part V—Items to Exchange With Attorney

Part VI—IRC Section 351 Transfer Statement

Part VII—Election to Amortize Organization Expense

Part VIII—Election to Amortize Start-Up Expenditures

Example 1: Compilation Letter

Example 2: Sample Balance Sheet

PART I—Initial Checklist of Duties and Accountant Responsibilities

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

- a. Rates and deposit requirements on FICA.
 - b. Federal and state withholding to be deducted? Give withholding booklets and Forms W-4 and I-9 to client.
 - c. Distribute employee's earnings records and instructions to client.
 - d. Transfer any previous unemployment rate.
9. Secure data for and draft Opening Corporate Balance Sheet.
- Example 1: Compilation Letter
Example 2: Sample Balance Sheet
10. Instruct client on bookkeeping requirements.
- a. Who will do bookkeeping? _____ Client _____ Accountant
 - b. Will a financial statement be required (at year-end for bank, etc.)?
_____ Yes _____ No
 - c. IRC Section 351 transfer statement (blank form (Part VI)).
 - d. Organization expense election (Part VII).
 - e. For new businesses, start-up expense election (Part VIII).
11. Complete engagement letter.

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

INITIALS _____

DATE _____

ADVANTAGES

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

2. Estate planning

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

3. Miscellaneous

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

4. Social Security

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

Comments:

Notes on follow-up possibilities:

(Text continued on page 39)

INITIALS _____

DATE _____

DISADVANTAGES

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

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

10. Miscellaneous

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

PART III—New Corporation Information Sheet

1. Name of corporation: _____

2. Address of corporation: _____

3. Date of incorporation: _____

4. County of incorporation: _____

5. Name, address, and Social Security number of incorporators:

a. _____

b. _____

c. _____

d. _____

e. _____

6. Names of officers and directors:

President: _____

Vice-President: _____

Secretary: _____

Treasurer: _____

Directors: _____

7. Corporate stock

a. Authorized capital: \$ _____

b. Number of shares authorized: _____

c. Number of shares issued: _____

d. Par value of shares: \$ _____

8. Stockholders and number of shares issued:

| | <u>Name</u> | <u>Social Security Number</u> | <u>Birth date</u> | <u>Number of Shares</u> | <u>Certificate Number</u> | <u>Date</u> |
|----|-------------|-------------------------------|-------------------|-------------------------|---------------------------|-------------|
| a. | _____ | _____ | _____ | _____ | _____ | _____ |
| b. | _____ | _____ | _____ | _____ | _____ | _____ |
| c. | _____ | _____ | _____ | _____ | _____ | _____ |
| d. | _____ | _____ | _____ | _____ | _____ | _____ |
| e. | _____ | _____ | _____ | _____ | _____ | _____ |

9. Name and address of bank: _____

10. Fiscal year-end: _____

11. Subchapter S corporation election? _____
(Note: be sure to file within fifteenth day of third month of tax year).

Indicate who will file election _____

12. Stockholders' restrictive agreements (buy-sell): _____

13. Date business was started: _____

14. Number of employees: _____

15. Date first wages will be paid: _____

16. Average monthly payroll: \$ _____

17. Employees and annual compensation:

| | | |
|-------|----|-------|
| _____ | \$ | _____ |
| _____ | \$ | _____ |
| _____ | \$ | _____ |
| _____ | \$ | _____ |
| _____ | \$ | _____ |

18. Attorney's name, address, and phone number: _____

19. Employee residence locations: _____

20. Tax identification numbers (TINs):

a. Federal tax identification number (per Tele-TIN) _____

b. State tax identification number (if applicable) _____

21. Corporate charter number: _____

22. Accounting method information:

a. Basis of accounting for tax purposes _____

b. Any special elections or computations required?

(1) IRC Section 461 accrual election _____

(2) IRC Section 351 transfer statement
(with individual's return) _____

(3) Organization expense amortization
election _____

(4) Start-up expenditures amortization
election _____

(5) _____

(6) _____

(7) _____

PART IV—Checklist of Duties and Client Responsibilities

Federal Tax Identification Number: _____

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

PART V—Items to Exchange With Attorney

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

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

PART VI—IRC Section 351 Transfer Statement

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

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

PART VII—IRC Section 248 Election to Amortize Organization Expenditures

Election Re: Amortization of organization expense

In this, its first taxable year, taxpayer incurred \$ _____ as organizational expenditures incident to its creation. Under the provisions of Section 248 of Internal Revenue Code and the Regulations thereunder, taxpayer hereby elects to amortize such expenses over the 60-month period commencing with the date of formation, which constitutes the month in which taxpayer began business.

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

FORM 1120

AMORTIZATION OF START-UP EXPENDITURES

Pursuant to IRC Section 195, _____ elects to amortize the following start-up expenditures over 60 months beginning with _____, 19____, the month in which the corporation began business. This information is submitted as required:

| <u>Description of Expense</u> | <u>Date Incurred</u> | <u>Amount</u> |
|-------------------------------|----------------------|----------------|
| | | \$ |
| | | <hr/> |
| | | <hr/> <hr/> |
| Total start-up costs | | \$ <hr/> <hr/> |

Example 1: Compilation Letter

April 4, 199X

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

We have compiled the accompanying opening corporate statement of assets, liabilities, and stockholders' equity—income tax basis and market value of **APPLE FARMS, INC.** as of March 14, 199X, and the related supplementary data in accordance with Statements on Standards for Accounting and Review Services (SSARSS) issued by the American Institute of Certified Public Accountants. The financial statement has been prepared on the accounting basis used by the company for income tax purposes, which is a comprehensive basis of accounting other than generally accepted accounting principles.

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

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

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

Example 2: Sample Balance Sheet

APPLE FARMS, INC.
Opening Corporate Statement of Assets, Liabilities, and Stockholder's Equity—
Income Tax Basis and Market Value
March 14, 199X

(See Accountants' Compilation Report)

| | <i>As Transferred by Greg Apple</i> | | <i>As Transferred by Frank Smith</i> | | <i>Total</i> | |
|--|---|-------------------------|--|-------------------------|----------------------|-------------------------|
| | <u>Tax Basis</u> | <u>Market Value</u> | <u>Tax Basis</u> | <u>Market Value</u> | <u>Tax Basis</u> | <u>Market Value</u> |
| <u>Assets</u> | | | | | | |
| <u>Inventory:</u> | | | | | | |
| Soybeans (8,700 bushels at \$5.50 per bushel) | \$ — | \$ 47,850 | \$ — | \$ — | \$ — | \$ 47,850 |
| Corn (21,000 bushels at \$2.00 per bushel) | — | 42,000 | — | — | — | 42,000 |
| Market hogs (469 head—all sizes) | — | 2,488 | — | 76,291 | — | 78,779 |
| Prepaid expenses: | | | | | | |
| Seed | — | 3,000 | — | 5,000 | — | 8,000 |
| Diesel fuel | — | 500 | — | — | — | 500 |
| Feed | — | — | — | 2,000 | — | 2,000 |
| Breeding stock (see attached list) | — | — | 2,872 | 9,903 | 2,872 | 9,903 |
| Equipment (see attached list) | — | — | 15,500 | 87,000 | 40,937 | 190,000 |
| <u>Total Assets</u> | <u>\$ 25,437</u> | <u>\$ 198,838</u> | <u>\$ 18,372</u> | <u>\$ 180,194</u> | <u>\$ 43,809</u> | <u>\$ 379,032</u> |

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

| <u>Attribute</u> | <u>Proprietorship</u> | <u>General, Limited, or LLP Partnerships</u> | <u>C Corporation</u> | <u>S Corporation</u> | <u>Limited Liability Company (where authorized by states)</u> |
|-------------------------------------|---|--|---|---|---|
| <u>Life of Entity</u> | Terminated at will or death of proprietor | Terminated at will or death of a major partner or transfer of material ownership | Indefinite | Indefinite | Stated limit |
| <u>Number of Owners</u> | One | Unlimited | Unlimited | Seventy-five | Unlimited |
| <u>Transferability of Interests</u> | Freely transferable | Typically, subject to partners' approval | Typically, freely transferable; can be restricted through buy-sell agreements | Typically, freely transferable; can be restricted through buy-sell agreements | Same as S corporation |

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

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

| <u>Attribute</u> | <u>Proprietorship</u> | <u>General, Limited, or LLP Partnerships</u> | <u>C Corporation</u> | <u>S Corporation</u> | <u>Limited Liability Company (where authorized by states)</u> |
|----------------------------------|--|---|--|---|---|
| <u>Required Tax Year</u> | Must use tax year of proprietor | Generally, must use fiscal year of partners or calendar year unless IRC Section 444 election is made | May select any fiscal year if not a personal service corporation | Generally, must use calendar year unless natural business year test is met or IRC Section 444 election is made | Same as S corporation |
| <u>Medical Insurance Premium</u> | 40 percent (45 percent for tax years beginning in 1998) of premium cost deductible above-the-line; if a spouse is an employee and a spousal insurance plan is in place, 100 percent of premium cost deductible as a business expense | 40 percent (45 percent for tax years beginning in 1998) of premium cost deductible above-the-line; if a partner's spouse is an employee of the partnership and an insurance plan is in place, 100 percent of the premium cost is deductible | 100 percent of premium cost is deductible | 40 percent (45 percent for tax years beginning in 1988) of premium cost deductible above-the-line by more than 2 percent shareholders | Same as partnership |

PARTNERSHIPS

1. INTRODUCTION

2. PARTNERSHIP FORMS

- 2.1 Partnership
- 2.2 Joint Venture
- 2.3 General and Limited Partnerships
- 2.4 Family Partnership
- 2.5 Professional Corporations as Partners
- 2.6 Limited Partnership Tax Shelters
- 2.7 Master Limited Partnerships
- 2.8 Limited Liability Companies
- 2.9 Registered Limited Liability Partnerships

3. LEGAL STATUS AND CHARACTERISTICS OF A PARTNERSHIP

- 3.1 Hybrid Nature
- 3.2 Legal Characteristics
 - 3.2.1 Duration
 - 3.2.2 Jointly owned property
 - 3.2.3 Other ownership issues
 - 3.2.4 Profit sharing
 - 3.2.5 Management and control

4. LAWS GOVERNING THE PARTNERSHIP

- 4.1 Applicable Statutes and Laws
- 4.2 Who Can Be a Partner
- 4.3 The Partnership Agreement
 - 4.3.1 Buy-sell agreements

5. DELEGATION OF AUTHORITY FOR MANAGEMENT DUTIES AMONG PARTNERS

6. DUTIES OF PARTNERS TO EACH OTHER

- 6.1 Duties of Partners to Co-partners
 - 6.1.1 Fiduciary duty
 - 6.1.2 Duty to share profits
 - 6.1.3 Duty to contribute capital
 - 6.1.4 Duty to share losses and liabilities
 - 6.1.5 Management duty

PARTNERSHIPS

- 6.2 Remedies for Breach
 - 6.2.1 Court action
 - 6.2.2 Dissolution or withdrawal

7. DUTIES AND LIABILITIES TO THIRD PARTIES

- 7.1 Express Authority
 - 7.1.1 Binding contracts
 - 7.1.2 Liability for wrongful acts or omissions
 - 7.1.3 Conveyance of real estate
- 7.2 Implied or Apparent Authority
 - 7.2.1 Public holding out
 - 7.2.2 Private holding out
- 7.3 Notice to Third Parties
- 7.4 Notice From Third Parties

8. ADVANTAGES AND DISADVANTAGES OF A PARTNERSHIP

- 8.1 Advantages
- 8.2 Disadvantages

9. CREATING THE PARTNERSHIP

- 9.1 Partnership and Limited Partnership Documents
 - 9.1.1 General partnerships
 - 9.1.2 Limited partnerships
 - 9.1.3 Advantages and disadvantages
- 9.2 Certificate of Assumed Name
- 9.3 Federal Employer Identification Number
- 9.4 Local and Professional Licensing and Permits
- 9.5 Sales Tax Permits
- 9.6 Workers' Compensation
- 9.7 Unemployment Compensation
- 9.8 Withholding Taxes
- 9.9 Other Employment Regulations
- 9.10 Amending Required Filings

10. FUNDING THE PARTNERSHIP

- 10.1 Contributions of Partners
- 10.2 Basis in Partnership Interest
 - 10.2.1 Sale of property
 - 10.2.2 Interest in exchange for personal services
 - 10.2.3 Liabilities assumed by other partners
 - 10.2.4 Summary

11. ACCOUNTING SYSTEMS AND ACCOUNTS

- 11.1 Accounting Methods and Consistency
- 11.2 Minimum Requirements
- 11.3 Accounts

12. DISTRIBUTION OF PROFITS AND LOSSES

- 12.1 Ongoing Distributions
- 12.2 Distribution on Retirement, Death, or Good-Faith Withdrawal
- 12.3 Liquidating Distributions

13. TAXATION OF PARTNERSHIPS

- 13.1 Conduit Nature of Partnership
 - 13.1.1 Advantages of partnership taxation over S corporation taxation
 - 13.1.2 Large partnership simplified pass-through election
- 13.2 Limitations on Passive Activities
- 13.3 Limitation on Losses to Amount at Risk
- 13.4 Interest Expense to Carry Partnership Interests
- 13.5 Transfers to the Partnership
- 13.6 Distributions and Liquidating Distributions
- 13.7 Sale of Partnership Interest
- 13.8 Partnership Can Elect to Adjust the Basis of Partnership Property
 - 13.8.1 Example: Adjustment to basis of property upon sale of partnership interest
- 13.9 Termination of a Partnership
- 13.10 Conversion to a Limited Liability Company or Limited Liability Partnership
- 13.11 Conversion to a Corporation
- 13.12 Merger of Partnerships
- 13.13 Death of a Partner
- 13.14 Tax Year
- 13.15 Examination Procedures
- 13.16 Self-Employment Tax
- 13.17 Self-Employed Health Insurance Deduction
- 13.18 Retirement Plans

14. TERMINATING A PARTNERSHIP

- 14.1 Dissolution
- 14.2 Termination
- 14.3 Termination Not Ending Liability to Third Parties
- 14.4 Disposition of Assets and Liabilities
- 14.5 Dissolution Where Business Continues

REFERENCES

APPENDIX 1: Partnership Agreement Checklist

APPENDIX 2: Partnership Creation Checklist

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

1. INTRODUCTION

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

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

2. PARTNERSHIP FORMS

2.1 Partnership

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

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

2.2 Joint Venture

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

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

2.3 General and Limited Partnerships

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

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

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

2.4 Family Partnership

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

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

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

a combination of capital contribution and services, or only services, depending upon whether the partnership business is labor-intensive, capital-intensive, or some combination of the two.

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

2.5 Professional Corporations as Partners

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

2.6 Limited Partnership Tax Shelters

Limited partnership tax shelters, developed with the intention of generating passive losses to offset other taxable income, have been altered by every major tax act since 1981. After TRA '86, which restricted the ability to offset other income with passive losses, a new breed of tax shelter has arisen. Passive income generators, or PIGs, are designed to produce passive income for a taxpayer, which, in turn, allows losses from other passive activities to be deducted.

2.7 Master Limited Partnerships

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

2.8 Limited Liability Companies

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

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

2.9 Registered Limited Liability Partnerships

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

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

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

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

3. LEGAL STATUS AND CHARACTERISTICS OF A PARTNERSHIP

3.1 Hybrid Nature

In one sense, a partnership is a legal entity with its own identity. In this sense, the partnership holds itself out as a business entity apart from

the individual personalities of its owners. This identity may be established, and its name protected, through filings with appropriate state agencies. The partnership may sue and be sued as a separate entity and is subject to tax reporting and other requirements.

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

(Text continued on page 9)

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

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

3.2 Legal Characteristics

3.2.1 Duration

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

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

3.2.2 Jointly owned property

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

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

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

3.2.3 Other ownership issues

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

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

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

3.2.4 Profit sharing

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

3.2.5 Management and control

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

4. LAWS GOVERNING THE PARTNERSHIP

4.1 Applicable Statutes and Laws

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

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

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

The Uniform Limited Partnership Act (ULPA) governs limited partnerships and has been adopted by most states. The Revised Uniform Limited Partnership Act (RULPA), drafted in 1976, has superseded the ULPA in many states.

The IRS, in Rev. Rul. 95-2, concluded that thirty-three states have RULPA statutes that conform to the ULPA for purposes of IRS Reg. 301.7701-2 (dealing with characteristics of partnerships and corporations). Those states *not* conforming are Alaska, Hawaii, Indiana, Kentucky, Louisiana, Maine, Nevada, New Hampshire, New Mexico, New York, North Carolina, North Dakota, Oregon, Rhode Island, South Carolina, South Dakota, and Vermont.

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

4.2 Who Can Be a Partner

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

4.3 The Partnership Agreement

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

- Name of partnership.
- Names of partners.
- Address of its principal offices.

- The purpose of the partnership.
- Its duration.
- Its executive, administrative, and capital structure; the financial, administrative, and functional relationship among its partners.
- Procedures for decision making and resolving disputes.
- Formulas for sharing profits, losses, and liabilities.
- The means of equitably terminating the partnership itself upon the occurrence of various events.
- The authority of the partners.
- Any restriction on the transfer of partnership interest.

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

- That the partners intend to form a partnership for a legal purpose and that the partners understand and accept the legal incidents of a partnership.
- That the partners intend to share, in some specified fashion, the profits, losses, rights, and obligations of a partnership.
- That the partners have a common interest of some variety in the property to be owned by or contributions to be made to the partnership.
- That the partners specify that they will have either an equal share or specifically delineated duties in the operation of the partnership's business enterprise.

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

(Text continued on page 13)

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

4.3.1 Buy-sell agreements

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

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

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

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

5. DELEGATION OF AUTHORITY FOR MANAGEMENT DUTIES AMONG PARTNERS

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

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

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

6. DUTIES OF PARTNERS TO EACH OTHER

6.1 Duties of Partners to Co-partners

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

6.1.1 Fiduciary duty

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

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

6.1.2 Duty to share profits

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

6.1.3 Duty to contribute capital

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

6.1.4 Duty to share losses and liabilities

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

6.1.5 Management duty

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

6.2 Remedies for Breach

6.2.1 Court action

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

6.2.2 Dissolution or withdrawal

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

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

7. DUTIES AND LIABILITIES TO THIRD PARTIES

7.1 Express Authority

7.1.1 Binding contracts

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

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

7.1.2 Liability for wrongful acts or omissions

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

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

7.1.3 Conveyance of real estate

A partner can convey title to real estate to third parties, but the conveyance may be voided if the partner was acting outside the scope of

authority or the party taking the real estate was aware of the lack of authority. The transfer cannot be voided if the property is subsequently purchased from the original buyer by a person who was unaware that the partner lacked authority in the previous transfer.

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

7.2 Implied or Apparent Authority

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

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

- The partner is not authorized to act, and
- The third party has knowledge of the lack of authority.

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

- The partnership or co-partners allow an unauthorized person to misrepresent himself or herself as an authorized agent of the partnership to an innocent third party.
- The partnership ratifies, or approves after the fact, the act or omission by the partner affecting the rights or interests of a third party.
- The acts of the partnership or a partner imply to a third party that a partner is authorized to do something or execute some document on behalf of the partnership and the third party relies on it.

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

7.2.1 Public holding out

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

7.2.2 Private holding out

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

7.3 Notice to Third Parties

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

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

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

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

7.4 Notice From Third Parties

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

8. ADVANTAGES AND DISADVANTAGES OF A PARTNERSHIP

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

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

8.1 Advantages

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

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

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

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

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

8.2 Disadvantages

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

The disadvantage of unlimited general partner liability can be mitigated by using a corporate general partner (often an S corporation). This limits the exposure to the assets held by the corporation and effectively walls off the personal assets of all the ultimate owners. Limited

partners, however, are able to avoid exposure to personal, nonbusiness assets for liabilities associated with a limited partnership, LLC, or LLP.

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

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

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

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

9. CREATING THE PARTNERSHIP

9.1 Partnership and Limited Partnership Documents

9.1.1 General partnerships

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

9.1.2 Limited partnerships

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

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

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

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

9.1.3 Advantages and disadvantages

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

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

9.2 Certificate of Assumed Name

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

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

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

9.3 Federal Employer Identification Number

A federal employer identification number (FEIN) must be obtained by filing Form SS-4 with the Internal Revenue Service. The IRS provides a procedure to obtain the FEIN by telephone. The service is called TELE-TIN and is used in connection with filing the SS-4. Further details may be obtained by contacting your local IRS center. Some states also require a state tax identification number. A new, unique FEIN may be required upon incorporation of the partnership or creation of a successor partnership.

9.4 Local and Professional Licensing and Permits

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

9.5 Sales Tax Permits

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

9.6 Workers' Compensation

When the partnership has employees, arrangements should be made with the local authority administering workers' compensation statutes

to determine if coverage is mandatory and to provide any necessary proof of compliance. (See also the chapter on Workers' Compensation, herein.)

9.7 Unemployment Compensation

Filings and deposits may need to be made with the agency administering unemployment compensation programs if the number and nature of employees of the business meet the requirements under federal and state laws. Accordingly, both state and federal unemployment taxes may be involved. Federal unemployment tax (FUTA) must be paid on a quarterly basis, using a federal tax deposit (FTD) coupon, if the liability exceeds \$100, with annual reporting required on IRS Form 940. (See the chapter on Unemployment Compensation, herein, for further detail.)

9.8 Withholding Taxes

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

Many states also require state income tax withholding. Applications, filing procedures, deposit requirements, and so forth vary from state to state.

9.9 Other Employment Regulations

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

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

9.10 Amending Required Filings

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

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

10. FUNDING THE PARTNERSHIP

10.1 Contributions of Partners

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

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

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

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

10.2 Basis in Partnership Interest

The contributing partner receives tax basis in the partnership interest equal to his or her existing basis in the property. Typically the contribution has no income tax effects, although there are certain exceptions.

For example, if property is contributed to a partnership and, within seven years before or after the exchange, (1) other property is distributed to the contributing partner or (2) the contributed property is distributed to another partner, the transaction is treated as an exchange on which taxable gain or loss may be recognized.

10.2.1 Sale of property

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

(Text continued on page 25)

10.2.2 Interest in exchange for personal services

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

10.2.3 Liabilities assumed by other partners

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

10.2.4 Summary

Generally, a partner's basis in a partnership will

— *Increase by*

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

— *Decrease by*

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

11. ACCOUNTING SYSTEMS AND ACCOUNTS

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

11.1 Accounting Methods and Consistency

The accounting method chosen should allow profit and loss to be determined under generally accepted accounting principles (GAAP)

or an other comprehensive basis of accounting (OCBOA). The cash basis of accounting is generally the simplest and can be used by many small businesses. If inventories are involved, the regulations at IRC Sections 446 and 471 require that the accrual basis be used. Whatever method is employed, it must be followed consistently from period to period.

IRC Section 448 specifies that tax shelters and partnerships with C corporations as partners cannot use the cash method of accounting. Exceptions exist for businesses with average annual gross receipts of \$5 million or less, farming businesses within the meaning of IRC Section 263A(e)(4), and qualifying personal service corporations.

In filing the initial Form 1065, the partnership can choose the appropriate accounting methods without IRS consent. Subsequently, if the partnership wants to change an accounting method, it must get IRS approval, which is usually accomplished by filing Form 3115, Application for Change in Accounting Method. A user fee is required to be paid at the time Form 3115 is filed.

11.2 Minimum Requirements

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

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

11.3 Accounts

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

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

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

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

12. DISTRIBUTION OF PROFITS AND LOSSES

12.1 Ongoing Distributions

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

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

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

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

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

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

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

12.3 Liquidating Distributions

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

13. TAXATION OF PARTNERSHIPS

13.1 Conduit Nature of Partnership

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

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

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

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

- Ordinary income (loss) from trade or business activities
- Net income (loss) from rental real estate activities
- Net income (loss) from other rental activities
- Guaranteed payments to partners
- Net gain (loss) under IRC Section 1231
- IRC Section 179 depreciation expense deduction
- Net short-term capital gain (loss)

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

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

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

Before the Treasury issued new Regulations 301.7701-1 through -3 in December 1996, former Regulation 301.7701-2 identified four criteria that distinguished corporations from partnerships: continuity of life, centralization of management, limited liability, and free transferability of interests. This regulation raised some problems for limited partnerships, although those formed under the ULPA generally qualified as partnerships, not as "associations taxed as corporations."

In December of 1996, Treasury issued the so-called check-the-box entity classification regulations (Regs. 301.7701-1 through -3). Effective on January 1, 1997, the new regulations implement an extremely simple approach to classifying most unincorporated entities. After that date, it is no longer necessary to consider the four corporate characteristics in deciding how a newly formed entity will be treated for federal income tax purposes. Also, an existing entity is allowed to change its classification, but such a change could trigger adverse tax consequences.

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

13.1.1 Advantages of partnership taxation over S corporation taxation

The taxation of partnerships and S corporations is often compared because of the conduit nature of both types of entities. Following are

some advantages that partnership taxation may have over S corporation taxation:

- *Basis from entity-level debt.* Partners are able to receive additional tax basis from entity-level debt. This is not available to S corporation shareholders, even if they guarantee the corporate debt.
- *Tax-free contribution of assets with debt in excess of basis.* Partners generally have the ability to contribute assets to the partnership along with debt in excess of the tax basis in a tax-free transaction. S corporation shareholders would have to recognize gain on a similar transaction.
- *Section 754 optional basis adjustment.* May result in ability to step up basis, resulting in larger depreciation deductions or decreased taxable gains (see section 13.8). No similar basis adjustments are allowed for S corporations.
- *Tax-free distribution of appreciated assets.* Partnerships generally have the ability to distribute appreciated assets to the partners tax-free, while similar distributions from an S corporation would result in taxable gain.

13.1.2 Large partnership simplified pass-through election

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

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

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

13.2 Limitations on Passive Activities

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

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

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

- To offset other passive income, excluding portfolio income.
- If from rental real estate activities, to offset up to \$25,000 of a partner's nonpassive income, assuming the taxpayer has at least a 10 percent ownership in the rental real estate activity and "actively participates" (within the meaning of IRC Sec. 469(i) and the rules contained in Reg. 1.469-9) in the activity. However, the \$25,000 rental real estate privilege phases out for taxpayers with adjusted gross income exceeding \$100,000.
- Unused losses and credits are carried forward indefinitely and used to offset passive income in succeeding years.
- Suspended losses are deductible in full upon a taxable disposition of the activity.
- Suspended losses are at least partially allowed in the case of a transfer by reason of death.

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

13.3 Limitation on Losses to Amount at Risk

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

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

- The loan is not convertible debt.
- The loan is from or guaranteed by any federal, state, or local government.
- The loan is from a qualified person (such as an independent bank or financial institution) as defined in IRC Section 465.

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

13.4 Interest Expense to Carry Partnership Interests

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

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

13.5 Transfers to the Partnership

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

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

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

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

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

13.6 Distributions and Liquidating Distributions

Partners are taxed on their distributive share of partnership income items, whether or not any distributions are actually made. Flow through of loss from the partnership interest is normally limited to the partner's adjusted basis in the partnership interest in the year the loss occurs.

See section 13.3 for the limitation on losses to the amount the partner has at risk.

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

13.7 Sale of Partnership Interest

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

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

13.8 Partnership Can Elect to Adjust the Basis of Partnership Property

Generally a partnership may not adjust the basis of its property as a result of property distributions to a partner or as the result of a transfer of an interest in the partnership, either by sale or exchange or because of a partner's death, unless the partnership chooses in writing to make an optional adjustment, pursuant to IRC Section 754, to the basis of its property upon the transfer.

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

Pete is a member of Changes Partnership in which the three partners have equal interests in capital gains and profits. The partnership has made the election under IRC Section 754, relating to the optional adjustment to the basis of partnership property. Pete sells his interest

to Julie for \$44,000. The balance sheet of the partnership at the date of sale shows the following:

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

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

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

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

13.9 Termination of a Partnership

A partnership does not terminate for tax purposes by death of a partner, substitution of a new partner, or by the liquidation of a partner's interest.

Termination occurs only when:

- No part of the partnership operation is carried on by *any* of the partners; or
- Within a twelve-month period, there is the sale or exchange of 50 percent or more of the total interest in both partnership capital and profits.

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

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

13.10 Conversion to a Limited Liability Company or Limited Liability Partnership

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

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

13.11 Conversion to a Corporation

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

- Exchange of partnership assets for shares of the corporation.

- A liquidating distribution of partnership assets in which individual partners exchange assets for shares.
- Exchange of partnership interests for shares followed by termination of the partnership.

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

13.12 Merger of Partnerships

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

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

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

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

13.13 Death of a Partner

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

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

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

13.14 Tax Year

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

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

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

13.15 Examination Procedures

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

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

to report any partnership items inconsistently with the partnership return, even if the partner notifies the IRS of the inconsistency. (See the IRS Practice and Procedure chapter.)

13.16 Self-Employment Tax

Limited partners are not subject to self-employment tax on their shares of partnership ordinary income. They may be subject to self-employment tax on guaranteed payments paid for services rendered.

General partners are generally subject to self-employment tax on their share of ordinary net earnings plus any guaranteed payments they received.

For general partners, net earnings do not include

- Dividends (paid on stock) and interest income, unless the dividends or interest were earned as a dealer.
- Rents, unless earned in the course of a trade or business in which services are provided.
- Royalties, unless earned as part of a trade or business.
- Gains or losses recognized under IRC Section 1231.
- Capital gains or losses.

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

13.17 Self-Employed Health Insurance Deduction

A partner cannot deduct as a business expense his or her health insurance premiums. If the partner or spouse is not eligible to participate in a subsidized health plan, 45 percent of the amount paid in 1998 for health insurance and eligible long-term care insurance for themselves and their families can be deducted as an adjustment to income on Form 1040.

13.18 Retirement Plans

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

14. TERMINATING A PARTNERSHIP

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

14.1 Dissolution

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

Partnerships may dissolve when any of the following events occur:

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

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

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

14.2 Termination

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

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

(Text continued on page 37)

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

14.3 Termination Not Ending Liability to Third Parties

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

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

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

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

14.4 Disposition of Assets and Liabilities

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

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

1. Obligations owed to creditors other than partners (secured creditors have priority over unsecured creditors with respect to the property secured; unsecured creditors share equally in any unsecured property)
2. Obligations owed to partners other than for their capital contributions or profits

3. Obligations to partners for their capital contributions
4. Obligations to partners for profits

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

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

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

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

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

14.5 Dissolution Where Business Continues

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

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

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

to assume the debts of the partnership, the creditors will retain such rights against the new entity.

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

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

REFERENCES

- AICPA. *Management of an Accounting Practice Handbook*. 3 vols. New York: American Institute of Certified Public Accountants. Supplemented annually.
- . *Planning Opportunities in Farm Taxation*. New York: American Institute of Certified Public Accountants, 1992.
- Beams, Floyd A. "Partnerships: Formation, Operations, and Changes in Ownership Interests; Dissolution and Liquidation of a Partnership." In *Advanced Accounting*, 6th ed. New York: Prentice Hall, 1995.
- Botkin, James. *Winning Combinations: The New Wave of Entrepreneurial Partnerships Between Large and Small Companies*. New York: John Wiley & Sons, Inc., 1992.
- Brody, Evelyn, and M. Kevin Bryant. *Partnerships: A Complete Tax Practice & Planning Guide*. Columbia, S.C.: Professional Tax & Business Publications, 1996. Looseleaf.
- Burke, Karen C. *Federal Income Taxation of Partnerships in a Nutshell*. St. Paul, Minn.: West Publishing Company, 1992.
- Cleveland, Grover A., et al. *PPC Tax Planning Guide: Partnerships*, 8th ed. Fort Worth, Tex.: Practitioners Publishing Company, 1993. Looseleaf service.
- Clifford, Denis, and Ralph Warner. *The Partnership Book*, 5th ed. Berkeley, Calif.: Nolo Press, 1997.
- Crouch, Holmes F. *Making Partnerships Work: Boost Profits and Benefits with Hands-on Participation*. Saratoga, Calif.: Allyear Tax Guides, 1997.

- Davidson, Robert L. *The Small Business Partnership Kit*. New York: John Wiley & Sons, Inc., 1992.
- Douglas, James A. *Partnership Tax Digest*. Boston: Warren, Gorham & Lamont, 1992.
- Eads, John A. *Practice Continuation Agreements: A Practice Survival Kit*. New York: American Institute of Certified Public Accountants, Inc., 1991.
- Employers' Tax Guide*. IRS Circular E. Washington, D.C.: Department of the Treasury—Internal Revenue Service. Annual.
- Englebrecht, Ted D., Jr., et al. *How to Save Time and Taxes Preparing the Federal Partnership Return*. Vol. 3. (How to Save Time and Taxes Series). New York: Matthew Bender. Supplemented annually.
- Farmers' Tax Guide*. Washington, D.C.: Department of the Treasury—Internal Revenue Service. Annual.
- Geens, Koen, ed. *Corporations and Partnerships*. Cambridge, Mass.: Kluwer Law & Taxation Publishers, 1992. Looseleaf.
- Gunn, Alan. *Partnership Income Taxation*. Westbury, N.Y.: Foundation Press, 1990.
- Haft, Robert J., and Peter M. Fass. *Investment Limited Partnerships Handbook* (Securities Law Series). New York: Clark Boardman Callaghan, 1994.
- Hamilton, Robert W. *Corporations—Including Partnerships and Limited Partnerships: Statutory Supplement to Cases and Materials*, 5th ed. St. Paul, Minn.: West Publishing Company, 1994.
- Haried, Andrew, "Partnerships: Formation, Operation, and Ownership Changes; Partnership Liquidation." In *Advanced Accounting*, 6th ed. New York: John Wiley & Sons, Inc., 1994.
- Harroch, Richard D. *Partnership and Joint Venture Agreements*. New York: New York Law Publishing Co., 1992.
- Hewitt, James, ed. *Resource Materials: Partnerships: UPA, ULPA, Securities, Taxation and Bankruptcy*, 9th ed. New York: American Law Institute—American Bar Association, 1990.
- Hoffman, William H., Jr. et al. *West's Federal Taxation: Corporations, Partnerships, Estates, and Trusts, 1997 Edition*. St. Paul, Minn.: West Publishing Company, 1996.
- Hoyle, Joe B. "Partnerships." In *Advanced Accounting*, 4th ed. Homewood, Ill.: Richard D. Irwin, 1993.

- Klein, William A. *Business Associations—Agency, Partnerships and Corporations 1994: Supplement to Cases and Materials*. Westbury, N.Y.: Foundation Press, 1994.
- Kramer, John L. *Prentice Hall's Federal Taxation: 1997 Corporations, Partnerships, Estates and Trusts*. New York: Prentice Hall, 1996.
- Lamming, Richard. *Beyond Partnership: Strategies for Innovation and Lean Supply*. New York: Prentice Hall, 1993.
- Lind, Stephen A. *Fundamentals of Partnerships Taxation*, 4th ed. Westbury, N.Y.: Foundation Press, 1993.
- McDaniel, Paul R. *Federal Income Taxation of Partnership and S Corporations: 1995 Supplement*. Westbury, N.Y.: Foundation Press, 1995.
- McKee, William S., and William F. Nelson. *Federal Taxation of Partnerships and Partners*. 2 vols. Boston: Warren, Gorham & Lamont, 1991. Looseleaf service. Supplemented tri-annually.
- Murray, Mark F. *Organizational Documents: A Guide for Partnerships and Professional Corporations*. New York: American Institute of Certified Public Accountants, 1990.
- Nunes, Morris A. *Basic Legal Forms for Business*. New York: John Wiley & Sons, Inc., 1993.
- Prentice Hall Editorial Staff. *Prentice Hall Small Business Survival Guide: A Blueprint for Success*. New York: Prentice Hall, 1993.
- Schneeman, Angela. *The Law of Corporations, Partnerships, and Sole Proprietorships*. Albany, N.Y.: Delmar Publishers, 1993.
- Solomon, Lewis D. *Business Workout Strategies: Tax and Legal Aspects*. New York: John Wiley & Sons, Inc., 1992.
- _____. *Corporations and Alternative Business Vehicles*. Santa Monica, Calif.: Casenotes Publishing Company, 1993.
- _____. *Selected Corporation and Partnership Statutes, Rules and Forms*, rev. ed. St. Paul, Minn.: West Publishing Company, 1994.
- Tax Guide for Small Businesses*. IRS Publication 334. Washington, D.C.: Department of the Treasury—Internal Revenue Service.
- Tax Information on Partnerships*. IRS Publication 541. Washington, D.C.: Department of the Treasury—Internal Revenue Service. Annual.
- Thompson, Samuel C., Jr. *Basic Federal Income Taxation: C Corporations, Partnerships and S Corporations*. St. Paul, Minn.: West Publishing Company, 1994.
- United States. *Internal Revenue Code*. Section 704(e) Family Partnerships, Section 471 General Rule for Inventories, Section 465 Deductions

Limited to Amount at Risk, Section 706(b) Partnerships Taxable Year, Section 752 Treatment of Certain Liabilities.

Whitmire, Robert L. et al. *Federal Taxation of Partnerships and Partners: Structuring and Drafting Agreements*. Vols. 3 and 4. Boston: Warren, Gorham & Lamont, 1993.

APPENDIX 1: Partnership Agreement Checklist

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

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

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

APPENDIX 2: Partnership Creation Checklist

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

| | Date Required | To Be Done By | | Date Finished |
|---|------------------|---------------|-------|------------------|
| | | Atty. | CPA | Company |
| 18. Insurance (secure necessary insurance, i.e., fire, liability, etc. Notify all agents if partnership was formed from a preexisting business) | _____ | _____ | _____ | _____ |
| 19. Special licenses and permits (secure, if necessary) | _____ | _____ | _____ | _____ |
| 20. Retirement plans | _____ | _____ | _____ | _____ |
| 21. Determine what, if any, fringe benefits will be offered to employees | _____ | _____ | _____ | _____ |
| 22. Vehicle requirements (if employee is to furnish vehicle, formally require him or her to do so in written agreement) | _____ | _____ | _____ | _____ |
| 23. Determine employment requirements (wage & hour) and hiring | _____ | _____ | _____ | _____ |
| 24. Employment agreement (prepare an employment agreement for key employees) | _____ | _____ | _____ | _____ |
| 25. Buy-sell agreements | _____ | _____ | _____ | _____ |
| 26. Consider life insurance coverage (on partner to fund replacement or buy-sell) | _____ | _____ | _____ | _____ |
| 27. Lease: | | | | |
| a) personal property | _____ | _____ | _____ | _____ |
| b) real estate | _____ | _____ | _____ | _____ |

Adapted from *Incorporation Checklist*, Charles Bailly & Company.

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

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

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

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

| <u>Attribute</u> | <u>Proprietorship</u> | <u>General, Limited, or LLP Partnerships</u> | <u>C Corporation</u> | <u>S Corporation</u> | <u>Limited Liability Company (where authorized by states)</u> |
|----------------------------------|---|--|--|--|---|
| <u>Required Tax Year</u> | Must use tax year of proprietor | Generally, must use fiscal year of partners or calendar year unless IRC Section 444 election is made | May select any fiscal year if not a personal service corporation | Generally, must use calendar year unless natural business year test is met or IRC Section 444 election is made | Same as S corporation |
| <u>Medical Insurance Premium</u> | 45 percent of premium cost deductible above-the-line; if a spouse is an employee and a spousal insurance plan is in place, 100 percent of premium cost deductible as a business expense | 45 percent of premium cost deductible above-the-line; if a partner's spouse is an employee of the partnership and an insurance plan is in place, 100 percent of the premium cost is deductible | 100 percent of premium cost is deductible | 45 percent of premium cost deductible above-the-line by more than 2 percent shareholders | Same as partnership |

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

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

CORPORATIONS

1. INTRODUCTION

- 1.1 Definition
- 1.2 Corporations in the United States
- 1.3 Three Important Terms
- 1.4 Reasons to Incorporate
- 1.5 Disadvantages of Operating as a Corporation

2. INCORPORATION PROCEDURES

- 2.1 Selection of State of Incorporation
- 2.2 Documents Needed to Incorporate
 - 2.2.1 Name reservation
 - 2.2.2 The articles of incorporation
- 2.3 Preliminary Procedures
- 2.4 The Corporate Bylaws
- 2.5 Doing Business Under a Fictitious Name
- 2.6 Foreign Corporations
- 2.7 Deduction of Organization Expenses

3. CORPORATE DIRECTORS AND OFFICERS

- 3.1 Directors
 - 3.1.1 Directors' meetings
 - 3.1.2 Director's right of dissent
- 3.2 Officers
- 3.3 Piercing the Corporate Veil

4. MINUTES, MEETINGS, AND SEAL

- 4.1 Minutes
- 4.2 Meetings
 - 4.2.1 Shareholders' meetings
 - 4.2.2 Directors' and committee meetings
- 4.3 The Corporate Seal
- 4.4 Corporation's Bank Accounts
- 4.5 Corporation Formalities

5. SHARES

- 5.1 Definitions
 - 5.1.1 Equity securities
 - 5.1.2 Par value
 - 5.1.3 Debt securities
 - 5.1.4 Treasury shares
 - 5.1.5 Watered stock

- 5.2 Authorized Shares
- 5.3 Shares Issued
- 5.4 Consideration for Shares
- 5.5 Preemptive Rights

6. SHAREHOLDER AGREEMENTS

- 6.1 Pooling Agreements
- 6.2 Voting Trusts
- 6.3 Share Transfer Restrictions

7. SHAREHOLDER REMEDIES

- 7.1 Definitions
- 7.2 Restrictions Governing Derivative Suits

8. CORPORATE DISTRIBUTIONS

- 8.1 Definitions
- 8.2 Shareholders' Rights to Dividends
- 8.3 Dividend Strategies: Publicly Held vs. Closely Held
 - 8.3.1 Publicly held corporations
 - 8.3.2 Closely held corporations
- 8.4 Stock Redemptions

9. AMENDMENTS, MERGERS, AND DISSOLUTIONS

- 9.1 Amending the Articles of Incorporation
 - 9.1.1 Right to amend
 - 9.1.2 Procedure for amending
 - 9.1.3 Filing the amended articles
- 9.2 Mergers
- 9.3 Voluntary Dissolution
- 9.4 Involuntary Dissolution

10. PLANNING HINTS FOR CLOSELY HELD CORPORATIONS

- 10.1 Who Should Own the Real Estate?
- 10.2 Giving Nonvoting Stock to Family Members
- 10.3 Avoiding Special Penalty Taxes
- 10.4 Choosing a Fiscal Year
- 10.5 Tax Interview Checklist

REFERENCES

APPENDIX 1: Incorporation Checklist

APPENDIX 2: Tax Interview Checklist

1. INTRODUCTION

1.1 Definition

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

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

- Title to property is held by the entity.
- Management is centralized.
- Continuity of operation is uninterrupted by death of beneficial owners.
- Transfer of interest can occur without affecting the continuity of the enterprise.
- Liability is limited to corporate assets.

For tax purposes, additional definitions are required:

- *Regular C corporation.* An income tax is imposed on the taxable income of the corporation. A personal service corporation (PSC) is a segment of this type of classification to which certain special tax rules apply.
- *Subchapter S corporation.* With some exceptions, income is not taxed at the corporate level, but is passed through and taxed to its shareholders (that is, similar to a partnership).

1.2 Corporations in the United States

The modern concept of incorporation can be traced back at least to the Roman Empire. The laws that govern modern corporations in the United States emerged primarily during the late nineteenth and early twentieth centuries. Initially, individual state laws, designed to regulate the behavior of corporations within their borders, varied widely. Today, however, many states have adopted similar bodies of corporation law primarily as a result of the Model Business Corporation Act (MBCA) developed by the American Bar Association. Based on the Illinois statute, the earlier versions of the MBCA have been adopted by many states, though not in their entirety. In 1984, the MBCA was completely revised on the basis of a revision of the Virginia corporation law, and numerous

states are in the process of considering adoption of the revised MBCA. (Reference here will be to the revised MBCA.) Several of the most important corporate jurisdictions (Delaware, New York, New Jersey, California, and Michigan) have not modeled their corporation laws on MBCA, and there are still significant differences from state to state. The federal government has also influenced corporation law with the passage of the Securities Act of 1933 and the Securities Exchange Act of 1934. Note, however, that there is no federal incorporation statute except for certain corporations such as savings and loan associations.

1.3 Three Important Terms

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

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

1.4 Reasons to Incorporate

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

Tax benefits. The corporate form provides great flexibility for income tax planning. Corporations have a wide choice in selecting a taxable year. For taxable years beginning after December 31, 1986, S corporations and personal service corporations (PSCs) were required to adopt the same taxable year as their owners. As a result, many fiscal-year S corporations and PSCs have switched to a calendar tax year. The

Revenue Act of 1987 allows S corporations and PSCs to elect (on Form 8716) to retain their fiscal years. An S corporation must make a "required payment," thus taking away the advantage of tax deferral. Personal service corporations must make minimum distributions to employee-owners.

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

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

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

If the investor is subject to the alternative minimum tax, one-half (42 percent for tax years ending after May 6, 1997) of the amount of capital gains excluded would be treated as a tax preference item.

Rollover of capital gain for certain investors in small business stock. In the case of a sale by an individual taxpayer after August 5, 1997, of qualified small business stock held for more than six months, IRC Section 1045 (which was added by the Taxpayer Relief Act of 1997) allows the taxpayer to elect to exclude the gain realized on the sale to the extent that the taxpayer uses the sale proceeds to purchase other qualified small business stock within sixty days after the sale.

Maximum tax rates. The top tax rate for individuals is now higher than the top corporate rate. The corporate rates, which include net capital gains, are

| <u>Taxable Income</u> | <u>Rate</u> |
|-----------------------|-------------|
| 0–\$50,000 | 15% |
| \$50,001–\$75,000 | 25% |
| \$75,001–\$10 million | 34%* |
| Over \$10 million | 35%** |

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

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

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

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

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

Fringe benefits. Owners of corporations can take advantage of fringe benefits not available to owners of other forms of business, such as borrowing from retirement plans and medical expense reimbursement plans. Beginning in 1996, self-employed and shareholders who own 2 percent or more of an S corporation's stock can deduct above the line, 30 percent of the amount paid for medical insurance costs. The Health Reform Act increases this deduction to 40 percent in 1997. The Taxpayer Relief Act of 1997 increases the deduction from 40 percent in 1997 to 100 percent by 2007. Even though these deductions have increased for shareholders of S corporations, these expenses are fully deductible for a C corporation. In addition, the dividends-received deduction allows for a favorable tax treatment in the corporate taxation of dividends from another domestic corporation.

The benefits of incorporating also include group term insurance, accident and health insurance, keyman insurance, major medical insurance, split-dollar insurance, salary continuation plans, employee meals

and lodging programs, ESOPs, and so forth. In 1982, The Tax Equity and Fiscal Responsibility Act (TEFRA) made it essentially unnecessary for professionals to be C corporations in order to obtain beneficial retirement benefits. This law created virtual parity between Keogh plans for self-employed individuals and corporate retirement plans.

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

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

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

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

1.5 Disadvantages of Operating as a Corporation

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

Alternative minimum tax on corporations. The rate will rise to 20 percent (from 15) and more items will be counted as income in figuring the tax: half the difference between a corporation's book income and its minimum taxable income is a tax preference. Note that the Taxpayer Relief Act of 1997 repealed the alternative minimum tax, effective for tax years beginning after 1997, on certain C corporations with three-year average annual gross receipts of \$5 million or less for its first taxable year beginning after 1996 and with three-year average gross receipts of \$7.5 million for later years.

For tax years beginning after 1989, alternative minimum taxable income is increased by 75 percent of the amount by which adjusted current earnings (ACE) exceed what otherwise would be alternative minimum income. ACE is alternative minimum income plus those items

of earnings and profit that are not included in the calculation of regular or alternative minimum income. This adjustment potentially subjects to tax all municipal bond interest, intercorporate dividends (before 70 percent deduction or 80 percent deduction if the corporate shareholder owns 20 percent or more of the stock of the dividend-paying corporation), and life insurance proceeds. For ACE purposes, depreciation is computed using the straight-line method. Therefore, C corporations can have four methods for depreciation: book, tax, AMT, and ACE. The earnings and profit adjustment is one of the most controversial aspects of the corporate AMT.

Maximum tax on noncorporate capital gains. Under the Taxpayer Relief Act of 1997, the maximum rate on net long-term capital gains for individual taxpayers was lowered from 28 percent to 20 percent for sales or exchanges after May 6, 1997. That rate will be further reduced to 18 percent for certain sales or exchanges after the year 2000. In contrast, the maximum tax rate on corporate income (including net long-term capital gains) is 35 percent.

Distribution following liquidation. Corporations must recognize gain or loss on a sale or distribution of assets under a plan of complete liquidation.

Flat tax rate of 35 percent. For tax years starting after 1992, all taxable income of personal service corporations is taxed at a flat rate of 35 percent. Therefore, there is no tax advantage for owner/employees of these corporations to retain earnings at the corporate level. However, if the IRS characterizes salary payments as “unreasonably high” and thus treats them as dividends, the personal service corporation would pay a tax at 35 percent on the disallowed salary, and the owner/employee would be taxed at a rate up to 39.6 percent on that distribution.

Another potential problem exists if a tax preparer makes an erroneous decision not to treat a corporation as a personal service corporation.

Example: Corporation B has a January 31 fiscal year and is in the business of selling products and giving financial advice. The tax preparers currently make the decision that Corporation B is not a personal service corporation. Its January 31, 1994, tax return shows the following data:

| | |
|--|--------------------|
| Income | \$ 300,000 |
| Operating expenses | \$(190,000) |
| Salaries to employee-owners (all paid January 1994) | <u>\$(100,000)</u> |
| Taxable income | <u>\$ 10,000</u> |
| Tax (15%) | <u>\$ 1,500</u> |

If, upon audit, the IRS determines Corporation B to be a personal service corporation, a series of things occurs, but most important, B must convert to the calendar year and all corporate income is taxed at 35 percent.

The “new” return would be disastrous and might look something like this:

| | |
|---|-------------------------|
| Income | \$ 300,000 |
| Operating expenses (190,000 × 11/12) | <u>\$(174,167)</u> |
| Taxable income | <u>\$ 125,833</u> |
| Tax (35%) | <u><u>\$ 44,042</u></u> |

Elimination of the cash method of accounting. Corporations other than farming corporations, qualified personal service corporations (those with substantially all activities in the fields of health, law, engineering, architecture, accounting, and so forth), and partnerships with a C corporation as a partner are not permitted to use the cash method of accounting if the entity has three-year average gross receipts of more than 5 million dollars.

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

2. INCORPORATION PROCEDURES

2.1 Selection of State of Incorporation

When corporations became popular in the United States, the individual states passed laws to regulate corporate behavior within their borders—laws often designed to make interstate corporation operation difficult. As a result, entities were forced to incorporate in the states in which they planned to do business. Eventually the U.S. Supreme Court struck down many of the state laws, allowing corporations to conduct interstate business with relative ease; corporations can now elect to incorporate in the state that will offer them the greatest benefits. Remember, however, that there are costs involved in operating a corporation in a state

other than its state of incorporation (see section 2.6, below). If the business of a proposed corporation will be primarily intrastate it is usually advisable to incorporate in the state where the corporation's business is to be conducted. Corporations that conduct business in many states may want to incorporate in a state (for example, Delaware) that has a liberal statute governing incorporation and other matters. Whatever incorporation locale is chosen, people who plan to establish a corporate entity should retain legal counsel for overall pre-incorporation advice and aid in preparing and filing the necessary corporate documents.

2.2 Documents Needed to Incorporate

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

2.2.1 Name reservation

A major item in the articles of incorporation is the corporate name. The rules vary among states, but typically the name must not be "the same or deceptively similar" to the name of any other corporation. To ensure that the desired corporate name is available at the time of incorporation, planners may want to reserve the name before incorporation. Not all states allow the reservation of corporate names, but most allow them to be reserved for a limited time by payment of a nominal fee. In most states, the secretary of state maintains a list of corporate names that are not available. Certain names are not permitted in some states—for example, the name of a governmental body if the corporation is not connected with it.

2.2.2 The articles of incorporation

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

- The name of the corporation
- The number of shares the corporation has authority to issue

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

2.3 Preliminary Procedures

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

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

See the incorporation checklist in appendix 1 of this chapter.

2.4 The Corporate Bylaws

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

2.5 Doing Business Under a Fictitious Name

Any time a corporation does business under a name other than the name on the corporation's incorporation certificate, it is doing business

under a fictitious name (some states use the term *trade name* or *assumed name*). Most states require corporations to file a public notice when using a fictitious name. Currently there is no such requirement in the following states:

| | |
|----------------------|--------------|
| Alabama | Mississippi |
| Alaska | Montana |
| Delaware | Nebraska |
| District of Columbia | North Dakota |
| Idaho | South Dakota |
| Kansas | Tennessee |
| Louisiana | Wisconsin |
| Maryland | Wyoming |
| Massachusetts | |

2.6 Foreign Corporations

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

- Maintaining or defending any action, suit, administrative proceeding, or arbitration proceeding, or effecting the settlement thereof or the settlement of claims or disputes.
- Holding meetings of its directors or shareholders or carrying on other activities concerning its internal affairs.
- Maintaining bank accounts.
- Maintaining offices or agencies for the transfer, exchange, and registration of its securities, or appointing and maintaining trustee depositories with relation to its securities.
- Effecting sales through independent contractors.
- Soliciting or procuring orders, whether by mail or through employees or agents or otherwise, if the orders require acceptance outside the state before becoming binding contracts.
- Creating evidences of debt, mortgages, or liens on real or personal property.

- Securing or collecting debts or enforcing any right in property in securing the same.
- Transacting any business in interstate commerce.
- Conducting an isolated transaction completed within a period of thirty days and not in the course of a number of repeated transactions of a like nature.

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

2.7 Deduction of Organization Expenses

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

3. CORPORATE DIRECTORS AND OFFICERS

3.1 Directors

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

- Overseeing the daily activity of the officers of the corporation.
- Declaring dividends.
- Formulating corporate policy.
- Authorizing contracts involving the corporation.

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

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

3.1.1 Directors' meetings

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

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

The bylaws of a corporation typically set the requirement for a quorum, which is the minimum number of directors who must be present for the board of directors to act. State statutes may *set* a quorum requirement. If a quorum is not present, the directors cannot act unless they are in the process of filling a vacancy, in which case fewer than a quorum may be permitted to act. With the advent of telecommunications, many corporations now hold their directors' meetings by teleconference (not all states permit this). Many states allow directors to act without a meeting unless the bylaws of the corporation prohibit such action.

3.1.2 Director's right of dissent

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

3.2 Officers

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

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

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

3.3 Piercing the Corporate Veil

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

The corporate veil can also be pierced if the corporation and its shareholders do not go to the trouble of conducting themselves as

separate legal persons. For example, if directors' meetings are not held, minutes are not kept, funds are commingled, loans are made without approval of corporate officers or documentation, and the like, the existence of the corporation may be ignored for legal and tax purposes even though the corporation was properly formed and was *not* used for any improper purpose. The point is the corporate veil is pierced if the corporation and shareholders do not transact with each other in substantially the same manner as they would with unrelated parties. The "form over substance" concept definitely applies in this context. (See section 4.5, below.)

4. MINUTES, MEETINGS, AND SEAL

4.1 Minutes

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

Typically the secretary of the corporation maintains the minute book.

4.2 Meetings

4.2.1 Shareholders' meetings

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

- A specified location for holding meetings, often left to the discretion of the directors (some states require that shareholders' meetings be held in their state if that is the state of incorporation)
- A specified date and time for the annual meeting of shareholders (including a provision for adjustment when the annual meeting falls on a legal holiday and a clause stating what should be transacted at such meetings)

- Specification of who is authorized to call for special meetings of shareholders and under what circumstances they may call them
- Policy for notice to be given before holding a meeting, including a specified method of giving notice
- The number of shareholders that constitutes a quorum
- Requirements for meeting adjournment and the procedure for giving notice thereof
- Specification of the voting rights of the shareholders at the meeting
- Policy regarding shareholder action without a meeting
- Policy regarding proxies representing shareholders at meetings

4.2.2 Directors' and committee meetings

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

4.3 The Corporate Seal

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

4.4 Corporation's Bank Accounts

One of the first things a corporation should do is open a corporate bank account. Often, the first time a corporate officer uses the corporate seal is on the bank's resolution form designating depository of funds. The bylaws of the corporation should limit the individuals authorized to sign checks drawn on the account.

4.5 Corporation Formalities

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

- Shareholder approval of the actions of officers and directors should be reflected in the minutes of annual meetings of shareholders.
- Director approval of the actions of officers should be reflected in the minutes of periodic meetings of directors.
- Officer action should be pursuant to resolutions and policy enunciated in the minutes of meetings of directors and shareholders.
- Complete corporate and financial records should be maintained.

5. SHARES

5.1 Definitions

5.1.1 Equity securities

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

- *Common shares.* Holders of common shares have a residual ownership interest in the corporation that issued the shares. The common shareholders elect the directors of the corporation and are entitled to dividends out of the corporation's earnings as declared by the directors. Upon dissolution of the corporation, holders of common shares are entitled to a per-share (normally pro rata) distribution of the corporate assets remaining after creditors and holders of senior securities have been satisfied.
- *Nonvoting common shares.* Some shares of common stock specifically exclude the power to vote. Not all states permit the issue of nonvoting common shares; some allow holders of nonvoting common shares to vote as a class on issues that affect them as a class.
- *Preferred shares.* Preferred shares are securities senior to common shares, and holders of preferred shares therefore have preferential rights to dividends and the assets of the corporation upon liquidation as compared to the rights of common shareholders. However, preferred shareholders are only entitled to a specified amount of dividends or assets upon liquidation, most commonly do not vote for the directors of the corporation, and generally do not participate in the management of the corporation unless their dividends have been omitted.

5.1.2 Par value

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

5.1.3 Debt securities

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

5.1.4 Treasury shares

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

5.1.5 Watered stock

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

- *Bonus shares*. Par value shares issued without further payment when a shareholder has fully paid for shares of another class.
- *Discount shares*. Par value shares paid for by cash issued at less than par value.

- *Watered shares.* Par value shares issued for property valued at less than par value. Watered shares usually occur when the promoters of the corporation convey property to the corporation at an inflated value in payment for the shares of the corporation. The issuance of watered shares may impose a liability on the recipient equal to the amount of the shortfall from par value.

5.2 Authorized Shares

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

5.3 Shares Issued

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

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

5.4 Consideration for Shares

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

5.5 Preemptive Rights

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

6. SHAREHOLDER AGREEMENTS

6.1 Pooling Agreements

A pooling agreement is an agreement among a group of shareholders in a corporation to vote in a certain manner on certain matters. The method of voting can be specified in the agreement or can be discussed and decided on before the vote on the matter in question. For example, a group of minority shareholders can agree to vote collectively against a proposed change detrimental to them as a group. Some states have statutes that regulate pooling agreements, but most do not. If disputes arise among shareholders in a pooling agreement, an outside arbiter usually resolves the disagreement.

6.2 Voting Trusts

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

- The agreement may not extend beyond ten years.
- The agreement must be in writing.

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

Voting trusts that do not comply with all statutory requirements are considered invalid by the majority of states.

6.3 Share Transfer Restrictions

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

- *Options.* The corporation must be given the option to buy the shares at a specified price before the shareholder sells them to an outside party.
- *Buy-sell agreements.* The corporation or its shareholders must purchase the shares of any shareholder wanting to sell them. In the case of the death of a shareholder, the corporation must buy the decedent's shares (usually funded by a life insurance policy).
- *Right of first refusal.* The corporation or its shareholders must be given the option to match the best bona fide offer that a shareholder wanting to sell shares has been able to obtain from outside parties.

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

7. SHAREHOLDER REMEDIES

7.1 Definitions

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

1. *Direct action.* A suit filed by a shareholder against the corporation. Direct action can be taken by a shareholder with a claim based on an ownership share in the corporation. For example, the shareholder

may claim entitlement to dividends that have not been paid to him or her.

2. *Class action.* A direct action in which a class of shareholders acts to cure or prevent a wrong from befalling that class of shareholders.
3. *Derivative action.* An action taken by one or more shareholders as an effort to cure or prevent a wrong from befalling the corporation. Derivative actions by shareholders are subject to various restrictions discussed in section 7.2.

7.2 Restrictions Governing Derivative Suits

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

- The shareholders must make an effort in good faith to resolve the problem by negotiating with the corporation's directors.
- The shareholders must make an effort in good faith to resolve the problem first by getting the directors of the corporation to remedy the situation, a requirement that does not apply to shareholders who can show existence of an adequate reason for not making such an effort. (For a complete description of reasons that are considered adequate consult Rule 23.1 of the *Federal Rules of Civil Procedure*.)
- Most states require that the shareholders taking the action must all have been shareholders in the corporation at the time the action causing the wrong took place.
- The plaintiff shareholders may be required to post a security bond for reasonable expenses incurred by the corporation or other defendants involved in the suit. (The MBCA has eliminated the security requirement.)

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

8. CORPORATE DISTRIBUTIONS

8.1 Definitions

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

- *Cash dividends.* Cash distributions paid to shareholders out of the profits of the corporation, usually expressed in terms of dollars and cents per share or as a percentage of the stated value of the share.
- *Property dividends.* Distributions of the corporation's assets other than cash or stock to the shareholders of the corporation. Dividend distributions of appreciated property will cause gain recognition at the corporate level.
- *Stock dividends or share dividends.* Distributions of additional shares of stock in the corporation issuing the dividend, usually expressed as a ratio.

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

All of the above distributions are normally nondeductible to the corporation and are taxable income to the shareholder.

8.2 Shareholders' Rights to Dividends

As a general rule, dividends declared by a corporation are a debt of the corporation and may not be revoked by its directors. Dividends are normally payable to shareholders on a specified date (known as the "record date"); if no date is specified, the shareholders are entitled to the dividends on the day dividends are declared by the directors of the corporation. If shares are transferred after the specified dividend payment date, the purchaser and seller must agree on who is entitled to receive the dividends; the corporation will simply pay the dividends to the owner of record on the record date.

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

8.3 Dividend Strategies: Publicly Held vs. Closely Held

8.3.1 Publicly held corporations

Publicly held corporations, especially large ones, generally pay dividends on a periodic basis. Payments made by these corporations tend to be

stable from period to period, often geared to a percentage of earnings over some period of time.

8.3.2 Closely held corporations

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

8.4 Stock Redemptions

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

When a corporation purchases shares of its stock from one of its shareholders, the question arises whether the shareholder should be treated as if he or she received a dividend or sold the stock. Dividends are taxed as ordinary income, while the sale of stock is construed as a capital gain or loss. Since there is a significant difference between the maximum tax rates for long-term capital gains (20 percent) and ordinary income (39.6 percent), it is important to make a distinction

between the two. IRC Section 302 answers the question in these terms: A redemption of stock by a corporation is treated as a sale or exchange of the stock if the redemption falls into one of the following four categories:

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

9. AMENDMENTS, MERGERS, AND DISSOLUTIONS

9.1 Amending the Articles of Incorporation

9.1.1 Right to amend

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

9.1.2 Procedure for amending

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

9.1.3 Filing the amended articles

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

- Endorse each duplicate original *Filed* and date it.
- File one of the duplicate originals in his or her office.
- Issue a certificate of amendment to which he or she will affix the other duplicate original.

9.2 Mergers

Most state statutes allow for any two or more domestic corporations to merge freely into one of the corporations, with proposed mergers subject to approval by the shareholders of the corporations involved. In addition, the board of directors for each corporation involved in the merger must formulate and state a plan for the exchange of stock that will take place at the time of the merger. There are many complexities in the Internal Revenue Code regarding mergers, some of which allow for tax-free treatment on the exchange of assets involved in these types of reorganizations. For detailed analysis of the tax ramifications of mergers, practitioners should consult other reference materials, including the various loose-leaf services of Commerce Clearing House, Inc., Bureau of National Affairs, Inc., and Research Institute of America.

9.3 Voluntary Dissolution

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

9.4 Involuntary Dissolution

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

- The corporation has failed to fulfill a state requirement (for example, failed to file its annual report with the secretary of state).

- The directors of the corporation are deadlocked and the deadlock is doing irreparable damage to the corporation.
- The shareholders of the corporation are deadlocked and cannot elect directors.
- Those in control of the corporation are acting illegally.
- The assets of the corporation are being misused.
- A creditor can show that the corporation is unable to pay its debts.

See the chapter on Bankruptcy/Insolvency, herein.

10. PLANNING HINTS FOR CLOSELY HELD CORPORATIONS

10.1 Who Should Own the Real Estate?

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

If the real estate owner personally does not have passive income to offset the passive losses generated or cannot effectively use the \$25,000 rental realty loss privilege, the real estate could be put into an operating corporation. The passive tax losses of real estate can then be offset by operating income of the corporation, since the limitations on passive losses do not apply to closely held corporations that have active income. However, since a corporation is subject to gain on a sale of its assets, holding appreciating real estate in a corporation could be undesirable if it is held for a long period of time. If the real estate is sold, the depreciation taken and any appreciation would be subject to federal income tax of up to 34 percent plus state tax (versus 28 percent if held directly or via a pass-through entity). Then, if the resulting cash is distributed as dividends, the tax at the shareholder level can be as high as 39.6 percent.

These days it often makes sense to own intangibles (e.g., patents, copyrights, and secret processes) outside of the C corporation when

possible. Knowledge- or technology-based intangibles have great potential for appreciation, and it is obviously desirable to avoid double taxation on such appreciation.

10.2 Giving Nonvoting Stock to Family Members

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

10.3 Avoiding Special Penalty Taxes

Corporations usually avoid paying accumulated earnings tax by paying dividends to shareholders. If shares of stock have been issued to family members, it will be desirable to pay dividends only to children over age fourteen who are in a low tax bracket. This can be accomplished by creating a preferred series of stock that gives certain shareholders special rights to dividends. The owner of the corporation would then distribute the preferred shares only to those children he or she wants to receive the dividends.

10.4 Choosing a Fiscal Year

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

For financial statement purposes, a fiscal year should end with the close of a cycle of business activity. Theoretically, this would be when

inventories and accounts receivable are at a minimum and before new inventory is acquired for another cycle of sales.

10.5 Tax Interview Checklist

Because of the complexity of corporate income tax laws and regulations, it is recommended that an annual checklist approach be used when completing the corporate income tax returns. This approach will help ensure that no significant items are overlooked when completing the return. The Appendix to this section includes a sample interview checklist that can be adapted and expanded upon.

REFERENCES

- Adams, Edward. *Corporations & Other Business Associations*. St. Paul, Minn.: West Publishing Co., 1997.
- Anderson, Stephen J. *Corporate Tax Practice Manual*. New York: Panel Publishers, 1991. Loose-leaf.
- Bittker, Boris I., and James S. Eustice. *Federal Income Taxation of Corporations and Shareholders*, 6th ed. Boston: Warren, Gorham & Lamont, 1989. Looseleaf. Supplemented tri-annually.
- Burke, Karen C. *Federal Income Taxation of Corporations and Stockholders in a Nutshell*, 4th ed. St. Paul, Minn.: West Publishing Co., 1996.
- Cavitch, Zolman. *Tax Planning for Corporations and Shareholders*. New York: Matthew Bender, 1985. Loose-leaf.
- Douglas, James A. *Modern Corporation Checklists*, 3d ed. Boston: Warren, Gorham & Lamont, 1990. Supplemented semi-annually.
- Eaton, Berrien C., Jr. *Professional Corporations and Associations*, 6 vols. New York: Matthew Bender, 1985. Loose-leaf.
- Eisenberg, Melvin A. *Corporations & Business Associations, Statutes, Rules, Materials & Forms: 1995 edition*. Westbury, N.Y.: Foundation Press, 1995.
- Emanuel, Steven. *Corporations*, rev. ed. Larchmont, N.Y.: Emanuel Law Outlines, Inc., 1993.
- Ginsberg, Martin D. and Jack S. Levin. *Mergers, Acquisitions and Buyouts*. Frederick, MD: Aspen Law & Business, July 1997 edition.
- Hamilton, Robert W. *The Law of Corporations in a Nutshell*, 4th ed. St. Paul, Minn.: West Publishing Group, 1996.

- Johnson, Gerry. *Exploring Corporate Strategy*, 4th ed. New York: Prentice Hall, 1997.
- Kahn, Douglas A. *Taxation of Corporations and Partnerships*, 4th ed. St. Paul, Minn.: West Publishing Co., 1994.
- McDaniel, Paul R., et al. *Federal Income Taxation of Business Organizations*, 2d ed. Westbury, N.Y.: Foundation Press, 1997.
- Nunes, Morris A. *Basic Legal Forms for Business*. New York: John Wiley & Sons, Inc., 1993.
- Raabe, William A. *1997 Multistate Corporate Tax Guide*. Vols. I and II. New York: Panel Publishers, 1996.
- Rohrlich, Chester A, ed. *Organizing Corporate and Other Business Enterprises*, 5th ed., rev. New York: Matthew Bender, 1985. Supplemented.
- Schneeman, Angela. *The Law of Corporations, Partnerships, and Sole Proprietorships*. Albany, N.Y.: Delmar Publishers, 1993.
- Sitarz, Daniel. *Incorporate Your Business: The National Corporation Kit*. Carbondale, Ill.: Nova Publishing Company, 1995.
- Solomon, Lewis D. *Corporations and Alternative Business Vehicles*. Santa Monica, Calif.: Casenotes Publishing Co., 1993.
- Wendell, Paul J. *Corporate Controller's Manual*, 2nd ed. Boston: Warren, Gorham & Lamont, 1991. Supplemented annually.
- Wood, Robert W. *Corporations: Complete Tax Practice and Planning Guide*. Columbia, S.C.: Professional Tax and Business Publications, 1996.

(Text continued on page 29)

APPENDIX 1: Incorporation Checklist

| | Date Required | To Be Done By | | | Date Finished |
|--|------------------|---------------|-------|---------|------------------|
| | | Atty. | CPA | Company | |
| 1. Target Date (date corporation is to commence business). | _____ | _____ | _____ | _____ | _____ |
| 2. Incorporators (names and addresses). | _____ | _____ | _____ | _____ | _____ |
| 3. Directors and Officers (names and addresses). | _____ | _____ | _____ | _____ | _____ |
| 4. Statutory Agent (name and address). | _____ | _____ | _____ | _____ | _____ |
| 5. Drafting Articles of Incorporation. | _____ | _____ | _____ | _____ | _____ |
| 6. Meeting of Incorporators (elect officers, transfer assets for stock, adoption of bylaws, adoption of seal, designation of depository, etc.). | _____ | _____ | _____ | _____ | _____ |
| 7. Assets and Liabilities (determine what assets and liabilities are to be turned over to the corporation and shares issued in exchange therefor). | _____ | _____ | _____ | _____ | _____ |
| 8. Identification Number (Form SS-4). | _____ | _____ | _____ | _____ | _____ |
| 9. Workmen's Compensation (file for coverage). | _____ | _____ | _____ | _____ | _____ |
| 10. Unemployment Compensation (file for coverage). | _____ | _____ | _____ | _____ | _____ |
| 11. Transfer of Credit from Unemployment Compensation (if incorporating existing business). | _____ | _____ | _____ | _____ | _____ |
| 12. Federal Unemployment (determine if final Form 940 is to be filed on old business). | _____ | _____ | _____ | _____ | _____ |
| 13. Final Returns (if incorporating existing business). | _____ | _____ | _____ | _____ | _____ |
| 14. Thin Corporation (debt structure and ratio of debts to equity in view of current and future financing requirements). | _____ | _____ | _____ | _____ | _____ |
| 15. Election under Subchapter S (if going to elect, prepare and file Form 2553). | _____ | _____ | _____ | _____ | _____ |

| | Date Required | To Be Done By | | | Date Finished |
|--|------------------|---------------|-------|---------|------------------|
| | | Atty. | CPA | Company | |
| 16. If stock of corporation should qualify as small business stock under IRC §1202, have all necessary steps been taken? | _____ | _____ | _____ | _____ | _____ |
| 17. IRC §1244 (should issue stock in accordance with §1244 and adopt "plan" before shares are issued). | _____ | _____ | _____ | _____ | _____ |
| 18. Multiple Corporations (determine if a problem). | _____ | _____ | _____ | _____ | _____ |
| 19. Accounting Methods (year-end accrual or cash basis, bad debt election, depreciation method, inventory valuation). | _____ | _____ | _____ | _____ | _____ |
| 20. Books and Records (chart of accounts, ledger, and journals). | _____ | _____ | _____ | _____ | _____ |
| 21. Officers' Salaries (establish officers' salaries and fill out Form W-4 authorizing corporation to withhold wages). | _____ | _____ | _____ | _____ | _____ |
| 22. Banks (select bank or banks and furnish resolution authorizing persons to sign checks and negotiate loans). | _____ | _____ | _____ | _____ | _____ |
| 23. Notify Utilities. | _____ | _____ | _____ | _____ | _____ |
| 24. Insurance (notify all pertinent insurance agents so that insurance policies may be transferred to the corporation if incorporating existing business; if new business, secure necessary insurance, i.e., fire, liability, etc.). | _____ | _____ | _____ | _____ | _____ |
| 25. Special Licenses and Permits (secure, if necessary). | _____ | _____ | _____ | _____ | _____ |
| 26. Accident and Health (formally adopt a plan under §105(c) and §106, if desired). | _____ | _____ | _____ | _____ | _____ |
| 27. Wage Continuation (formally adopt a plan under §105(d)). | _____ | _____ | _____ | _____ | _____ |
| 28. Medical Reimbursement Plan (formally adopt a §105(b) medical reimbursement plan, if desired). | _____ | _____ | _____ | _____ | _____ |

Reprinted with permission of Charles Bailly & Company.

APPENDIX 2: Tax Interview Checklist

Form 1120 Interview Worksheet

Client: _____

DONE BY: Interviewer _____; Preparer _____; Reviewer _____
 (initials & date) (initials & date) (initials & date)

| | Done | N/A | Comments or Explanations |
|--|------|-----|--------------------------|
| A. For Interviewer | | | |
| 1. Do we have engagement letter in file? | | | |
| 2. Thoroughly compare prior year return to current data, scan prior file notes, prior year points, correspondence. | | | |
| 3. Any notices/correspondence from IRS or state? | | | |
| 4. Any corporate-owned life insurance to Schedule M-1? | | | |
| 5. Were W-2s/1099s done? Who's to do? | | | |
| 6. Claim §179? Fast or slow depr? | | | |
| 7. Identify amount of 50% disallowed meals/enter. | | | |
| 8. Do we need to do Form 5500—fringes? | | | |
| 9. Any changes for current year est.? | | | |
| 10. Complete worksheet re: veh & mileage. | | | |
| 11. <u>Manufacturers to whom uniform capitalization rules apply:</u> | | | |
| a. Identify §263A current yr. costs | | | |
| b. If §263A applies, have Form 3115 and §263A checklist been filed? | | | |
| 12. Contractor using completed-contract method? ('86 - '87 Act rules) | | | |
| 13. Bad debts—Reserve Method: Bring 1/4 back into income. | | | |
| 14. Corp. AMT: What is "adjusted current earning" for 75% preference? | | | |
| 15. Any data back to client to be copied for our file? | | | |
| 16. Any disc. w/client re: exp. outcome? | | | |
| B. For Preparer | | | |
| 1. Read and clear <i>all</i> interviewer points. | | | |
| 2. Review file thoroughly for any prior notes/carryovers into this TR. | | | |

| | Done | N/A | Comments or Explanations |
|---|------|-----|--------------------------|
| 3. After reaching net amount, consider any adjustments up or down or other elective items to improve results. | | | |
| 4. Corp. AMT: prepare a worksheet to test especially re: 75% ACE preference. | | | |
| <u>C. For Reviewer:</u> | | | |
| 1. Are all interviewer & prep. pts. cleared? | | | |
| 2. Any follow-ups re: add. work/CB's? | | | |
| 3. Any carryforward points for next year? | | | |
| 4. Any T/letter advice points for client? | | | |

| | Vehicle 1 | | Vehicle 2 | | Vehicle 3 | | Vehicle 4 | | Vehicle 5 | | Vehicle 6 | |
|--|-----------|----|-----------|----|-----------|----|-----------|----|-----------|----|-----------|----|
| | Yes | No | Yes | No | Yes | No | Yes | No | Yes | No | Yes | No |
| 29 Total business miles driven during the year (DO NOT include commuting miles) | | | | | | | | | | | | |
| 30 Total commuting miles driven during the year | | | | | | | | | | | | |
| 31 Total other personal (noncommuting) miles driven | | | | | | | | | | | | |
| 32 Total miles driven during the year (Add lines 29 through 31) | | | | | | | | | | | | |
| 33 Was the vehicle available for personal use during off-duty hours? | | | | | | | | | | | | |
| 34 Was the vehicle used primarily by a more than 5% owner or related person? | | | | | | | | | | | | |
| 35 Is another vehicle available for personal use? | | | | | | | | | | | | |

Section C.—Questions for Employers Who Provide Vehicles for Use by Their Employees
(Answer these questions to determine if you meet an exception to completing Section B. Note: Section B must always be completed for vehicles used by sole proprietors, partners, or other more than 5% owners or related persons.)

| | Yes | No |
|---|-----|----|
| 36 Do you maintain a written policy statement that prohibits all personal use of vehicles, including commuting, by your employees? | | |
| 37 Do you maintain a written policy statement that prohibits personal use of vehicles, except commuting, by your employees? (See instructions for vehicles used by corporate officers, directors, or 1% or more owners.) | | |
| 38 Do you treat all use of vehicles by employees as personal use? | | |
| 39 Do you provide more than five vehicles to your employees and retain the information received from your employees concerning the use of the vehicles? | | |
| 40 Do you meet the requirements concerning qualified automobile demonstration use (see instructions)? | | |

Note: If your answer to 36, 37, 38, 39, or 40 is "Yes," you need not complete Section B for the covered vehicles.

S CORPORATIONS

1. HISTORY

- 1.1 History of the S Corporation
- 1.2 Advantages of Operating as an S Corporation
- 1.3 Disadvantages of Operating as an S Corporation

2. ELIGIBILITY REQUIREMENTS

- 2.1 Corporation Requirements
 - 2.1.1 Domestic corporations
 - 2.1.2 Ineligible corporations
- 2.2 Stock and Shareholders
 - 2.2.1 Maximum number of shareholders
 - 2.2.2 Eligible shareholders
 - 2.2.3 Classes of stock
 - 2.2.3.1 Nonconforming distributions
 - 2.2.3.2 Debt instruments and other arrangements
 - 2.2.4 Subsidiaries

3. MAKING AN S CORPORATION ELECTION

- 3.1 Timely Filing of Form 2553
- 3.2 Shareholders' Consents
- 3.3 Election by a Beneficiary of a Qualified Subchapter S Trust (QSST)
- 3.4 Taxable Years

4. TERMINATING AND REVOKING AN ELECTION

- 4.1 Termination
- 4.2 Revocation
- 4.3 Reporting Following a Termination or Revocation
- 4.4 Reelecting: The Five-Year Waiting Period

5. PREVENTING UNWANTED TERMINATION OF ELECTIONS

- 5.1 Invalid Elections
- 5.2 Inadvertent Termination of Elections
- 5.3 Methods of Protecting the Election
 - 5.3.1 Transfer of stock to escrow
 - 5.3.2 Shareholders' agreements

6. PASSIVE INCOME PROBLEMS

- 6.1 Gross Receipts

- 6.2 Preventing Passive Income Problems
 - 6.2.1 Eliminate accumulated earnings and profits
 - 6.2.2 Increasing gross receipts
 - 6.2.3 Additional methods

7. TAXATION AT THE CORPORATE LEVEL

- 7.1 *General Utilities* Repeal
- 7.2 Recognition of Built-in Gains Under IRC Section 1374
- 7.3 Tax on Passive Investment Income
- 7.4 Estimated Tax

8. TAXATION AT THE SHAREHOLDER LEVEL

- 8.1 Passthrough Items
- 8.2 How Shareholders Treat Passthrough Items
 - 8.2.1 If a shareholder terminates his or her interest
 - 8.2.2 A substantial disposition of stock
 - 8.2.3 If a shareholder dies
- 8.3 Shareholder's Basis
 - 8.3.1 Basis in stock
 - 8.3.2 Basis in debt
 - 8.3.3 Reduction of basis of individual shares
- 8.4 Fringe Benefits

9. DISTRIBUTIONS

- 9.1 By a Corporation With No Accumulated Earnings and Profits
- 9.2 By a Corporation With Accumulated Earnings and Profits
 - 9.2.1 Order of applying distributions
 - 9.2.2 Accumulated adjustments account (AAA)
- 9.3 Property Distributions
- 9.4 Post-Termination Transition Period Distributions
- 9.5 Distributions Treated by IRS as Compensation to Owner-Employees

REFERENCES

1. HISTORY

1.1 History of the S Corporation

In 1958, Subchapter S of the Internal Revenue Code of 1954, as amended, was enacted. Under that law, corporations electing Subchapter S status (then called Subchapter S corporations) were not subject to the corporate income tax, but were treated as passthrough entities somewhat like partnerships. In order to elect and maintain Subchapter S status, corporations had to meet certain requirements, such as a maximum number of shareholders and limitations on the classes of stock issued.

Despite the restrictions imposed by the status and notwithstanding the regulations and rulings added since 1958, increasing numbers of corporations chose to elect Subchapter S status as time went by. As the popularity of Subchapter S continued to increase, and as even further regulations were added to an already complex set, the need to simplify matters relating to Subchapter S became increasingly clear. Eventually, Congress made major revisions and changes to Subchapter S. The 1982 Subchapter S Revision Act (SSRA) was the product of a collegial group (including the American Institute of Certified Public Accountants [AICPA]) similar to the one formed to prepare the 1980 Installment Sale Revision Act. This group's work was embodied in the April 30, 1980 joint committee pamphlet, which would have provided an even simpler system than that contained in the 1982 act. SSRA officially designated the name S corporation for corporations that qualified under Subchapter S and designated all other corporations C corporations. The Subchapter S rules were again liberalized by the enactment of the Small Business Job Protection Act of 1996.

1.2 Advantages of Operating as an S Corporation

One of the most attractive features of an S corporation is that its shareholders limit their personal liability to trade creditors while avoiding double taxation—taxation at both the corporate and the shareholder levels. Bank lenders and landlords typically require shareholder guarantees of corporate borrowings or leases, at least in the early stages of the business enterprise. The guarantee removes insulation of personal liability to the extent of the loan or lease. However, shareholders would still, in most instances, be shielded from personal liability for acts arising in the ordinary course of the corporation's business (other than certain professional corporations, for which state statutes extend personal liability to the physician, attorney, etc.). In addition, losses experienced

during the first few years of a developing corporation's existence can be passed through to the shareholders, who may be able to use the losses to offset other income. While general partnerships and proprietorships offer these same advantages, they cannot offer the limited liability of the S corporation.

An S corporation has these tax advantages over a C corporation:

- Avoids the accumulated earnings tax under IRC Section 531.
- Avoids the unreasonable compensation problems that occur when officers' salaries are high enough to run the risk of being reclassified as dividends.
- Affords flexibility in the use of accounting methods. An S corporation can use the cash method of accounting even if the amount of gross receipts exceeds \$5,000,000.
- Avoids, in most cases, corporate tax on sale or distribution of appreciated assets in a complete liquidation (but see section 7.2, below, regarding the built-in gains tax).
- Avoids onerous alternative minimum tax (AMT) for regular corporations (which requires a minimum tax on taxable income), increased by preference items and other adjustments. For example, the receipt by a C corporation of proceeds of life insurance contracts on a shareholder's life is generally not taxable. However, these proceeds could easily incur the AMT. S corporation owned life insurance can avoid the severe AMT consequences.

For tax years beginning after 1997, the AMT is repealed for certain small C corporations (see the chapter on Corporations, section 1.5, "Disadvantages of Operating as a Corporation," herein).

- Allows operating losses to pass through for potential deduction on Form 1040 of the shareholders. The losses are still subject to the hobby loss rules under IRC Section 183.
- Allows shareholders to obtain tax basis for amounts loaned to the S corporation.

A corporation may find S corporation status beneficial if it is anticipating substantial losses. If the losses are ordinary losses, the tax savings for shareholders may outweigh the tax savings the corporation could receive as carrybacks or carryforwards. In this case it is usually in the best interest of the shareholders to elect S corporation status. Personal holding companies can also benefit from S corporation status, which permits the company to eliminate personal holding company tax. However, there is a 25-percent passive receipts limitation for S corporations that

have retained earnings and have converted from C corporation status to S corporation status (see section 6.1, below).

Historically, S status has been elected to permit deduction of operating losses at the shareholder's level. Under the Tax Reform Act of 1986, unless the shareholder materially participates in the business (in a regular, substantial, and continuous manner), S losses are treated as passive activity losses to inactive shareholders and are deductible only against the shareholders' passive activity income. Thus, S corporation losses of inactive shareholders cannot be deducted against salary, dividends and interest, and so forth.

Unused losses from passive activities are carried forward indefinitely and can be used to offset passive income in succeeding years. Alternatively, suspended passive losses may be claimed upon complete disposition of the activity, if the divestiture is accomplished in a fully taxable transaction.

S corporations allow a shareholder to pass along business profits to family members other than spouses and save money at the same time. The shareholder can give away shares to family members (up to the maximum shareholder limit) and divide the profits of the S corporation among them, based on their percentage of ownership. This limits the amount of profit on which the original taxpayer has to pay tax but keeps the money in the hands of family members who may fall into a lower tax bracket than the taxpayer. By naming children over the age of thirteen as shareholders it is possible to have the additional profit taxed at the minimum rate. Such a plan does, however, have a major limitation: the taxpayer must claim a percentage of the profits as salary large enough to compensate for the amount of work he or she does for the corporation and the amount of capital he or she has provided to the corporation. If the IRS determines that the taxpayer is not claiming a sufficient percentage of the corporation's taxable income, it may increase the original taxpayer's percentage and lower the percentages of the other family members. In addition, the IRS may claim that the transfer of stock to the children is a "paper transaction" if the transfer did not include all rights and privileges of stock ownership. In such a case, the IRS may tax the entire income as income earned by the donor parent.

1.3 Disadvantages of Operating as an S Corporation

Despite its many advantages, there are situations in which S corporation status is not advantageous. The top individual tax rate is currently higher than the top corporate rate. The S corporation may no longer be as

beneficial as it was in the past when the top individual rates were lower than the top corporate rates, and using a C corporation should be reconsidered. Other disadvantages of operating as an S corporation include the following:

- S corporation stockholders are not eligible for the 50 percent exclusion or the rollover of gain on the sale of qualified small business stock since only C corporations qualify (see the chapter on Corporations, section 1.4, “Reasons to Incorporate,” herein).
- Income splitting between a C corporation and its shareholders is not allowed.
- No special allocation provisions exist for income and deductions, as in the case of a partnership.
- S corporations, like partnerships and individuals, are subject to “passive-activities” provisions that eliminate the sheltering of salaries, interest, and dividends with losses from tax shelters. C corporations (other than personal service corporations) can offset passive tax losses against operating income of the corporation but not investment income.
- Several states and the District of Columbia do not recognize S corporations which, in those jurisdictions, pay state taxes at corporate rates. Also, federal tax-free distributions in those states could be subject to a second tax under state law. Several other states recognize S corporations but impose tax on all or a portion of the income of such corporations.
- No partial dividend-received deduction exists for S corporations.
- Certain employee tax-advantaged fringe benefits for shareholders owning more than 2 percent of S corporation stock are taxable as compensation to S corporation shareholders. (See section 8.4 of this chapter.)
- Operating problems may arise from insurgent shareholders, who might take actions to disqualify the S corporation status.
- Passive income tax occurs if the corporation’s investment income exceeds 25 percent of its gross income (applicable to S corporations with Subchapter C accumulated earnings and profits at end of year; see section 6 of this chapter.)
- Five percent or greater shareholder-participants cannot borrow from employee retirement plan trusts. (See the chapter on Employee Retirement and Deferred Compensation Plans.)
- Banks may be reluctant to lend to S corporations that distribute all of their earnings.

2. ELIGIBILITY REQUIREMENTS

If a corporation wants to be treated as an S corporation, it must file an election (Form 2553) within a specified period of time. Eligibility requirements must be met by the date of that election.

2.1 Corporation Requirements

2.1.1 Domestic corporations

To be eligible for an S corporation election, a corporation must have legal existence and must have been created and organized in the United States. The corporation must be operated with a profit intent, not just as a hobby. (The hobby-loss curbs in IRC Section 183 are equally applicable to a C corporation, partnership, or individual.)

An association that is taxed as a corporation may elect S corporation status if it otherwise qualifies (Reg. 1.1361-1(c)).

2.1.2 Ineligible corporations

Certain corporations are ineligible to elect S corporation status, including:

- Insurance companies subject to tax under Subchapter L.
- A domestic international sales corporation (DISC) or former DISC. An S corporation may not hold a foreign subsidiary or a DISC unless the S corporation held the foreign subsidiary or DISC on September 28, 1982. In that case, the corporation may remain an S corporation as long as its election does not terminate and a majority of its stock is not transferred other than by reason of death (SSRA Sec. 6 (c) (1)).
- A financial institution that is allowed a deduction for bad debts under the reserve method of accounting for bad debts, per IRC Section 585 or IRC Section 593 (bank or thrift institution).
- A corporation electing the Puerto Rico or possessions tax credit (IRC Section 936).

2.2 Stock and Shareholders

2.2.1 Maximum number of shareholders

To be treated as an S corporation a corporation may have no more than seventy-five (formerly thirty-five) shareholders. When determining the number of shareholders it is important to consider the following factors:

- Husbands and wives who each own stock are counted as a single shareholder, regardless of whether the stock is owned jointly (although the consent of each spouse to the S election is required). If the marriage is dissolved and both former spouses retain stock in the corporation, they are counted as separate shareholders.
- Estates are counted as single shareholders as long as the stock remains part of the estate. Once the stock is distributed to the beneficiaries, each beneficiary receiving stock is counted as a shareholder.
- Persons who are not husband and wife and who own stock jointly are counted as separate shareholders.

If more than seventy-five shareholders want to form an S corporation they can form multiple S corporations, each consisting of no more than seventy-five shareholders, and have these corporations form a partnership for the joint operation of a single enterprise (Rev. Rul. 94-43, 1994-1 C.B. 27).

When a trust qualifies as a shareholder (see section 2.2.2, below) the following rules apply:

- Each beneficiary of a voting trust and electing small business trusts is treated as a shareholder.
- The grantor or owner of a grantor or Section 678 trust is considered the shareholder.
- The estate of the testator is considered the shareholder of a qualifying testamentary trust.
- The sole beneficiary of a qualified Subchapter S trust (QSST) is treated as the shareholder.

2.2.2 Eligible shareholders

Eligible shareholders of stock in an S corporation are limited to

- Individuals (except nonresident aliens). A nonresident alien can form a partnership with an S corporation to conduct a business. This way, the nonresident can share the profits and losses of the business without being a shareholder of the S corporation (Reg. 1.701-2(d)). If the nonresident alien spouse obtains an ownership interest in the shareholder's stock under applicable law, such as state community property law or a foreign country law, the corporation does not qualify as an S corporation (Reg. 1.1361-1(g)(1)(i)).
- The estate of a decedent.
- The estate of a bankrupt individual.

- Tax-exempt organizations described in IRC Section 401(a) (qualified pensions, profit sharing, and stock bonus plans) and IRC Section 501(c)(3).
- Specific trusts (defined below).

New for 1998. Beginning January 1, 1998, an organization described in IRC Section 401(a) or 501(c)(3) that is exempt from taxation under IRC Section 501(a) is permitted to own stock of an S corporation.

A partnership or a C corporation may not own any stock in an S corporation; even one share of stock in the hands of a partnership or C corporation violates the eligibility of the S corporation. Effective for taxable years beginning after December 31, 1996, an S corporation is allowed to be a wholly owned subsidiary of another S corporation if the parent elects to treat the corporation as a “qualified Subchapter S subsidiary.” Under this election, the subsidiary is not treated as a separate corporation for tax purposes.

Trusts that qualify as shareholders of S corporations include

- A voting trust for which each beneficiary is treated as a separate shareholder (Sec. 1361(c)(2)(B)(iv)).
- A trust owned entirely by a grantor who is a U.S. citizen or resident; such a trust remains an eligible shareholder for two years after the grantor’s death (Sec. 1361(c)(2)(A)(ii)).
- A trust that has Subchapter S stock transferred to it as part of a will, restricted to a two-year (formerly sixty-day) period that starts on the day of the transfer (Sec. 1361(c)(12)(A)(iii)).
- A trust, all of which is treated as owned by the grantor (Secs. 671–677).
- A trust of which someone other than the grantor is treated as the owner of the entire trust under IRC Section 678.
- A qualified Subchapter S trust (Sec. 1361(d)(3)).
- An electing small business trust (see Secs. 641(d), 1361, and 1366).

A qualified Subchapter S trust (QSST) is a trust that owns stock in at least one S corporation and distributes (or is required to distribute) all of its income currently to an individual who is the sole income beneficiary of the trust. Note that IRC Section 1361(e)(3), relating to qualified Subchapter S trusts, treats separate shares of a multiple beneficiary trust under IRC Section 663(c) as separate trusts for qualifications as QSST. In addition, a qualified Subchapter S trust must

- Distribute all trust income to only one income beneficiary who is a U.S. citizen or resident during the time the trust owns S corporation stock (Reg. 1.1361-1(e)).

- Distribute any trust corpus only to the income beneficiary.
- Provide that the income interest of the current income beneficiary must terminate on the earlier of the termination of the trust or the death of the income beneficiary.
- Provide that all corpus will be distributed to the income beneficiary if the trust is terminated during the life of the income beneficiary.

The IRS has ruled that a trust provision allowing the trust to accumulate income does not prevent QSST status if the trust does not hold S corporation stock. A trust may be a QSST even if its terms do not require income to be distributed currently, provided that trust income is actually distributed during periods that S stock is held (Rev. Rul. 92-20, 1992-1 C.B. 301).

If the trust is set up to provide funds for a beneficiary that are legal support obligations of the grantor, the trust does not qualify as a QSST (Reg. 1-1361-1(j)(2)(ii)(B)).

For sales of S corporation stock by a QSST after July 21, 1995, the trust recognizes gain or loss.

Electing small business trust. Effective for taxable years beginning after December 31, 1996, an electing small business trust is permitted to be a shareholder of an S corporation. An electing small business trust is a trust that owns stock in an S corporation, and all of the beneficiaries of the trust are individuals or estates eligible to be S corporation shareholders or charitable organizations holding a contingent remainder. No interest in the trust can be acquired by purchase, and each beneficiary is counted as a shareholder for the 75-shareholder limitation. The income earned by the trust that is attributable to the S corporation is taxed at the highest individual income tax bracket 39.6 percent (for ordinary income) and 20 percent (for capital gains). There is no deduction for distributing S corporation income to the trust beneficiaries.

2.2.3 Classes of stock

S corporations may have only one class of stock outstanding. Outstanding shares must entitle all shareholders to identical rights to the dividends and liquidating distributions of the corporation. Regulation Section 1.1371-1(g) specifies that a corporation authorized to issue different classes of stock is not barred from making a valid S election if only one class of stock is issued and outstanding. In other words, the existence of other classes of stock authorized but unissued does not bar an S election. S corporations may, however, issue voting stock to shareholders with managing interests and may issue nonvoting stock, with identical rights to dividends and liquidating distributions, to shareholders who own stock for investment purposes. The nonvoting stock

will not be classified as a second class of stock (Sec. 1362(d)(4)). Warrants, options, and convertible debentures issued by the corporation may constitute a second class of stock. Certain debt may be determined to actually represent capital, and if deemed to be capital, could be considered a second class of stock.

IRC Section 1362(b)(5) provides a “safe harbor” wherein straight debt in an S corporation will not be treated as a second class of stock. Straight debt is a written unconditional promise to pay on demand or on a specific date a certain sum in money if

- The interest rate and interest payment dates are not contingent on profits, the borrower’s discretion, or similar factors.
- There is no direct or indirect convertibility to stock.
- The creditor is a person, estate, or trust eligible to hold S corporation stock.
- The creditors are not individuals who are actively engaged in the business of lending money.

On October 5, 1990, the IRS proposed regulations regarding the one-class-of-stock requirement for S corporations. These proposed regulations provided that S corporations making “nonconforming distributions” (see section 2.2.3.1, below) to shareholders would, with certain exceptions, be treated as having more than one class of stock outstanding, thus causing the corporation to lose its S election status. Nonconforming distributions are distributions that differ in either timing or amount with respect to each share of the corporation’s outstanding stock.

Considerable opposition to these October 1990 proposed regulations from taxpayers and tax practitioners caused the IRS to issue, on August 8, 1991, revised proposed regulations (Prop. Reg. 1.1361-1) to replace them. The revised proposed regulations reduced the danger that S corporations would be in technical violation of the one-class-of-stock rule and thus in danger of inadvertent termination of their S election.

On May 28, 1992, the IRS issued final regulations on the one-class-of-stock requirement.

2.2.3.1 Nonconforming distributions

Like the originally proposed regulations, the final regulations require that all outstanding shares confer identical rights to distribution and liquidation proceeds. However, under the final regulations, as long as the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation proceeds (all collectively constituting “the governing provisions”) of

the S corporation provide identical rights for all shares to distribution and liquidation proceeds, any distributions that differ in timing or amount are not treated as creating more than one class of stock.

The regulations shift the emphasis from an actual in-fact disproportionate distribution to the legally enforceable rights of the shareholders under the governing provisions of the S corporation. Under the more liberal treatment of the final regulations, a single-class-of-stock violation will not be triggered by situations such as

- Excessive compensation and fringe benefits received by employee-shareholders.
- Loans made by S corporations to their shareholders at a below-market interest rate, because a loan agreement is not a governing provision, just a business agreement. This disproportionate distribution will not give rise to a second class of stock even though the corporation must impute interest income and expenses on the loan under IRC Section 7872.

However, this rule would not apply if the IRS can prove that the excessive compensation or the loan was entered into to circumvent the single-class-of-stock requirement. In that case the business contract will be treated as a “governing provision” and will likely result in a second class of stock.

The regulations provide additional instances in which distributions disproportionate in timing and amount do not result in a second class of stock:

- State law mandated payments and withholding of income tax on distributions for nonresident shareholders.
- Payments pursuant to bona fide buy-sell and redemption agreements upon the death, disability, or termination of employment of a shareholder.
- Payments pursuant to an agreement that calls for cash distributions based on a shareholder’s varying interest in the S corporation’s income in the preceding taxable year.

It should be noted that even though nonconforming distributions do not trigger a single-class-of-stock violation, they will be given appropriate tax effect under the facts and circumstances of the distribution.

2.2.3.2 Debt instruments and other arrangements

Generally, a debt instrument will be characterized as a second class of stock only if it constitutes equity or otherwise results in the holder’s being treated as the owner of stock under general tax principles. However, under the final regulations, before a debt instrument meeting

these criteria will be considered as creating a new class of stock, it must be shown that the instrument also contravenes either (a) the rights to distribution or liquidation proceeds conferred by the outstanding stock or (b) the limitations on eligible shareholders of an S corporation.

The regulations discuss specific instruments and arrangements that will not be considered as outstanding stock and therefore are not affected by the nonconforming distribution rule or the “one class of stock issued and outstanding” rule:

- A debt instrument meeting the criteria for straight debt discussed in section 2.2.3, above.
- Restricted stock that is nonvoting and substantially nonvested, issued as consideration for the performance of services and for which a Section 83(b) election has not been made.
- Instruments, obligations, or arrangements issued in connection with the performance of services as deferred compensation if the recipient is not currently taxed on the income.
- Call options issued to commercial lenders as additional consideration for loans and to employees and independent contractors in connection with the performance of services, are not considered a second class of stock provided they have an exercise price at least 90 percent of the fair market value of the underlying stock.
- Unwritten advances from an S corporation shareholder that in the aggregate are never more than \$10,000 and that are expected to be repaid within a reasonable time.
- Debt obligations due to S corporation shareholders in the same proportion as they own the outstanding stock of the S corporation.

The regulations provide that obligations owned by a shareholder who owns all the stock of the S corporation are held proportionately to the corporation’s outstanding stock.

Under the regulations, convertible debt is a second class of stock if

- It is treated as equity under general principles of tax law and is used to contravene the single-class-of-stock rule or other S corporation rules; or
- The convertible debt has rights equivalent to those of a call option that is substantially certain to be exercised and has an exercise price that is substantially below the fair market value of the underlying stock.

Since convertible debt is more likely to be considered a second class of stock than is a call option, the S corporation might find it

advantageous to issue a call option that would fall into the exception described above instead of using convertible debt.

The final regulations generally apply to taxable years beginning on or after May 27, 1992. However, the provisions applicable to debt instruments, call options, and convertible debt do not apply to arrangements that were issued or entered into on or before May 27, 1992, and are not materially modified after that date. These are grandfathered in S corporations, and their shareholders have the option to apply the regulations to prior years.

2.2.4 Subsidiaries

Beginning January 1, 1997, an S corporation is permitted to own 100 percent (but not less than 100 percent) of another S corporation, provided that the parent corporation elects to treat the subsidiary as a qualified subchapter S subsidiary (QSSS). A temporary procedure for making such an election is provided in Notice 97-4, 1997-2 I.R.B. 24. If an S corporation makes a valid QSSS election, the separate existence of the QSSS is ignored for all purposes under the Internal Revenue Code. If a QSSS election terminates (for example, because the parent corporation transfers some of the stock of the subsidiary) the subsidiary is treated as a newly formed C corporation as of the date of the termination.

Also as of January 1, 1997, an S corporation is permitted to own any percentage (including 100 percent) of the stock of a C corporation. Previously, an S corporation was not permitted to own 80 percent or more of a C corporation.

Note, however, that a C corporation is not permitted to own any shares of stock of an S corporation.

3. MAKING AN S CORPORATION ELECTION

3.1 Timely Filing of Form 2553

To become an S corporation, a corporation that meets all the eligibility requirements for becoming an S corporation must make a valid election on or before the fifteenth day of the third month of the taxable year (March 15 for calendar-year corporations) or in the preceding year. If the election is made after this date, the corporation will not be treated as an S corporation until the beginning of the next tax year, unless the IRS treats the late S election as timely filed (that is, the IRS determines

that there was reasonable cause for the late election). For new corporations, the two and one half month S election deadline begins to run on the date the corporation first has shareholders, acquires assets, or begins doing business.

Example. Corporation X is formed and begins doing business on September 24, 1997. The two-month and fifteen-day period within which it must file its election is calculated as follows:

- *Month 1.* September 24, 1997 to October 23, 1997.
- *Month 2.* October 24, 1997 to November 23, 1997.
- *Plus 15 days.* December 8, 1997.

An S corporation election is made by filing Form 2553. Form 2553 or a separate written consent must be signed by all of the stockholders (see section 3.2, below). Form 2553 must also be signed by a corporate officer who is authorized to sign the corporation's tax return and must be filed at the IRS Service Center where the corporation will file its tax returns.

The election should be hand delivered to the local IRS office and a copy of the election should be stamped by the IRS indicating the date it was received. If this is not practical, the election should be sent by certified mail or by registered mail with a return receipt requested.

3.2 Shareholders' Consents

All shareholders in a corporation making an election must consent in writing to the election. If the election is to be effective in the year in which it is made, any person who was a shareholder at any time during the portion of the year before the election is made must consent to the election regardless of whether or not he or she is a shareholder at the time of the election. Consent may be made on Form 2553 or in a separate statement.

Any persons who become shareholders after the election has been filed are bound by the election unless it is revoked or terminated. Only a majority of shareholders (those owning more than 50 percent of the corporation's stock) may revoke the election. However, any shareholder can cause the election to be terminated by transferring shares to a disqualified shareholder.

It is possible to get a time extension when the election has been filed within the specified time limit but a shareholder has failed to consent in time. To receive such an extension the corporation must satisfy the IRS that there was reasonable cause for the failure to file the consent on time and must show that the interest of the government

will not be jeopardized by allowing the election. Once the IRS has granted the extension, any shareholders who have not consented must do so within the extension period. In addition, new consents must be filed by any persons who were shareholders at any time during the year in which a shareholder failed to file a consent. Any additional persons who have become shareholders before the end of the consent period must also file consents. Remember that all consents must be filed within the extension period.

3.3 Election by a Beneficiary of a Qualified Subchapter S Trust (QSST)

A special election is required by the beneficiary of a QSST to qualify the trust as an eligible S shareholder. This election is made by the income beneficiary who is the deemed owner and must be made separately with respect to each S corporation the stock of which is held by the trust. The beneficiary must elect within two months and fifteen days beginning on the later of the following two dates:

- The date the stock is transferred to the trust.
- The first of the taxable year on which the corporation's S election is effective.

The election by a beneficiary of a QSST to qualify the trust is an election to be made in addition to the election made on Form 2553 and the consents to that form. If the trust is a shareholder at the time the Form 2553 S election is filed, the QSST election may be made on Part III of Form 2553. If the trust becomes a shareholder after the corporation has already elected S status, a separate statement according to Regulation Section 1.1361-1(j)(6) must be filed.

3.4 Taxable Years

An S corporation that wants to use an accounting period other than the calendar year must establish a business purpose to the satisfaction of the IRS or comply with a portion of Revenue Procedure 87-32, 1987-2 C. B. 396. This revenue procedure allows an S corporation to request a fiscal year-end under the following three situations:

1. *Ownership Tax Year.* A fiscal year-end may be adopted to coincide with the tax year-end of the shareholders owning a majority of the stock.
2. *Natural Business Year.* This allows expeditious approval of a fiscal year based on meeting a three-year historical seasonality test (meaning

that 35 percent or more of gross receipts have consistently occurred in the last two months of the desired year-end, based on the prior three-year average).

3. *Business Purpose Request.* Upon request, which includes submission of a user fee for the ruling, the IRS may approve a fiscal year-end for business reasons (see Rev. Rul. 87-57, 1987-2 C. B. 117).

Unfortunately, the ability of either a new entity or an existing corporation to meet any of the three criteria when making an S election is very limited. Seasonal businesses such as resorts may meet the natural-business-year test, but satisfying the ownership-year test requires a fiscal-year majority of individual shareholders, and the contents of Revenue Ruling 87-57 give little hope for IRS National Office approval of business-purpose requests. To the extent a fiscal request is attempted, Part II of Form 2553 must be completed as part of the S election process.

The Revenue Act of 1987 contained a special provision for fiscal year-end S corporations under which an S corporation could elect to retain its current fiscal year, even though it would be required by the 1986 Tax Reform Act to change to a calendar year. The 1987 act also allowed an election under Section 444 whereby an S corporation can adopt or change to a new fiscal year in which the deferral period would be three or fewer months (meaning that it can adopt a fiscal year-end of either September, October, or November). However, for existing corporations, the deferral period may not be increased. For example, a regular corporation with a November year end could only make a Section 444 election for November; September and October would not be permitted.

The election is made by filing Form 8716 with, or at the time of, filing the Form 2553 S election, and by designating the Section 444 election on Part II of Form 2553.

There is a price to be paid for this election. S corporations must make a "required payment," thus taking away the advantage of a tax deferral. In general, S corporations pay approximately the same amount in "required payments" as their owners would have paid in actual tax payments for the short period had the entity reported on the calendar tax year. The required payment is submitted with IRS Form 8752.

The required payments are not deductible by the S corporation (or by any other person) for federal income tax purposes. Rather, these required payments are in the nature of refundable deposits, which do not earn interest. Furthermore, the payments are not passed through to S shareholders. If the amount of required payment exceeds the amount currently due, the corporation is entitled to a refund (IRC Sec. 7519(c)).

Those S corporations allowed a fiscal year based on the established business purpose test (including the 25-percent-of-revenue test reflected

in Revenue Procedures 87-32 and 87-57) are not affected by the Revenue Act of 1987. They need not make required payments as a condition of retaining their fiscal years.

4. TERMINATING AND REVOKING AN ELECTION

4.1 Termination

An S corporation retains its S corporation status until the election is terminated or revoked. Termination occurs when any of the eligibility requirements for electing S corporation status are violated. For example, the corporation has more than seventy-five shareholders, issues a second class of stock, or a shareholder in a community property state marries a nonresident alien. Elections can be terminated for certain S corporations if the corporation has excessive passive investment income (see section 6 of this chapter). If a terminating event occurs, the corporation loses its S corporation status as of the day of the event: the termination is not retroactive to the beginning of the year.

A corporation should report a terminating event to the IRS, including the cause and the date. If a transfer of stock to a nonqualified shareholder is the cause of the termination, the corporation should also include the number of shares transferred, name of the recipient, and the names of the original shareholders. If a second class of stock was issued, the number of shares of new stock should be reported along with a description of the features of the new stock that make it different from existing stock still outstanding. See section 5.2, below, for circumstances under which the IRS can waive an inadvertent termination of an S election.

4.2 Revocation

An election can be revoked by persons holding more than 50 percent of the corporation's outstanding stock. In contrast to a termination, a revocation can be retroactive to the beginning of the taxable year if it is made on or before the fifteenth day of the third month of the taxable year. If the revocation is made after this day, the corporation can specify whether it wants the revocation to take place immediately, at the beginning of the next taxable year, or at any date in between. A corporation may specify a date for the revocation only if the date chosen is on or after that of the revocation. To make a revocation, a corporation must

file a written statement with the IRS Service Center where the election was filed.

4.3 Reporting Following a Termination or Revocation

If a corporation's status changes from that of an S corporation to that of a C corporation at any time during a taxable year, the corporation must file two tax returns: one for the portion of the year when the corporation was an S corporation (S short year) and one for the remainder of the year (C short year). The returns for the two short years are both due on the date specified for the return of the C short year. The corporation can allocate income or loss either by a pro rata daily method or by electing the normal tax accounting method (interim closing of the books). (See IRC Section 1362(e)(2), (3).) The election to close the books requires the consent of all who were shareholders during the S short year and all who are shareholders on the first day of the C short year. If more than 50 percent of the shares of the corporation were sold or exchanged during the termination year, or an election is made under IRC Section 338 to treat the purchase of its stock as an asset purchase, normal tax accounting rules must be used (Sec. 1362(e)(6)).

4.4 Reelecting: The Five-Year Waiting Period

In general, after termination of an election, a corporation must wait a full five years before making another election. The five-year waiting period applies regardless of whether termination was voluntary or involuntary. The IRS has the power to consent to an earlier election (Sec. 1362(g)).

In other situations, the five-year waiting period will not apply if the corporation revoked its election effective on the first day of the taxable year for which the election would have been effective. In addition, the five-year waiting period will not apply to a corporation if the termination occurred because the corporation failed to meet the definitional test for an S corporation on the first day of the first taxable year for which its election to S status was effective (Reg. Sec. 1.1362-5(b)). In the foregoing situations, there is no need to wait the five years, because the S corporation status never became effective.

Pursuant to the Small Business Job Protection Act of 1996, any corporation that terminated its S corporation election before January 1, 1997 may now reelect S status without the consent of the Secretary.

5. PREVENTING UNWANTED TERMINATION OF ELECTIONS

Termination of an election, whether intentional or inadvertent, causes a corporation to be reclassified as a C corporation. Shareholders who want the corporation to remain an S corporation should take steps to ensure that the election is not terminated because of careless lack of compliance.

5.1 Invalid Elections

If an election is invalid from the onset, no corrective action can be taken afterward to correct the situation, and the corporation will not be exempt from income taxation at the corporate level. If the election is not effective because it was filed after the fifteenth day of the third month of the taxable year, it will become effective at the beginning of the next taxable year. In this case the corporation will only be responsible for paying corporate income tax plus interest for the period of time before the election became effective (additional penalties may also be levied for failure to pay estimated tax). More seriously, the corporation will have exposure to the built-in gains tax for the first ten years in S status, by reason of its prior classification as a C corporation (see section 7.2, below).

If, however, the election is invalid because the election process was invalid, no election ever occurred and the corporation is responsible for all corporate taxes and interest accumulated plus any penalties incurred. If it is discovered that no election was ever made, the corporation can make a new election immediately, since in such a case the five-year waiting period does not apply. Again, the built-in gains tax issue will arise because of the prior C corporation status.

To prevent any of these situations from arising, the shareholders should verify that the election was indeed valid before treating the corporation as an S corporation. Even though the IRS Service Centers send S election acceptance letters to filing corporations, proof of mailing the election by certified mail and a receipt should be requested.

5.2 Inadvertent Termination of Elections

Any action that causes a violation of the eligibility requirements of an S corporation will cause the corporation's election to be terminated despite the fact that the action may be inadvertent or carried out by

certain shareholders without the knowledge and consent of other shareholders (for example, if a shareholder sells his or her shares to an ineligible shareholder, such as a corporation or partnership). If the termination is inadvertent, a corporation may receive permission from the IRS under IRC Section 1362(f) to treat it as though it had never occurred: the corporation will be treated as an S corporation during the period of termination if the IRS agrees that the termination was inadvertent and steps are taken to remedy the situation within a reasonable amount of time. If it is believed that the S corporation's election was inadvertently terminated, a ruling must be requested from the IRS. Before a ruling is issued, the corporation and shareholders must consent to any adjustment required by the IRS for a specific period (Reg. Sec. 1.1362-4).

5.3 Methods of Protecting the Election

5.3.1 Transfer of stock to escrow

If shareholders agree to transfer possession of their shares to an escrow agent, no shareholder can transfer stock without first consulting the agent. The agent, who can be one of the shareholders, could then discuss any proposed transfers of stock with all the shareholders before allowing them.

5.3.2 Shareholders' agreements

If all shareholders consent, an agreement to protect the election can be created. An agreement to protect an election should include

- A statement of intention to continue the election.
- A restriction on transfers of shares.
- A right-of-first-refusal either by the shareholders who are not transferring stock, or by the corporation redeeming the stock.
- A predetermined buyout price.
- A provision to prevent a majority of shareholders from revoking the election.

6. PASSIVE INCOME PROBLEMS

Passive income, also called passive investment income, generally includes gross receipts from investment items. Rents (except when significant services are performed or substantial costs are incurred in

conducting an active rental business), royalties (as defined in Reg. Sec. 1.1362-2(c)(5)(ii)(A)), dividends, interest (including tax-exempt interest but excluding interest from notes resulting from the sale of inventory or the performance of services), annuities, and gains from sales and exchanges of stocks and securities are usually classified as passive income and, before 1982, presented problems to many S corporations.

Since the SSRA, however, passive income no longer presents a problem for the vast majority of S corporations. For new S corporations, no passive income restrictions apply. For example, new S corporations have no restrictions on income earned from rental property. This is also the case for S corporations with no C corporation accumulated earnings and profits at the end of the taxable year. Problems arise for corporations with C corporation earnings and profits when passive income constitutes more than 25 percent of the corporation's gross receipts (see section 6.1, below). In this situation, passive income in excess of the allowable limit will be taxed at the highest corporate rate. (See section 7.3 for an explanation of this tax on excess passive income.) In addition, excessive passive income will lead to termination of an election at the beginning of the fourth year when

- The corporation has C corporation earnings and profits at the end of three consecutive tax years.
- Passive investment income accounts for more than 25 percent of the corporation's gross receipts in each of those three years.

It is therefore necessary for S corporations with C corporation earnings and profits to prevent passive income from exceeding the allowable level.

6.1 Gross Receipts

To determine if passive income presents a problem for an S corporation one must understand the IRS's definition of gross receipts. The IRS defines gross receipts as the total amount of receipts not reduced by returns, allowances, costs, or deductions. For sales and exchanges of capital assets other than stocks and securities (stock trading gains are passive receipts), however, only a net gain from such transactions is counted when figuring gross receipts. In the case of stocks and securities, only gains are considered; losses do not offset gains in measuring gross receipts (Reg. Sec. 1.1362-2(c)(4)). In addition, loans, repayments of loans, contributions to capital, and issuance by a corporation of its own stock do not count as gross receipts.

6.2 Preventing Passive Income Problems

6.2.1 Eliminate accumulated earnings and profits

Both the S termination risk and the excess passive receipts tax (see section 7.3, below) can be eliminated by paying out the C corporation's accumulated earnings and profits. This may be accomplished by an election to bypass the normal distribution tiers, or by the special deemed-dividend election (see section 9.2.1). Remember, however, that the S corporation shareholders will be taxed on the distribution as a dividend. Earnings and profits consist of all recognized income (both taxable and nontaxable) reduced by all losses and payments (both deductible and nondeductible).

6.2.2 Increasing gross receipts

A corporation that is in danger of having passive income exceeding the 25-percent gross receipts limit can protect itself by increasing its gross receipts from nonpassive-income sources. Business asset sales are counted in the gross receipts test at full sale price. Another method is to sell capital assets other than stocks and securities for a capital gain. The capital gain on the sale or exchange will increase the corporation's gross receipts but, because the gain was not on the sale or exchange of stocks or securities, it will not be counted as passive income.

6.2.3 Additional methods

Additional methods for preventing passive income problems include selling the investment assets that produce the rental, dividend, interest, or other passive income, and reinvesting the proceeds into active business assets. Also, the Section 1375 passive tax (but not the three-year termination rule) can be defeated by reducing the S corporation taxable income to zero, such as with bonuses or other expenses. Finally, if the entity is beyond the reach of the built-in gains tax (see section 7.2, below), a liquidation as an S corporation will often be preferable to a termination of S status, which brings the assets back into C corporation status.

7. TAXATION AT THE CORPORATE LEVEL

In the great majority of instances, S corporations are not subject to corporate income taxes. S corporations that were C corporations before

the election are, however, subject to investment credit recapture on assets acquired when they were C corporations, if such assets are disposed of during the recapture period of an S corporation. In addition, excess passive investment income may also be subject to corporate tax. A built-in gains tax exists to prevent elections before sale or liquidation for the purpose of avoiding corporate-level tax.

7.1 General Utilities Repeal

The Tax Reform Act of 1986 repealed the *General Utilities* doctrine (*General Utilities & Operating Co.*, 296 US 200 (1935)). Before the Tax Reform Act of 1986, a C corporation could sell virtually all of its assets for cash, distribute the cash and balance of its assets to its shareholders, and avoid corporate-level tax, except for investment credit and depreciation recapture, by liquidating within a twelve-month period after adopting a plan of liquidation (Sec. 337). The shareholder would pay a tax on the distribution of the proceeds. The shareholder tax on distribution of the proceeds is not an outcome of the Tax Reform Act of 1986, but a continuation of the law as it existed before the repeal of the *General Utilities* doctrine.

Following the repeal of the *General Utilities* doctrine, if a C corporation sells its assets and liquidates, or merely distributes appreciated assets to its shareholders, it will pay a corporate-level tax on the gain, with its shareholders being subject to tax on the distribution of the proceeds. This double tax will generally not apply to the sale of assets of certain S corporations (see section 7.2, below).

7.2 Recognition of Built-in Gains Under IRC Section 1374

IRC Section 1374 provides a tax on “built-in” gains when a C corporation elects S status after December 31, 1986. Ordinary income and capital gain will be recognized to an S corporation that was formerly a C corporation on a distribution or sale of its property to the extent of any built-in gains that arose before conversion to S corporation status, if the gains are recognized within ten calendar years of the date the election took effect. The tax is computed at the maximum corporate rate (currently 35 percent). The corporation can take into account any C corporation tax attributes, such as net operating loss and credit carryforwards, in the calculation of its tax.

Under Notice 90-27 (1990-1 C. B. 336), S corporation shareholders are not able to avoid built-in gains on installment sales after March 25, 1990. When gain is recognized after the ten-year recognition period,

it is taxed under IRC Section 1374 to the extent that it would have been so taxed in a prior year had the installment method not applied. Therefore, if part of the gain is deferred to the eleventh year, the entire deferred gain is subject to tax under IRC Section 1374 in the eleventh year (Reg. Sec. 1.1374-4(h)).

Assets subject to the built-in gains tax include not only those disposed of through sale or exchange but also through other asset-based income recognition mechanisms, such as collection of accounts receivable by a cash-basis taxpayer. The IRS takes the position that these items will be considered a disposition for purposes of triggering the built-in gains tax (Reg. Sec. 1.1374-4(b)(3)). In addition, the sale of appreciated inventory may be subject to this tax. For built-in gains purposes, the fair market value of the inventory at the time of conversion to S status is determined as the amount a willing buyer would pay to a willing seller for inventory in a purchase of all the assets of the S corporation assuming the buyer expects to continue the business (Reg. Sec. 1.1374-7). Thus, a bulk sale approach of the entire business, not only the inventory, is used. The inventory value often will not exceed tax basis; most accrual method taxpayers will not have built-in gain on their inventories.

The ten-year built-in gains tax may be minimized or even eliminated if taxable income for the year is lower than the recognized built-in gain. However, for S elections made on or after March 31, 1988, any built-in gain that is defeated by the taxable income limit becomes a carryforward to each remaining year in the ten-year recognition period. Thus, to completely avoid a built-in gain, taxable income must be zero in the year of initial recognition *and* for each remaining year in the ten-year period.

7.3 Tax on Passive Investment Income

Passive income is only subject to corporate tax under IRC Section 1375 if a corporation has earnings and profits from years when the corporation was a C corporation. For S corporations with C corporation earnings and profits, excess passive income is taxed at the highest corporate rate (35 percent). A corporation's excess passive income can be figured as follows:

- Determine net passive income by subtracting allowable deductions that are directly attributable to the production of the passive income from gross passive income. (See section 6 above for the definition of passive income and gross receipts.)
- Determine what percentage of gross passive income exceeds the 25 percent of gross receipts limit.

- Multiply the percentage determined above by the amount figured for net excess passive income.

Example. Calculation of Excess Passive Income Tax

During the year, F corporation had the following:

| | | |
|--|---------------------|-----------|
| Gross receipts | | \$200,000 |
| Total passive investment income | \$80,000 (A) | |
| Less: | | |
| Expenses attributable to passive income | <u>20,000</u> | |
| Net passive income | <u>\$60,000 (B)</u> | |
| 25% of gross receipts (200,000 × .25) | \$50,000 (C) | |

$$\left(\frac{\text{Total Passive Income less 25\% of Gross Receipts}}{\text{Total Passive Income}} \right) \times \text{Net Passive Income} = \text{Excess Net Passive Income}$$

$$\frac{80,000 (A) - 50,000 (C)}{80,000 (A)} \times 60,000 (B) = \text{Excess Net Passive Income}$$

$$.375 \times 60,000 = 22,500$$

$$\begin{aligned} & \$22,500 \text{ Excess net passive income*} \\ & \times \underline{.35} \text{ Highest corporate rate} \\ & \underline{\underline{\$7,875}} \text{ Tax on excess net passive income} \end{aligned}$$

If this condition of excess passive receipts and C corporation earnings and profits exists for three consecutive years, the S status will terminate (see section 6).

*Note that the excess passive income subject to the tax may not exceed the corporation's taxable income.

7.4 Estimated Tax

S corporations are required to pay estimated tax, for tax liability attributable to the following situations:

- Tax on capital gain under IRC Section 1374 (see section 7.2 herein)
- Tax on excess passive investment income (see section 7.3 herein)
- Tax from recapture of past investment tax credits for assets acquired by a former C corporation before the effective date of the S corporation election (Sec. 1371(d)(2))

- The required annual estimated tax payment is the lesser of
- 90 percent of the tax shown on the return for the tax year, or
 - The sum of 90 percent of the tax liability incurred for built-in gains tax and investment credit recapture, plus 100 percent of the tax due on excess passive income reported in the preceding year.

An S corporation cannot use the exceptions that allow estimated tax based on the prior year's built-in gains and tax credit recapture. The prior-year tax based on excess passive income is allowed, even if there was no excess passive income in the prior year.

8. TAXATION AT THE SHAREHOLDER LEVEL

8.1 Passthrough Items

The principal factor differentiating the shareholders of an S corporation from the shareholders of a C corporation is that the shareholders of an S corporation pay taxes on passthrough items at the shareholder level. Shareholders of an S corporation must take into account the taxable items, similar to those governed by partnership rules under IRC Section 702. However, the partnership and S corporation rules are not identical. Thus, an S corporation shareholder must report his or her pro rata share of

- Nonseparately computed income or loss (taxable income).
- Items of income, loss, deduction, or credit, the separate treatment of which could affect the shareholder's tax liability (Sec. 1366 (a) (1)).

The following are additional examples of some of the separately stated items that pass through to shareholders:

- *Capital gains and losses.* Capital gains or losses pass through to the shareholders as capital gains or losses.
- *Section 1231 gains and losses.* Section 1231 gains (relating to realty and depreciable property used in a trade or business) are passed through separately, to be combined with the shareholder's other Section 1231 gains or losses.
- *Charitable contributions.* The corporate 10 percent limitation will not apply. If the S corporation makes a charitable contribution of \$250 or more, the S corporation must obtain the contemporaneous written acknowledgment from the charity and not the shareholders,

who are subject to the individual limitations on deductibility of the charitable deduction.

- *Tax-exempt interest.* Such interest passes through and is not taxed to the shareholder when it is received by the S corporation. However, tax-exempt income, which increases basis but does not increase the accumulated adjustments account (AAA) (see section 9.2.2, below), is treated as distributed only after all accumulated earnings and profits have been distributed (Secs. 1368 (a)(1)(A); 1368 (e)(1)(A)).

Example: SAM Corporation has ordinary income of \$70,000 and tax-exempt income of \$20,000 during the first year it elected S status. SAM Corporation has \$100,000 of accumulated earnings and profits from years before its S election. During the year the corporation distributed \$90,000 to its shareholders. The shareholder pays tax on \$90,000, because \$70,000 is his or her distributable share of the corporation's taxable income. The remaining \$20,000 results from the corporation's making a distribution in excess of AAA. The distribution comes out of the corporation's accumulated earnings and profits from the years before the S election. The \$20,000 nontaxable income increases stock basis but not AAA.

- *Foreign tax credit.* Foreign taxes paid by the corporation pass through as such to the shareholders, who claim the taxes either as deductions or credits, subject to the applicable limitations. An S corporation is not eligible for the foreign tax credit with respect to taxes paid by a foreign corporation in which the S corporation is a shareholder, and these tax credits do not pass through to its shareholders.
- *Credits.* These include the credit for backup withholding on dividends, interest income, and other types of income. In addition, credits for nonconventional fuel sources and for increasing research activities are passed through to the shareholders. However, any gas tax and diesel fuel credits are claimed by the S corporation (Sec. 1366 (b)(1)).
- *Depletion.* S corporations treat depletion as partnerships do; that is, the corporation states such items separately and passes them through to the shareholders.
- *Foreign income and loss.* Domestic and foreign income or losses each pass through separately, without aggregation at the corporate level.
- *Self-employment tax.* The shareholder's share of net income from an S corporation is not subject to self-employment tax; therefore, net losses from an S corporation cannot be used to reduce the shareholder's self-employment income (Ltr. Rul. 9530005).

8.2 How Shareholders Treat Passthrough Items

All items of income, loss, credit, and deduction passed through to the shareholders are allocated on a per-share, per-day basis. Passed-through items must be reported in the shareholder's taxable year that includes the last day of the S corporation's taxable year. Net operating losses are allocated as other corporate items are, with the exception that each shareholder's ability to deduct losses is affected by his or her basis in the stock (see section 8.3, below). If shares are transferred during the taxable year, the transferee is considered as the owner of the shares on the day of the transfer.

Example: At the beginning of the taxable year, Z Corp had 500 shares of outstanding stock that were owned by two people:

| | |
|---------|------------|
| Barbara | 200 shares |
| Elena | 300 shares |

On June 1, Elena sold fifty shares of stock in Z Corp to Dawn. At the end of the taxable year Z Corp's only passthrough item was its taxable income of \$50,000. To calculate each shareholder's share of taxable income, the instructions in Form 1120S suggest the following steps:

— Compute percentages of stock owned for the year:

| | | |
|---------|---------------|-----|
| Barbara | | 40% |
| Elena | Before June 1 | 60% |
| | After June 1 | 50% |
| Dawn | Before June 1 | 0% |
| | After June 1 | 10% |

— Compute percentages of the year before and after transaction:

| | | |
|-----------------------|-----------|-----|
| January 1 to June 1 | (151/365) | 41% |
| June 1 to December 31 | (214/365) | 59% |

— Multiply each shareholder's percentage of stock owned by the percentage of the year during which they owned them:

| | | |
|----------|---------------------|---------------|
| Barbara: | $40\% \times 100\%$ | 40.0% |
| Elena: | $60\% \times 41\%$ | 24.6% |
| | $50\% \times 59\%$ | 29.5% |
| Dawn: | $10\% \times 59\%$ | 5.9% |
| | | <u>100.0%</u> |

— Multiply each shareholder's percentages as determined above by the corporation's taxable income to determine her share of the corporation's taxable income:

| | | |
|----------|-------------------------------------|-----------------|
| Barbara: | $40\% \times \$50,000$ | \$20,000 |
| Elena: | $(24.6\% + 29.5\%) \times \$50,000$ | \$27,050 |
| Dawn: | $5.9\% \times \$50,000$ | \$ 2,950 |
| | | <u>\$50,000</u> |

8.2.1 If a shareholder terminates his or her interest

If a shareholder terminates his or her entire interest in the corporation and if both the corporation and all “affected shareholders” consent, under IRC Section 1377(a)(2) the corporation can elect to treat the taxable year as if it consisted of two separate years, with the first year ending at the close of the day the shareholder’s interest terminated. The term *affected shareholder* means the shareholder whose interest is terminated and all persons to whom such shareholder has transferred shares during the taxable year. In the case of a redemption, however, the term affected shareholders includes all persons who were shareholders of the corporation during the taxable year.

The election to treat the taxable year as two separate years does not terminate the S corporation election, and only one corporate return (Form 1120S) has to be filed for the year. The treatment of the S corporation year as two separate taxable years means the books are closed. The income or loss accruing before the shareholder left the corporation is allocated among all shareholders. The income or loss accruing after the shareholder terminates his or her interest is allocated only to the remaining shareholders. The election represents an alternative method of allocating pass-through items. If no election is made, then the income or loss is computed under the pro rata method. Under this method, an S shareholder’s pro rata share of each tax item is determined by assigning an equal portion of each tax item to each day of the S corporation’s tax year and dividing that portion pro rata among the outstanding shares on each day (see section 4.3).

Example: Y Corp is a calendar-year S corporation, with 100 shares of common stock outstanding. John owns fifty shares all year. Mary owns fifty shares until September 30th when she sells all of her shares to Steve. The corporate accounting records show that the corporation had \$30,000 profit at transfer date and experienced a \$10,000 loss after the transfer date, making a profit of \$20,000 for the year ended December 31. The results to Mary and Steve will be different, depending upon which method is used for allocation of income and loss.

Method 1: Pro Rata Mathematical Allocation Formula

| | <u>1/1 to 9/30</u> | <u>10/1 to 12/31</u> | <u>Total</u> |
|--|--------------------|----------------------|-----------------|
| Number of days | 273 | 92 | 365 |
| Ratio: $\frac{\text{Number of days}}{365}$ | .7479 | .2521 | 1.00 |
| Income (Ratio \times \$20,000) | \$14,958 | \$5,042 | \$20,000 |
| Allocated as follows | | | |
| John | \$ 7,479 | \$2,521 | \$10,000 |
| Mary | 7,479 | | 7,429 |
| Steve | | 2,521 | 2,521 |
| | <u>\$14,958</u> | <u>\$5,042</u> | <u>\$20,000</u> |

Method 2: Use of Actual Accounting Records and Election under Section 1377(a)(2)

The corporation elects to treat the tax year as if it consisted of two years, with the first one ending at the close of the day the shareholder's interest terminated. John (not required to consent for taxable year beginning after December 31, 1996), Mary, and Steve must consent to the corporation's election. The income for each shareholder is computed as follows:

| | <u>1/1 to 9/30</u> | <u>10/1 to 12/31</u> | <u>Total</u> |
|-----------------------------|--------------------|----------------------|-----------------|
| Income (or loss) for period | <u>\$30,000</u> | <u>\$(10,000)</u> | <u>\$20,000</u> |
| Allocated as follows | | | |
| John | \$15,000 | \$ (5,000) | \$10,000 |
| Mary | 15,000 | | 15,000 |
| Steve | | (5,000) | (5,000) |
| | <u>\$30,000</u> | <u>\$(10,000)</u> | <u>\$20,000</u> |

Because of these differing results to the buyer and seller, it may be important to secure an agreement among the shareholders at the time of sale as to which method will be used at year-end to allocate the income or loss. In many cases, the results of either method will be neutral to the seller because any extra income increases stock basis, which then brings a reduced stock sale gain.

8.2.2 A substantial disposition of stock

If there is a disposition by any shareholders of 20 percent or more of the issued stock of the corporation in one or more transactions during any thirty-day period in the corporate tax year, the S corporation may make an election similar to the one in section 8.2.1, above, to treat the taxable year as if it were two separate tax years, for purposes of allocating items of income and loss to shareholders (Reg. Sec. 1.1368-1(g)(2)).

8.2.3 If a shareholder dies

If a shareholder dies, his or her final return will include the pro rata share of passthrough items up to and including the date of death (Prop. Reg. Sec. 1.1377-1(a)(2)) and will be included on the decedent's final return (Sec. 1366(a)(1)). Items for the remainder of the year will pass through to the estate or the person acquiring the stock.

Since death is considered a termination of the deceased shareholder's interest, the S corporation can make the election to split the tax year—see section 8.2.1, above (Prop. Reg. Sec. 1.1377-1(b)(3)).

8.3 Shareholder's Basis

8.3.1 Basis in stock

Basis is important because it measures the amount of S corporation loss that is deductible by a shareholder. Also, basis is increased annually for any undistributed income, thereby assuring that double tax will not occur when the stock is eventually sold or liquidated. Under current law, the basis of a shareholder's S corporation stock is computed as follows:

- Original cost or basis, however arrived at
- Increased by
 - Nonseparately computed income (Sec. 1367 (a)(1)(B)). (This would be the shareholder's share of the corporation's "taxable" income.)
 - Separately stated items of income (Sec. 1367(a)(1)(A)). (This includes capital gains, Section 1231 gains, and the like.)
 - Excess of the deductions for depletion over the basis of the property subject to the depletion (Sec. 1367(a)(1)(C)).

The depletion increase does not include depletion attributable to oil and gas property (Reg. Sec. 1.1367-1(b)).

- Decreased by
 - Nonseparately computed loss (Sec. 1367(a)(2)(C)).
 - Separately stated items of deduction or loss (Sec. 1367(a)(2)(B)) such as capital losses and Section 1231 losses.
 - Any expense of the corporation not deductible in computing its taxable income and not properly chargeable to capital account (Sec. 1367(a)(2)(D)). Examples of nondeductible noncapital expenses include fines and penalties and 50 percent disallowed meals and entertainment.
 - The amount of the shareholder's deduction for depletion of oil and gas wells under IRC Section 611 (Sec. 1367(a)(2)(E)).
 - Distributions (that is, nondividend distributions), which are not includable in the shareholder's income (Sec. 1367(a)(2)(A)). This category includes distributions of items that have already been taxed to the shareholder, such as the accumulated adjustments account (AAA) and previously taxed income (PTI), and includes distributions that are applied against stock basis to the extent the basis does not go below zero.

Under the ordering rules (Reg. Sec. 1.1367-1(e)) the adjustment to basis is made in the following order:

1. Increase in basis attributable to income items;
2. Decrease in basis attributable to noncapital, nondeductible expenses and oil and gas depletion;
3. Decrease in basis attributable to items of losses;
4. Decrease in basis attributable to distribution by corporation.

The ordering rules decrease the basis for nondeductible items before they decrease basis for deductible items. It is possible, if the nondeductible items are large enough, the basis would be reduced and the shareholders would not be able to use the full loss. If this were to happen, there is a provision for the shareholders to make an election under Regulation Section 1.1367-1(f) to reverse the order by reducing the basis by deductible losses first, then by noncapital or nondeductible expenses to the extent of basis. Any of the items in excess of basis will reduce basis in the succeeding taxable year.

The Small Business Job Protection Act of 1996 provides that the adjustment for distributions made by an S corporation during the tax year are taken into account before applying the loss limitation for the year. Therefore, distributions during a year reduce the adjusted basis in determining the allowable loss for the year, but the loss for the year does not reduce the adjusted basis in determining the tax status of the distributions made during that year.

8.3.2 Basis in debt

When losses are passed through to S corporation shareholders, they first reduce the basis of the shareholder's stock; when the stock basis is zero, further basis reductions are made in shareholder loans to the corporation. There can be no negative basis. The shareholder's basis in stock cannot be increased until any reduction of basis in debt has been restored. Basis is increased by passthrough of S corporation income. Losses not deductible by reason of insufficient basis in stock or indebtedness are not lost forever but may be carried forward and deducted in later years when basis increases.

In contrast to a partner, a shareholder in an S corporation only has basis in the indebtedness of the S corporation to that shareholder (partners have basis in partnership indebtedness to others for which they may be held personally liable). A shareholder's personal guarantee of an S corporation's note or loan does not increase basis for loss purposes unless: the shareholder pays the corporate note or substitutes his or her own note for those of the corporation, and the creditor relieves the corporation from its liability on the note and substitutes the shareholder as the primary obligor. The rule that shareholders only obtain basis for amounts they loaned the corporation, while partners have basis for all partnership debts for which the partners are personally

liable, is the reason that partnerships have been the preferred vehicle for most tax-advantaged investments even after SSRA.

8.3.3 Reduction of basis of individual shares

Whether the shareholder basis is attributable to stock or debt, it is first necessary to reduce the individual basis in shares to which the loss can be attributed, and then the basis in debt. The following example shows the calculations involved in figuring the reduction of basis of individual shares.

Example: At the beginning of the taxable year Sue owned three shares of stock in Q Corp. During the year Sue sold one of her shares and later purchased another share. At the end of the taxable year Sue was notified that her share of the corporation's losses was \$2,000. Sue's basis in each of her shares after loss allocation is calculated as follows:

| <i>Share:</i> | #1 | #2 | #3 | #4 | <i>Total</i> |
|--|---------|-------|-------|-------|--------------|
| Days shares held during year: | 365 | 365 | 182 | 92 | 1,004 |
| Basis of shares at beginning of year or at purchase: | \$500 | \$800 | \$400 | \$900 | \$2,600 |
| Loss allocation: | | | | | |
| Share 1: $(365/1004) \times \$2,000$ | | | | | |
| Share 2: $(365/1004) \times \$2,000$ | | | | | |
| Share 3: $(182/1004) \times \$2,000$ | | | | | |
| Share 4: $(92/1004) \times \$2,000$ | | | | | |
| | 727 | 727 | 363 | 183 | 2,000 |
| Basis minus loss: | \$(227) | \$ 73 | \$ 37 | \$717 | \$ 600 |
| Reallocate subzero basis to: | | | | | |
| Share 2: $(73/827) \times \$227$ | | | | | |
| Share 3: $(37/827) \times \$227$ | | | | | |
| Share 4: $(717/827) \times \$227$ | | | | | |
| *827 = 73 + 37 + 717 | | | | | |
| | 227 | (20) | (10) | (197) | 0 |
| Basis after loss allocation: | \$0 | \$53 | \$27 | \$520 | \$ 600 |

*Example reprinted from *S Corporations*, CPE Course Handbook (New York: American Institute of Certified Public Accountants, 1986), p. T7-7.

Regulation Section 1.1367-1(c)(3) adopts a separate basis approach for each share of stock. Basis adjustments are allocated on a per-share, per-day method. If a decrease attributable to a share exceeds its basis, the excess is applied to reduce (but not below zero) the remaining bases of all other shares of stock owned by the shareholder in proportion to the

remaining basis of each of those shares (Reg. Sec. 1.1367-1(c)(3)). Therefore, if Sue was planning to sell one of the shares the following year, she would be advised to sell Share 4 since that share had a higher basis than her other shares.

If a shareholder's basis in debt has been reduced as a result of passthrough losses, repayment received from the corporation on the debt will generate taxable gain to the shareholder. The debt has to be evidenced in writing in order to create capital gain on repayment as opposed to ordinary income.

8.4 Fringe Benefits

Any person who owns more than 2 percent of the stock of an S corporation is treated like a partner when it comes to fringe benefits. A person who is a more-than-2-percent shareholder at any time during the S corporation's taxable year must treat fringe benefits as income. The following is a list of such fringe benefits:

- Accident and health plans and medical expenses (Secs. 105 and 106)
- Group-term life insurance of \$50,000 (Sec. 79)
- Meals and lodging furnished for convenience of the employer (Sec. 119)

Accident and health insurance payments paid on behalf of 2-percent-or-more shareholders must be reported as wages on the employee's W-2 form (Rev. Rul. 91-26, 1991 C. B. 184). The insurance premiums are exempt from the Social Security and Medicare tax base, although they are treated as wages for income tax purposes (IRS Ann. 92-16, IRB no. 1992-5). Although the IRS, to date, has only issued specific guidance for medical insurance premiums, the Form 1120S tax return instructions direct that all of these fringe benefit expenditures are to be reclassified as compensation if provided, directly or indirectly, to a more-than-2-percent shareholder.

9. DISTRIBUTIONS

One of the advantages of operating an S corporation is the fact that income is taxed only once. Generally, income escapes tax at the corporate level, and the shareholder pays tax on the income by reporting it on his or her personal income tax return.

9.1 By a Corporation With No Accumulated Earnings and Profits

Distributions are handled differently by S corporations with earnings and profits and by S corporations without accumulated earnings and profits. (See section 9.2, below, for corporations with accumulated earnings and profits.) For S corporations that have no earnings and profits, the application of distributions is in the following order:

1. As a nontaxable return of capital to the extent of the shareholder's basis.
2. As a gain from the deemed sale or exchange of stock (capital gain) (Sec. 1368(b)).

The taxable or nontaxable characteristics of a distribution cannot be determined until the taxable year ends. First, basis of the stock is adjusted by the passthrough items, then distributions are taken into account.

As discussed above, the tax treatment of adjustments during a loss year have been changed by the Small Business Job Protection Act of 1996, so that the adjustments to basis for distributions are made before applying the loss limitation for the year. The net result is that the distribution reduces the adjusted basis for determining the allocable loss, but the loss for the year does not reduce the adjusted basis for purposes of determining the tax status of the distribution.

9.2 By a Corporation With Accumulated Earnings and Profits

9.2.1 Order of applying distributions

A distribution of earnings and profits (E & P) is a taxable dividend to the recipient. An S corporation without E & P *cannot* distribute a taxable dividend, and is subject to the simplified distribution rules (see section 9.1, above).

An S corporation will have E & P in one of three ways:

1. The S corporation was previously a C corporation, and generated during C years E & P that was not paid out as dividends to shareholders.
2. The S corporation was in existence in S status for tax years beginning before 1983, and generated positive E & P (for tax years beginning after 1982, an S corporation does not generate E & P).
3. The S corporation acquired a C corporation in a merger or other tax-free reorganization, such that C corporation E & P carried over to the S corporation.

The Small Business Job Protection Act of 1996 eliminated, effective for taxable years beginning after December 31, 1996, any pre-1983 earnings and profits (E & P) attributable to S corporation years.

S corporations with accumulated earnings and profits (AE & P) apply distributions in the following order:

1. As a distribution of the accumulated adjustment account (AAA) (see section 9.2.2, below), which is treated in the same manner as a distribution from an S corporation without accumulated earnings and profits (return of capital up to basis in stock and a disposition of stock subject to capital gain treatment to the extent AAA exceeds basis) (Sec. 1368(c)(1)).
2. As a dividend to the extent of the corporation's accumulated earnings and profits (Sec. 1368(c)) (ordinary dividend income).
3. As a nontaxable reduction of basis to the extent of the remaining basis, if any, in stock (tax-free—reduces basis of stock).
4. As a taxable gain from the deemed sale or exchange of stock subject to capital gain treatment (Sec. 1368(c)(3)).

With the consent of all shareholders who received a distribution, the corporation may elect, under IRC Section 1368(e)(3), to bypass first-tier distribution and treat the entire distribution as taxable as a dividend to the extent of accumulated earnings and profits. This would be beneficial if the S corporation wants to avoid the tax on passive investment income. (See section 7.3, above.)

The treatment of distributions during the loss year have been changed by the Small Business Job Protection Act of 1996 (see section 9.1, above). The Small Business Job Protection Act of 1996 also provides that, in determining the amount of AAA for the tax treatment of distributions made during the tax year by an S corporation with accumulated earnings and profits, net negative adjustments to AAA (for example, the excess of losses and deductions over income) for that taxable year are disregarded. Distributions are measured first, before the net loss affects AAA.

For S corporations with previously taxed income (PTI) from years before 1983, the distribution rules from pre-SSRA years are still in effect, and distributions are applied in the following order:

1. AAA
2. PTI
3. Dividend to extent of AE & P
4. Nontaxable return of capital to the extent of remaining basis
5. Taxable disposition of stock

S corporations having shareholders with PTI must make an additional election to bypass PTI if they want to distribute accumulated

earnings and profits before PTI. The AAA and PTI bypass elections operate independently of each other, and either one can be made without the other (Reg. Sec. 1.1368-1(f)(2)(ii)).

In conjunction with the bypass election in distributing AE & P the corporation may also elect to distribute all or part of its AE & P through a deemed dividend, if the corporation lacks the cash to make an actual distribution. Each shareholder owning stock on the last day of the tax year must consent in writing to the corporate deemed-dividend election (Reg. Sec. 1.1368-1(f)(3)).

9.2.2 Accumulated adjustments account (AAA)

The purpose of the AAA is to maintain a running tabulation of an S corporation's ability to distribute profits tax-free to shareholders, because the income has already been taxed. The AAA starts at zero on the first day of an S corporation's first taxable year beginning after 1982. For subsequent years the AAA will have a positive balance from earnings or a negative balance (deficit) if there are accumulated post-1982 S corporation losses. AAA is adjusted by the same amounts that affect a shareholder's stock basis (see section 8.3.1, above). However, tax-exempt income does not increase AAA and related expenses do not reduce it. Tax-exempt income, therefore, cannot generally be distributed tax-free if there are accumulated earnings and profits.

9.3 Property Distributions

On distributions of appreciated property by an S corporation to the shareholders, the gain is recognized to the corporation just as if it had sold the property to the shareholder at its fair market value (Sec. 1363(d)(a)). However, no gain is recognized on distributions of appreciated property in a tax-free reorganization distribution (Sec. 1363(e)).

9.4 Post-Termination Transition Period Distributions

After the termination of an S corporation's election, the corporation may still make cash distributions (not in property) during a post-termination transition period, which are applied against stock basis to the extent of AAA. This gives the corporation an escape hatch, so it has some time to distribute its AAA (which has already been taxed) as a tax-free return of capital in the event the election is revoked or involuntarily terminated. IRC Section 1377(b) defines this period as one of the following:

- The period beginning on the day after the last day of the corporation's last taxable year as an S corporation and ending on the later of one of the following:
 - The day that is one year after the last day
 - The due date for filing the return for the last year as an S corporation (including extensions)
- The 120-day period beginning on the date of a determination that the corporation's election under Section 1362(a) had terminated for a previous year. (A determination is a court decision that has been finalized, a closing agreement, or an agreement between the corporation and the IRS that the election had ceased to be valid in a prior year.)
- The 120-day period beginning on the date of any determination (after termination of the S corporation) that adjusts items of income, loss, or deductions of former S corporations. The definition of *determination*, used in defining post-termination includes a final disposition by the Secretary of a claim for a refund and, under regulations, certain agreements between the Secretary and any person, relating to the tax liability of the person.

9.5 Distributions Treated by IRS as Compensation to Owner-Employees

Some S corporations, to avoid payroll and unemployment taxes for payments to owner-employees, treat these payments as distributions of earnings rather than as compensation—a questionable practice. To stop this, the IRS is recharacterizing these payments as compensation and assessing FICA and FUTA taxes if inadequate compensation has been paid to owner-employees.

Shareholders who render services to their S corporations should consider entering into employment agreements with the corporations to receive compensation for their services. The taxpayers could then argue that the compensation is reasonable and distributions in excess of the compensation are dividends not subject to employment tax.

REFERENCES

- Anosike, Benji O. *How to Form Your Own Chapter "S" Business Corporation*. Newark, N.J.: Do-It-Yourself Legal Publishers, 1995.
- Biebl, Andrew R. *Practitioners 1120S Deskbook*. 3d ed. Fort Worth, Tex.: Practitioners Publishing Company, 1993. Supplemented annually.

- ____ and Gregory B. McKeen. *PPC Tax Planning Guide: S Corporations*. 8th ed. 3 vols. Fort Worth, Tex.: Practitioners Publishing Co., 1994. Supplemented annually.
- Bittker, Boris, and James S. Eustice. *Federal Income Taxation of Corporations and Shareholders*. New York: Warren, Gorham & Lamont, 1989. Supplemented annually.
- Boucher, Karen, et al. *Multistate S Corporation Tax Guide*. New York: Panel Publishers, 1991. Supplemented annually.
- Bravenac, Lorence L. *Federal Taxation of S Corporations & Shareholders*. Philadelphia: American Law Institute—American Bar Association, 1995.
- Bryant, M. Kevin. *S Corporations: Complete Tax Practice and Planning Guide*. Columbia, S.C.: Professional Tax & Business Publications, 1996.
- Closely Held Business: Estate Freezes and Other Planning Considerations*. New York: Practising Law Institute, 1992.
- Cooke, Robert A. *How to Start Your Own Subchapter S Corporation*. New York: John Wiley & Sons, Inc., 1995.
- Douglas, James A., et al. *Closely Held Corporations: Forms and Checklists*. Boston: Warren, Gorham & Lamont, 1989. Supplemented.
- Eustice, James S., and Boris Bittker. *Federal Income Taxation of S Corporations*. New York: Warren, Gorham & Lamont, 1987. Supplemented annually.
- Faber, Peter L. *S Corporation Manual*. New York: Prentice Hall, 1989.
- Fehsenfeld, A. S. *Benefit Designs for the S Corporation*. Carmel, Ind.: Rough Notes, Inc., 1993.
- Fox, Ira. *S Corporation Tax Practice Manual: 1992 Edition*. New York: Panel Publishers, 1991.
- Grant, Irving M., and William R. Christian. *Subchapter S Taxation*. 3d ed. Colorado Springs, Colo.: Shepard's McGraw-Hill, 1990. Loose-leaf service.
- Grasso, Albert L., et al. *PPC Tax Planning Guide: Closely Held Corporations*. Fort Worth: Practitioners Publishing Company, 1995. Loose-leaf service.
- Haynsworth, Harry J., IV. *Organizational Forms for the Closely Held Corporation*. Philadelphia: American Law Institute—American Bar Association, 1989. Loose-leaf service.
- Hutton, Marguerite R. *Tax Return Practice Problems for Corporations, S Corporations, and Partnerships*. Burr Ridge, Ill.: Richard D. Irwin, 1992.

- McDaniel, Paul R. *1995 Supplement to Federal Income Taxation of Partnerships and S Corporations*. Westbury, N.Y.: Foundation Press, 1995.
- Ness, Theodore, and Eugene L. Vogel. *Taxation of the Closely Held Corporation*. 4th ed. Boston: Warren, Gorham & Lamont, 1991.
- Nicholas, Ted. *Complete Guide to "S" Corporations*. Chicago: Dearborn Financial Publishing, Inc., 1993.
- Nunes, Morris A. *Basic Legal Forms for Business*. New York: John Wiley & Sons, Inc., 1993.
- O'Neal, F. Hodge, and Robert B. Thompson. *O'Neal Close Corporations: Law and Practice*. 2 vols. New York: Clark Boardman Callaghan, 1990.
- Reardon, Dennis C. *S Corporations: Estate, Business, and Compensation Planning*. Cincinnati: National Underwriter Co., 1992.
- Schlesinger, Michael. *S Corporation Desk Book*. New York: Prentice Hall, 1990. Supplement.
- Shepard's McGraw-Hill Staff. *Tax Aspects of Forming and Operating Closely Held Corporations*. Colorado Springs, Colo.: Shepard's McGraw-Hill, 1992.
- Thompson, Samuel C., Jr. *Basic Federal Income Taxation of Partnerships and S Corporations*. St. Paul, Minn.: West Publishing Company, 1994.
- Traum, Sidney S. *S Corporation Answer Book*. New York: Panel Publishers, 1994. Annual edition.

LIMITED LIABILITY COMPANIES

1. INTRODUCTION

2. DEFINING AN LLC

- 2.1 Advantages of LLC Status
- 2.2 Variation in State LLC Laws

3. LLC OPERATIONS AND MANAGEMENT

- 3.1 Kinds of Businesses Eligible to Operate as LLCs
- 3.2 Formation and Governing Documents
- 3.3 Management
- 3.4 LLC Ownership Interests
- 3.5 Dissolution
- 3.6 Liability of LLC Members
- 3.7 Single-Member LLCs

4. CLASSIFICATION OF LLCs FOR TAX PURPOSES

- 4.1 Why Tax Classification Is an Issue
- 4.2 The Check-the-Box Regulations
- 4.3 Making an Affirmative Check-the-Box Election

5. TAXATION OF MULTI-MEMBER LLCs

- 5.1 Partnership Taxation in General
- 5.2 LLC Taxation Compared to Limited Partnership Taxation
- 5.3 LLC Taxation Restrictions Compared to S Corporation Restrictions
- 5.4 LLC Taxation Compared to S Corporation Taxation
- 5.5 State and Local Tax Considerations

6. TAX ASPECTS OF CONVERTING EXISTING ENTITIES INTO LLCs

- 6.1 Partnership Conversions
- 6.2 Conversions of S and C Corporations

7. CONCLUSION

REFERENCES

1. INTRODUCTION

Limited liability companies (LLCs) are attractive because they offer both liability protection and pass-through taxation.

Most practitioners are familiar with the basic concept of LLCs. Until recently, however, LLCs were of only theoretical interest to many, because several states did not actually have LLC statutes. That is no longer the case.

Now all fifty states and the District of Columbia have laws permitting the formation and operation of LLCs within their borders.

The nationwide availability of LLC status and the obvious benefits of such status have led to a rapid increase in the number of entities choosing to operate as LLCs. Many more are on the way. It is likely that LLCs will soon become—if they have not already—the preferred entity choice for small to medium-sized businesses.

As a result, it is now important for well-rounded practitioners to understand the advantages and disadvantages of the LLC format. The purpose of this chapter is to provide general information to facilitate such understanding.

2. DEFINING AN LLC

LLCs are unincorporated legal entities created under applicable state law. However, the fundamental intent of state LLC statutes is to allow the formation of entities that are legally similar to corporations.

2.1 Advantages of LLC Status

An LLC is more properly viewed as a self-contained entity that owns its assets and is liable for its debts. Therefore, the personal assets of LLC owners (referred to as *members*) are generally beyond the reach of LLC creditors, and the assets of the LLC are generally beyond the reach of members' creditors. In contrast, a general partnership can be viewed as an aggregation of partners who share ownership in partnership assets and who are each jointly and severally liable for partnership debts. A sole proprietor is similarly exposed to business liabilities.

The limited liability of LLC members is the fundamental nontax advantage of LLC status. The key tax advantage of multi-member LLCs (meaning LLCs that are owned by two or more members) is that they can be treated as partnerships for federal income tax purposes.

Multi-member LLCs are considered neither partnerships under state law, even though partnership taxation is available to them, nor

corporations, even though they have the corporate characteristic of protecting members from exposure to entity-level liabilities. Instead, the LLC is simply a different kind of legal entity that can be formed and operated under the provisions of the state's LLC statute.

No other kind of entity is able to offer both the legal advantage of limited liability for all owners and the tax advantage of partnership taxation—which combines pass-through treatment with maximum flexibility. This unique combination of legal and tax benefits explains the increasing popularity of LLCs.

In addition, recent developments ensure that single-member LLCs, if allowed under state law, will become popular for small businesses that would otherwise be operated as sole proprietorships. See section 3.7.

2.2 Variation in State LLC Laws

Unfortunately, LLCs have disadvantages as well. One significant negative factor is that there is no uniform act (similar to the Revised Uniform Limited Partnership Act) for state legislators to follow in enacting LLC statutes. As a result, there is considerable diversity among the states' LLC laws. Most statutes include a mix of provisions derived from state business corporation acts and limited partnership acts.

In time, it is expected that state LLC statutes will become more uniform, and steps have been taken in that direction. In 1992, the American Bar Association released its Prototype Limited Liability Company Act (PLLCA), which was available to legislators drafting recent LLC statutes. In addition, work has begun on drafting a Uniform Limited Liability Company Act.

The discussion of LLCs in this chapter is by necessity very general in nature. Therefore, practitioners should not rely on the information herein when assessing specific client issues. Instead, the provisions of the applicable state LLC statute should be examined in detail.

3. LLC OPERATIONS AND MANAGEMENT

3.1 Kinds of Businesses Eligible to Operate as LLCs

Generally, state statutes permit LLCs to conduct any lawful business except those outlawed by the LLC acts themselves or prohibited under the particular LLC's articles of organization.

A number of states do not allow LLCs to be used for certain professional practices or in certain lines of business, such as banking or insurance.

The AICPA permits the use of LLCs for CPA practices, provided LLCs are allowed under applicable state rules, including state CPA society rules.

3.2 Formation and Governing Documents

LLCs are formed under the laws of a particular state by filing articles of organization with the secretary of state. The articles of organization are set forth in a document similar to a corporation's articles of incorporation. In states allowing single-member LLCs (see section 3.7), generally, all that will be necessary will be to file the LLC's articles of organization with the secretary of state.

Multi-member LLCs will generally find it advisable to draft a separate contractual arrangement called an *operating agreement* (also called *regulations*, or *limited liability company agreements* in some states). The operating agreement is similar to the partnership agreement of a limited or general partnership.

A thoughtfully drafted operating agreement will include basic operating rules regarding LLC management issues, cash and property contributions, profit- and loss-sharing ratios, allocations of tax items, rights of the members to current and liquidating distributions, rights of members to transfer their ownership interests, and events causing dissolution or winding up of the LLC.

LLC statutes generally provide for the possibility that an operating agreement will *not* exist in written or oral form. In such cases, the statutes supply so-called *default* language specifying the contractual relationships between the members. The default rules will cover how the LLC is managed, member rights to profits and distributions, restrictions on transfers of ownership interests, events causing dissolution of the LLC. This arrangement also resembles a corporation where the officers, under the guidance of the directors, run the corporation.

These default provisions will apply unless an operating agreement exists to override them. Because statutory default provisions are necessarily general, they will be unsatisfactory in many real-life situations. It is highly advisable to include a written operating agreement that contemplates the unique aspects of the business at hand and the specific needs of the various members.

State LLC statutes include certain mandatory provisions that cannot be modified by agreement among the members. For example, the statute may be inflexible regarding the approvals required for legal

transfers of LLC ownership interests. However, members will generally be able to customize their operating agreements as needed without running afoul of statutory limitations. Nevertheless, it is clearly necessary to have an adequate understanding of what is permitted and prohibited by the applicable LLC statute.

3.3 Management

Members of multi-member LLCs can generally choose to manage the LLC themselves or appoint *managers*. If the members reserve all management powers for themselves, the LLC is run more or less like a general partnership; such LLCs are often described as *member-managed*. If the members appoint managers who are also members, the arrangement resembles a limited partnership run by its general partners. These LLCs are often described as *manager-managed*. LLC statutes contain default management language, usually providing that the LLC will be managed by all members unless the articles of organization or operating agreement stipulate otherwise.

3.4 LLC Ownership Interests

As stated earlier, the owners of the LLC are called members. They are analogous to partners in a partnership or shareholders in a corporation. Generally, the members will have significant restrictions on their ability to transfer LLC ownership interests to nonmembers.

Some LLC statutes require that the transfer of ownership interests be approved unanimously by the nontransferring members unless the operating agreement provides different rules. Other states require less than unanimous consent for transfers.

Until proper member consent is obtained, the transferee generally does not become a full member entitled to all rights of membership, such as the right to vote. The transferee is only entitled to step into the shoes of the transferor member with regard to his or her share of profits and capital.

Ownership interests may or may not be evidenced by the issuance of LLC ownership certificates. State laws generally permit but do not require the issuance of such certificates.

3.5 Dissolution

LLC members generally have the right to voluntarily withdraw from the LLC and receive payment for the value of their ownership interests.

The LLC is generally legally dissolved upon the withdrawal of a member. The operating agreement may also specify that the LLC will legally dissolve after a designated number of years of existence or after the attainment of a stated business goal (such as the sale of a real estate development).

LLCs are also generally dissolved upon the occurrence of certain other events such as unanimous written consent of the members, or upon the occurrence of events such as the retirement, resignation, expulsion, bankruptcy, insolvency, death, or mental incompetence of a member. However, the remaining members can generally vote to continue the existence of the LLC after such events.

In other words, LLCs have limited legal life spans that generally end upon the occurrence of specified events affecting their members. This is not the case for corporations, whose legal lives continue indefinitely regardless of the fates of their shareholders.

In the event of the withdrawal of a member or other dissolution events, several LLC acts require the remaining members to unanimously consent to the continuation of the LLC. Other statutes are more flexible.

For example, a Texas LLC can be continued following the withdrawal of a member if there is the following:

- At least one remaining member
- Either the consent of the number of members or class of members stated in the articles of organization, or unanimous consent of the remaining members

3.6 Liability of LLC Members

As stated earlier, LLCs offer the advantageous corporate characteristic of limiting the exposure of members and managers to entity-level liabilities. This is a fundamental reason for considering the LLC as a form of doing business.

Specifically, status as an LLC member or manager does not in and of itself expose the member or manager to any risk of personal financial loss beyond the value of the LLC ownership interest, plus any unfulfilled capital contribution obligations. (Nonmember managers are not even exposed to that risk.) This is analogous to the legal positions occupied by corporate shareholders and limited partners.

However, if the LLC's articles of organization are not properly filed with state authorities, the persons purportedly conducting the activities as an LLC may be exposed to third-party liabilities.

With regard to the issue of limited liability, multi-member LLCs have two significant advantages over limited partnerships. First, a limited

partnership must have at least one general partner with unlimited exposure to partnership liabilities. In the case of an LLC, however, *no* member need be exposed to LLC liabilities. Second, a limited partner can lose limited liability protection by becoming too actively involved in managing the limited partnership. However, this is not a concern for LLC members who can have any degree of management involvement without risking loss of their limited liability protection.

The liability-limiting advantages of LLCs are critically important, but they should not be overstated. Although the personal assets of LLC members and managers are protected from general LLC debts, they generally remain exposed to liabilities resulting from the individual actions of those members and managers. This is a matter of state law.

For example, if an LLC is used to operate a professional practice, the LLC itself is generally liable for professional malpractice and negligence on the part of its members or managers. However, the members and managers generally are also personally liable for damages caused by their own professional malpractice or negligence and for their own negligence in supervising other professionals, who may be members, managers, or employees. In short, LLCs generally do *not* offer liability protection to members and managers beyond what corporations offer to their shareholders.

In addition, like corporate shareholders, LLC members may be required on occasion to personally guarantee certain LLC debts as a condition of obtaining financing or for other reasons. Members are personally obligated with respect to such guaranteed LLC debts.

Despite the preceding warnings, LLC members and managers are in the favorable position of generally being insulated from exposure to entity-level debts (except under personal guarantees), including liabilities resulting from the tortious acts of other members, managers, or employees.

3.7 Single-Member LLCs

Several states allow single-member LLCs. Before 1997, the federal income tax classification of these entities was unclear. Specifically, there was a significant risk that the IRS would treat single-member LLCs as C corporations, with the resulting problem of double taxation. Accordingly, they were not generally considered advisable.

However, the new *check the box* entity classification regulations (described in more detail in section 4.1) have favorably resolved the issue of how single-member LLCs will be taxed after December 31, 1996. The release of the check-the-box rules is expected to result in state legislation making single-member LLCs available in most, if not all, jurisdictions in the relatively near future.

Under the check-the-box regulations, single-member LLCs can elect to simply have their existence ignored for federal income tax purposes. In other words, an LLC owned by an individual and used to operate a business can elect to be treated as a sole proprietorship. An LLC that is wholly owned by another legal entity (for example, a corporation, partnership, or another LLC) can elect to be treated as an unincorporated branch of the parent entity. The fact that an electing single-member LLC is “invisible” for federal income tax purposes does *not*, however, affect the liability limiting advantages of the LLC.

The ability of sole proprietors to gain liability protection by forming single-member LLCs (while continuing to handle their taxes as before by filing Schedules C and SE along with Form 1040) may turn out to be the most prevalent use of LLCs in the small business world. The advantage of liability protection should not be underestimated, because claims can result from such commonplace occurrences as a delivery person slipping on the sidewalk in front of a business owner’s office in the home or a car accident caused by an employee running errands.

As with a corporation, it *will* be necessary to segregate business and personal assets and liabilities to achieve the intended liability protection benefits. This means establishing separate bank accounts, titling property in the correct fashion, maintaining separate financial records, having the LLC rather than the individual owner enter into contracts, and so on. In other words, the expected liability protection may vaporize without some attention to detail. Having said that, it seems that many sole proprietors should strongly consider forming LLCs as soon as permitted by state law—particularly if the business has employees.

4. CLASSIFICATION OF LLCs FOR TAX PURPOSES

4.1 Why Tax Classification Is an Issue

The former entity classification tax regulations required assessing the presence or absence of the following four corporate characteristics:

- Limited liability for entity owners
- Free transferability of entity ownership interests
- Continuity of legal life of the entity
- Centralized management

If an unincorporated entity such as an LLC possessed three or four of these characteristics, it was classified as a corporation for federal income

tax purposes. However, evaluating whether or not corporate characteristics were present was often an uncertain process. Therefore, it was sometimes difficult and relatively expensive to determine whether multi-member LLCs qualified for the desired partnership classification. Moreover, as mentioned earlier, the proper tax classification for single-member LLCs was completely up in the air under the former regulations.

This was a frustrating situation because LLC owners justifiably wanted certainty that LLCs would not be treated as corporations and thus be subject to double taxation and other relatively unfavorable corporate tax rules.

4.2 The Check-the-Box Regulations

In December of 1996, the U.S. Treasury addressed the preceding problem by issuing the so-called check-the-box entity classification regulations (Regs. 301.7701-1-3). Effective on January 1, 1997, the new regulations implement an extremely simple approach to classifying LLCs. After that date, it is no longer necessary to consider the four corporate characteristics in deciding how a newly formed LLC will be treated for federal income tax purposes.

Under the new rules, multi-member LLCs can be treated as partnerships. (They can also elect to be treated as corporations, which will be attractive in only limited circumstances.)

The existence of single-member LLCs can be ignored. As stated earlier, this means that an LLC owned by a single individual can be treated as a sole proprietorship. An LLC that is wholly owned by another legal entity can be treated as an unincorporated branch or division of the parent entity. (Alternatively, a single-member LLC can elect to be treated as a corporation in the relatively unlikely event that is deemed advisable.)

In summary, multi-member LLCs can be treated as partnerships with certainty while single-member LLCs, if allowed under state law, can simply be treated as the same tax *person* as their owner with no change in existing tax reporting obligations and procedures. In fact, under the check-the-box regulations, the preceding treatment is the default rule for LLCs formed in the United States—no affirmative election statement is needed.

4.3 Making an Affirmative Check-the-Box Election

Despite the favorable default classification rule explained in the preceding paragraph, some may consider it prudent to guarantee the expected

results by making an affirmative check-the-box election. This is accomplished by filing Form 8832 (Entity Classification Election) with the designated IRS Service Center. Form 8832 should also be filed with the LLC's tax return for the year the election is made (or the owner's tax return in the case of a single-member LLC whose existence is to be ignored for federal income tax purposes).

The effective date of the election will be the date specified on Form 8832—if it is not more than 75 days before the election filing date or more than twelve months after the election filing date. If no date is specified, the effective date will be the election filing date. If the specified effective date violates the 75-day or twelve-month rule, the effective date will be 75 days before the filing date or twelve months after the filing date, respectively. If the Form 8832 specifies an election date before January 1, 1997, the effective date will be January 1, 1997.

The Form 8832 must be signed by each LLC member or by an authorized manager or member, if allowed under state law.

Generally, a second check-the-box election cannot be made within 60 months after the first such election.

The check-the-box regulations do *not* change the federal income tax results of conversions to LLC status. For example, an existing corporation could decide to convert, under applicable state law, to an LLC and then make a check-the-box election to be treated as a partnership. However, any such transaction will be regarded as a complete corporate liquidation for federal income tax purposes. The result is corporate-level gain recognition if the corporation holds appreciated property. There may be taxable gain recognition at the shareholder level as well. (See section 6.2 for additional discussion.)

5. TAXATION OF MULTI-MEMBER LLCs

5.1 Partnership Taxation in General

The tax advantage of operating as a multi-member LLC is that the entity can be treated as a partnership for federal income tax purposes.

The partnership tax provisions are found in Subchapter K of the IRC. Subchapter K encompasses IRC Secs. 701 through 761. The partnership tax rules are considered much more favorable than those that apply to C corporations, because partnerships are subject to only a single level of federal income tax under the principles of pass-through taxation.

The partnership rules are also considered more favorable than the S corporation tax rules. Although pass-through taxation principles also

apply to S corporations, they are subject to strict eligibility provisions that often make using an S corporation impractical. In addition, certain favorable pass-through taxation rules apply to partnerships but not to S corporations.

LLCs file Form 1065 and issue Schedules K-1 to their members, who are treated as partners for tax return purposes. The LLC's income, gains, losses, deductions, and credits will flow through to the members, who then take these items into account in preparing their returns.

The various other IRC provisions applicable to partnerships and partners (for example, IRC Sec. 448 regarding use of the cash method and IRC Sec. 1402 regarding the determination of self-employment income) also apply to LLCs and their members.

5.2 LLC Taxation Compared to Limited Partnership Taxation

Generally, there are few differences between the tax rules that apply to limited partnerships and multi-member LLCs. However, one potentially significant difference is in the allocation of basis from entity-level debt (under IRC Sec. 752).

In the case of limited partnerships, limited partners generally receive additional basis only from partnership nonrecourse debt. Nonrecourse debt is debt for which no partner, including the general partner, is personally liable. Usually, nonrecourse debt is secured by specific partnership assets, most commonly real estate. However, in today's economic environment, nonrecourse debt is relatively rare. Therefore, limited partners often do not receive any additional basis from the partnership's debts.

In the case of LLCs, *all* entity-level debt is nonrecourse by definition—unless it has been guaranteed by an LLC member. (The LLC's debt may be secured by all the entity's assets, but it is typically *not* guaranteed by members.) Therefore, the entity-level debt can usually be allocated for IRC Sec. 752 basis purposes among all members. This additional basis from entity-level debt is an advantage of LLC status for LLC members who would be limited partners if the entity were operated as a limited partnership.

Another difference between limited partnerships and LLCs arises in applying the passive activity loss (PAL) rules. Under the PAL regulations, limited partners must satisfy a stricter test to be considered to materially participate in the partnership's trade or business activities. However, the status of LLC members is unclear. Are LLC members who are inactive in managing the entity to be treated as limited partners for purposes of the PAL rules? No one really knows at this point, although

it is difficult to believe the government will allow a looser standard for inactive LLC members. We await guidance from Treasury on this issue.

5.3 LLC Tax Restrictions Compared to S Corporation Restrictions

There are no federal income tax law restrictions that affect the ability of an entity to qualify as an LLC. And, multi-member LLCs are treated under the pass-through taxation principles applicable to partnerships. In contrast, a number of strict federal income tax rules must be satisfied for a corporation to be eligible for S status.

Specifically, an S corporation can have no more than 75 shareholders (35 for tax years beginning before 1997), and shareholders can be only individuals (other than nonresident aliens), estates, and certain kinds of trusts. LLCs are not subject to any restrictions on the number of members or kinds of entities that can be members. (In relatively unusual circumstances, some care must be taken with LLCs to avoid C corporation tax status under the IRC Sec. 7704 publicly traded partnership provisions.)

S corporations are also limited by the one-class-of-stock rule. On the other hand, LLCs can issue a variety of equity ownership interests specifically tailored to meet the financial requirements of their members. Such interests can, for example, include varying rights to cash flow, liquidation proceeds, and allocations of tax items.

Finally, certain corporations are by definition ineligible for S status. Ineligible corporations include the following:

- Corporations that are not domestic corporations
- Certain financial institutions
- Domestic international sales corporations (DISCs) or former DISCs
- Insurance companies other than certain casualty companies
- Certain corporations electing to take the IRC Sec. 936 possessions tax credit

A former C corporation that accumulated earnings and profits during its C corporation years must not earn more than 25 percent of its gross receipts from passive sources in three consecutive years, or it will lose its S status (IRC Sec. 1362(d)(3)).

The preceding restrictive S corporation eligibility rules generally make the flexibility of LLCs very attractive by comparison. However, that is not to say LLCs are always preferable to S corporations for tax reasons.

One potential fly in the ointment is that LLCs are legally dissolved upon the withdrawal of any member and upon the occurrence of certain other events. The members can generally vote to continue the LLC. However, a number of statutes require unanimous consent. This can present practical problems that make operating as an LLC difficult.

Also, in cases in which the business will have only one owner, operating as an S corporation (if that is possible) achieves both limited liability and pass-through taxation. As discussed in section 3.7 of this chapter, several states allow single-member LLCs, but they are not yet available in all states.

Finally, when the owners' objectives can be satisfied with a simple ownership and capital structure, the flexibility to create multi-member LLC ownership interests with varying financial and tax characteristics may not be viewed as a meaningful advantage over S corporations.

5.4 LLC Taxation Compared to S Corporation Taxation

The federal income tax rules for S corporations are often described as virtually identical to the partnership tax rules. However, there are actually significant differences. Most of the differences are in favor of partnerships, including multi-member LLCs treated as partnerships.

An S corporation shareholder obtains basis for loss deduction purposes only to the extent of basis in stock plus the amount of any loans made to the corporation (IRC Sec. 1366). This is the case even if the shareholder personally guarantees some or all of the corporation's debt. However, an LLC member is treated as a partner and obtains additional basis in the LLC interest for the share of LLC debts (IRC Sec. 752).

Because no member is personally liable for LLC debt, it will be allocated for basis purposes among the members pursuant to the IRC Sec. 752 regulations covering nonrecourse liabilities. However, unless the LLC's debt is qualified nonrecourse financing secured by real property, the IRC Sec. 465 at-risk rules will generally disallow an increase in basis for at-risk limitation purposes.

It is important to recognize that the additional basis from LLC debt can eliminate or minimize current taxable gain when a member contributes low-basis property burdened by debt to the LLC. Under IRC Sec. 357, taxable gain *always* results when the amount of debt exceeds the basis of property contributed by a shareholder to an S (or C) corporation.

Under the partnership tax rules, a purchaser of an LLC ownership interest can step up the tax basis of the share of appreciated LLC assets to reflect the purchase price. This benefit is available if the LLC makes

an IRC Sec. 754 optional basis adjustment election. After an IRC Sec. 754 election, the allocations to the purchasing member of deductions related to LLC assets (for example, depreciation deductions) will be based on the higher purchase price rather than on the LLC's historical tax basis. Also, if the LLC sells the appreciated property, the purchasing member's allocation of taxable gain will be smaller.

No similar basis adjustment provision is available to purchasers of S (or C) corporation shares.

Under the partnership tax rules, LLC members can generally make tax-free contributions of appreciated property to the LLC at any time throughout the life of the entity (IRC Sec. 721). Also, LLCs can generally make tax-free distributions of appreciated property to members (IRC Sec. 731).

However, if appreciated property is contributed to an S (or C) corporation, nonrecognition treatment is available only if the transferor or transferrors are in control of the corporation immediately after the transaction (IRC Sec. 351). If appreciated corporate property is distributed to S (or C) shareholders, gain is recognized at the corporate level just as it would in the event that the property was sold for full-market value (FMV) (IRC Secs. 311(b), 336(a), and 1371(a)).

The key point is that the partnership taxation rules often give LLCs and their members substantial flexibility to make transfers of appreciated property without immediate recognition of taxable gains. This is not the case for S corporations and their shareholders.

Finally, under the partnership taxation rules, special tax allocations of income, gain, loss, deduction, or credit can be made among the members (IRC Sec. 704). In contrast, all S corporation pass-through items must be allocated among the shareholders strictly in proportion to stock ownership (IRC Sec. 1366). The ability to make special tax allocations to meet the needs of LLC members can be a significant advantage of LLC status compared to S corporation status.

5.5 State and Local Tax Considerations

Although generally there are no major differences between the federal income tax rules for multi-member LLCs and those for partnerships, the same cannot always be said for state income tax rules.

Most states follow the federal income tax treatment for LLCs. In such states, an LLC classified as a partnership for federal income tax purposes will be classified as a partnership for state tax purposes as well. In this regard, most states do not distinguish between LLCs formed in-state (*domestic LLCs*) and those formed in other states (*foreign LLCs*).

In most states, LLCs treated as partnerships are not subject to income tax at the entity level, but members are taxed on their shares of LLC income.

A number of states require LLCs to file information returns showing members' shares of income, and some states require LLCs to pay or withhold taxes on behalf of nonresident members. It appears that a number of states will allow LLCs to file composite returns on behalf of their nonresident individual members, which then relieves these members from any further state filing responsibilities.

However, LLCs are subject to entity-level state income taxes in a number of states. For example, in Florida, LLCs are taxed as corporations. In Texas, LLCs (whether single-member or multi-member) are subject to the state's franchise tax, which is actually somewhat similar to an income tax. In the states of Washington and Michigan, LLCs are subject to the state business taxes that apply to all business entities.

Whether LLCs must pay state franchise taxes on capital varies. A number of states tax capital only if the LLC is classified as a corporation for federal income tax purposes, while others tax capital in any case. In still other states, the rules are unclear.

With regard to other state and local business taxes, LLCs are generally treated in the same manner as other kinds of business entities. For example, LLCs are generally required to collect sales taxes and pay use taxes on items purchased in other states. LLCs must generally comply with state and local business organization, registration, and licensing rules and pay applicable fees and taxes. Transfers of real estate to LLCs may be subject to state and local real estate transfer taxes. A number of states also charge LLCs annual fees in the form of minimum taxes.

State and local taxes are often significant enough to affect the attractiveness of LLCs as business entities. The issue should be carefully assessed in making choice-of-entity decisions.

6. TAX ASPECTS OF CONVERTING EXISTING ENTITIES INTO LLCS

6.1 Partnership Conversions

The conversion of an existing domestic general or limited partnership into a U.S. multi-member LLC classified as a partnership can generally be accomplished without federal income tax consequences to the converting partnership or partners (Rev. Rul. 95-37).

The former partners generally become LLC members without recognizing any gain from the transaction, and the taxable year of the

converting partnership does not close. In other words, the LLC is considered a continuation of the same taxable entity.

These results apply whether the partnership conversion is accomplished by formally liquidating the partnership and forming an LLC, or by merging with a newly formed LLC, or by a purely legal conversion to LLC status. In addition, the tax consequences are the same if the LLC is formed in the same state as the converting partnership or in a different state.

If conversion is via liquidation of the old partnership, this can be mechanically accomplished by having the partnership contribute all its assets and liabilities to the newly formed LLC in exchange for LLC ownership interests. The LLC interests are then distributed to the partners in liquidation of the partnership. The former partners now hold LLC interests, and the LLC now holds all the assets and liabilities of the old partnership.

Alternatively, a liquidation can be accomplished by having the partners contribute their partnership interests to the newly formed LLC in exchange for LLC interests. The partnership then distributes all assets and liabilities to the LLC in liquidation. Again, the former partners now hold LLC interests, and the LLC now holds all the assets and liabilities of the old partnership.

Finally, state law may permit an existing partnership to merge with the newly formed LLC with the LLC being the surviving entity. Merger transactions, if they are allowed, are generally cleaner than liquidations, from a legal standpoint, because the LLC simply assumes all the rights and obligations of the former partnership.

A few state LLC statutes permit conversion of a partnership into an LLC by simply filing articles of organization and complying with certain other filing and paperwork requirements. Like a merger transaction, this is cleaner than a transaction involving a liquidation of the old partnership.

With regard to the tax implications of converting an existing general or limited partnership into a multi-member LLC by any of the above methods, Rev. Rul. 95-37 apparently leads to the following conclusions:

- Former partners do not recognize gain on the conversion unless changes in their percentages of liabilities (under IRC Sec. 752) would cause the basis in their interests to fall below zero.
- Former partners obtain the same basis in their new LLC interests as in their old partnership interests unless the conversion results in changes in their shares of liabilities under IRC Sec. 752.
- The members' holding periods for the new LLC interests tack on to the holding periods for the old partnership interests.

- The LLC is considered a continuation of the former partnership. As a result, the tax year continues and there is no need for a new taxpayer identification number (TIN). The LLC continues to use the former partnership's tax accounting methods and elections.

6.2 Conversions of S and C Corporations

The conversion of an existing S or C corporation into an LLC can be accomplished in several ways. The same basic principles apply to conversions into both multi-member and single-member LLCs. The assets of the corporation can be contributed to the newly formed LLC in return for LLC ownership interests that are then distributed to the shareholders in complete liquidation of the corporation.

Alternatively, the corporation can distribute its assets to the shareholders in complete liquidation, and the shareholders can then contribute their undivided interests in the assets to the newly formed LLC in exchange for LLC ownership interests.

Finally, the corporation may be permitted under state law to merge with the newly formed LLC with the LLC being the surviving entity. The corporation does this by making a tax-free contribution of all assets and liabilities to the LLC in exchange for LLC interests (under IRC Sec. 721). The corporation then goes out of existence by distributing the LLC interests to shareholders in complete liquidation.

In any of the preceding cases, there will be corporate-level gain or loss recognition as if the property distributed in complete liquidation were sold by the corporation for FMV (IRC Sec. 336). This means a converting corporation with appreciated assets—whether it is an S or C corporation—may recognize significant taxable income or gain as a result of the liquidation transaction.

At the shareholder level, the receipt of the liquidating distribution in exchange for corporate stock is treated as a taxable sale or exchange of the stock for proceeds equal to the FMV of the distributed property (IRC Sec. 331). Gain or loss may be recognized by the shareholder on the transaction—depending on whether the FMV of the distributed property is greater or less than the basis of the corporate stock exchanged.

In the case of a converting S corporation, any corporate-level gain is passed through and increases the shareholders' basis in their stock. Therefore, the gain already recognized at the corporate level is not recognized again when the stock is deemed sold in exchange for the liquidating distribution. However, if the S corporation is a former C corporation, the IRC Sec. 1374 built-in gains tax may apply to some or all of the corporate-level gain.

In the case of a converting C corporation, the shareholders receive no basis step-up from any corporate-level gain. As a result, there is generally taxable gain at both the corporate and shareholder levels upon the liquidation of a C corporation with appreciated assets.

Since the conversion of S or C corporations to LLC status involves liquidation transactions, the federal income tax cost for corporations with significantly appreciated assets will often be unacceptably high. In such situations, there will often be unfavorable state income tax consequences as well.

However, if the corporation does not hold significantly appreciated assets, it is possible that liquidation and conversion to LLC status can be accomplished without adverse tax consequences.

If a corporate conversion is undertaken, the resulting LLC will be a new taxable entity. New multi-member LLCs will almost always desire partnership tax classification, and new single-member LLCs will almost always desire to have their existence ignored for federal income tax purposes. Under the check-the-box entity classification regulations (see section 4.1), these outcomes are permitted. The new LLC will then fall under general tax rules regarding selecting tax accounting methods and periods, making various tax elections, depreciating property, and so on.

7. CONCLUSION

A number of legal uncertainties concerning LLCs remain because they are such a new kind of entity. For example, suppose an LLC operates in several states, each of which has LLC statutes. It may not be clear which laws have precedence: those of the state of formation or those of the state in which operations are conducted.

Even if an LLC operates only in the state of formation, the novelty of LLC statutes means there are inevitably a number of legal uncertainties that do not exist for more established kinds of entities. At this early stage in the evolution of LLCs, the rights and obligations of LLC members, creditors, and other third parties contracting with LLCs are less well understood than would be the case if operations were conducted via limited or general partnerships or corporations.

Until LLC statutes are fine-tuned to resolve uncertainties, and until a base of LLC common law is established by litigation occurring over the years, LLCs will continue to expose their owners to at least some risks that may be avoided with the more traditional business entities. As a result, LLCs may be somewhat less attractive to clients with low risk tolerances.

Nevertheless, a fundamental fact should not be forgotten: Under applicable state laws, LLCs are intended to be vehicles that offer both limited liability to all members *and*, for multi-member LLCs, the flexibility and other benefits of partnership taxation. LLCs offer a powerful mix of advantages to their members. The existence of some legal uncertainties may be a relatively small price to pay for these valuable advantages.

REFERENCES

- Auderieth, Steven. *Limited Liability Companies: Complete Planning and Practice Guide*. Madison, Conn.: Business and Legal Reports, 1994.
- Bishop, Carter G. and Daniel S. Kleinberger. *Limited Liability Companies: Tax and Business Law*. Boston: Warren, Gorham & Lamont, Inc., 1994.
- Callison, J. William and Maureen A. Sullivan. *Limited Liability Companies, State Statutes and Federal Materials*. St. Paul, Minn.: West Publishing Co., 1996.
- Friedlander, Jerome P., III. *The Limited Liability Company: With a State-by-State Review*. Charlottesville, Va.: Michie Butterworth, 1994.
- Limited Liability Tax Rules for Companies*. Leverett, Mass.: Rector Press, 1994.
- Mares, Michael E., et al. *Limited Liability Companies*. 4 vols. Fort Worth: Practitioners Publishing Company, 1996. Looseleaf.
- Martin, Alson R. *Limited Liability Company and Partnership Answer Book*. New York: Panel Publishers, 1995.
- Moore, Mary V. *Limited Liability Companies: Legal Research Guide—Pathfinder*. Buffalo, N.Y.: William S. Hein & Co., 1994.
- Pischak, Kathryn A. "State Tax Issues Complicate the Decision to Do Business as a Limited Liability Company," *Journal of Taxation*, pp. 76–80, August 1995.
- Shenkman, Martin M., Ivan Taback, and Samuel Weiner. *Starting a Limited Liability Company*. New York: John Wiley & Sons, Inc., 1996.
- Thomas, James C., III and John C. Morgan. *Limited Liability Companies Guide*. San Diego, Calif.: Harcourt Brace Professional Publishing, 1995.
- Wood, Robert W., ed. *Limited Liability Companies: Formation, Operation, and Conversion*. 1996 Cumulative Supplement. New York: John Wiley & Sons, Inc., 1996.

SECURITIES REGULATION

1. INTRODUCTION

- 1.1 Purpose
- 1.2 Scope

2. DEFINITIONS

3. FEDERAL SECURITIES REGULATION: OVERVIEW

4. THE SECURITIES ACT OF 1933

- 4.1 The Purpose of Registration Under the 1933 Act
- 4.2 The Process of Registration
- 4.3 Contents of the Registration Statement
- 4.4 Contents of the Prospectus
- 4.5 Exemptions From Registration
 - 4.5.1 Accredited investors
 - 4.5.2 Intrastate offerings
 - 4.5.3 Judicially approved exchanges
 - 4.5.4 Private placements
 - 4.5.5 Rule 506
 - 4.5.6 Small issues
 - 4.5.7 Voluntary exchanges
 - 4.5.8 Other exemptions
- 4.6 Secondary Transactions and Rule 144
- 4.7 Simplified Registration

5. THE SECURITIES EXCHANGE ACT OF 1934

- 5.1 Overview
- 5.2 Securities and Exchange Commission (SEC)
- 5.3 Registration of Brokers and Exchanges
- 5.4 Registration of Securities: General Issues
- 5.5 Registration of Over-the-Counter Securities: Specifics

6. OTHER FEDERAL SECURITIES-RELATED ACTS

- 6.1 Foreign Corrupt Practices Act of 1977
- 6.2 Investment Advisers Act of 1940
 - 6.2.1 Consequences of registering
 - 6.2.2 Examples of situations involving public accountants
- 6.3 Investment Company Act of 1940
- 6.4 Trust Indenture Act of 1939
- 6.5 Public Utility Holding Company Act of 1935

- 6.6 Racketeer Influenced and Corrupt Organizations Act (RICO)
 - 6.6.1 State RICO statutes
- 6.7 Securities Investor Protection Act of 1970
- 6.8 Small Business Incentive Act of 1980

7. STATE SECURITIES REGULATION

- 7.1 Uniform Securities Act
- 7.2 States With Exemptions Equivalent to Federal Rules Under Regulation D

8. ACCOUNTANTS' LIABILITY UNDER THE FEDERAL SECURITIES ACTS

- 8.1 Securities Act of 1933
- 8.2 Securities Exchange Act of 1934 and SEC Rule 10b-5

9. GOING PUBLIC

- 9.1 Registration Statement
- 9.2 Alternative Registration for Small Issues
- 9.3 Selling Securities Without Registration
- 9.4 State Securities Laws
- 9.5 Advantages and Disadvantages of Going Public
 - 9.5.1 Advantages
 - 9.5.2 Disadvantages
- 9.6 Costs of Going Public
- 9.7 Deciding to Go Public
- 9.8 Planning and Assistance
 - 9.8.1 Underwriters and Investment Bankers
 - 9.8.2 Law Firms
 - 9.8.3 Financial Public Relations Firms
 - 9.8.4 Certified Public Accountants
- 9.9 Pricing the Securities
- 9.10 Public Trading

REFERENCES

APPENDIX 1: Common 1933 Act Forms for Registration of Securities

APPENDIX 2: Commonly-Used 1934 Act Forms for Registration of Securities

APPENDIX 3: SEC Accounting and Reporting Requirements

APPENDIX 4: SEC Industry Guides

APPENDIX 5: State Securities Regulators

APPENDIX 6: SEC Regulation S-X (Excerpts on Accountants' Reports and General Instructions Regarding Financial Statements)

APPENDIX 7: Solicitation of Proxies

1. INTRODUCTION

1.1 Purpose

Originally intended to protect investors by assuring that they were provided with the information necessary to make informed investment decisions, securities regulation in the United States has expanded to encompass:

- Offerings of securities in both original issuances and as secondary distributions
- The information a prospective investor is entitled to receive
- The information an investor is entitled to receive periodically and when significant events happen
- Trading in securities
- Securities exchanges
- Self-regulatory institutions active in securities matters
- Proxy solicitation
- Investment advisers and investment newsletters
- Broker-dealers
- Insider trading and trading by any person who has inside information
- Fraudulent and manipulative use of financial statements in the buying or selling of securities

1.2 Scope

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

- *The Securities Act of 1933*, which requires registration with the SEC of publicly offered securities. The act contains antifraud provisions that apply to accountants and other persons involved with the process of registration.
- *The Securities Exchange Act of 1934*, which requires registration of securities prior to their trading on an exchange as well as of certain

over-the-counter securities in which there is a significant trading interest. The act also regulates broker-dealers, the national securities exchanges, and associations of securities dealers. Its antifraud provisions apply to persons, such as accountants, involved in securities transactions carried out by use of the mail, telephones, or any instrumentality of interstate commerce.

- *The Trust Indenture Act of 1939*, which requires that an independent trustee be appointed for publicly offered debt securities.
- *The Investment Company Act of 1940*, which requires the registration of investment companies. Their financial statements must be audited by independent accountants.
- *The Investment Advisers Act of 1940*, which requires registration with the SEC of persons deemed to be investment advisers, including accountants in some cases.

Significant attention is devoted in this chapter to the three securities acts of greatest importance to accountants and to two other federal laws with potential impact on accountants:

- The Securities Act of 1933 (cited as the 1933 act)
- The Securities Exchange Act of 1934 (the 1934 act)
- The Investment Advisers Act (the Advisers act)
- The Foreign Corrupt Practices Act (FCPA)
- The Racketeer Influenced and Corrupt Organizations Act (RICO)

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

2. DEFINITIONS

The following terms appear within the context of this chapter.

Accountant. The federal securities acts refer throughout to *independent public accountant*, a person who—by SEC policy—is almost always a certified public accountant.

Accounting and Auditing Enforcement Release (AAER). Since 1982, the AAERs have been the means by which the SEC announces enforcement actions against accountants.

Accounting Series Release (ASR). Accounting Series Releases were used until 1982 by the Securities and Exchange Commission to communicate matters of interest to members of the accounting community. They included matters as diverse as interpretations concerning SEC Regulation S-X and notification of disciplinary action against accountants. They were replaced by two new series: Financial Reporting Releases and Accounting and Auditing Enforcement Releases. In 1982, portions of the previously issued ASRs that retained relevance were reissued in the SEC's Codification of Financial Reporting Policies.

Accredited investor. An accredited investor is one for whom the disclosure requirements associated with registration are unnecessary in most circumstances. Because of their bargaining power and their assumed ability to access information on their own, accredited investors are expected not to need the protection afforded by the registration process. Certain institutional investors and certain large investors are called accredited investors for purposes of the exemptions of Securities and Exchange Commission (SEC) Rules 505 and 506 and Section 4(6) of the 1933 act. (See section 4.5.1 of this chapter.)

Blue sky laws. State laws dealing with the regulation of securities are known as blue sky laws, a phrase that originated more than fifty years ago in a judicial comment denouncing speculative schemes that were no more tangible than "so many feet of blue sky." In this chapter *blue sky law* will be used interchangeably with *state law* to refer to the applicable laws at the state level that govern issuance and trading of securities.

Certification. In SEC-related matters, it is common to refer to the independent auditor's report as a certification and to say that the auditor has certified the statements. In other contexts, accountants themselves generally avoid these terms on the grounds that they connote too strong an endorsement of accuracy. SEC Regulation S-X defines *certified* as "examined and reported upon with an opinion expressed by an independent public or certified public accountant."

Comfort letter. The contract between a securities issuer and its underwriter commonly requires that the issuer's independent accountant provide a comfort letter to the underwriter. Underwriters request comfort letters not only to acquire information but also to show their reliance on the auditors as part of the underwriter's due diligence examination. Comfort letters are not required by the SEC or by any of the securities acts. Standards to be followed for the accountant's review that culminates in the comfort letter are expressed in Statement on Auditing Standards No. 49, *Letters for Underwriters* (AICPA, *Professional Standards*, AU sec. 634).

Due diligence. Section 11(b) of the 1933 act provides a defense for public accountants and others who are charged in a civil action on account of a false registration statement. This due-diligence defense provides that no person shall be liable who shall sustain the burden of proof “that he had, after reasonable investigation, reasonable ground to believe and did believe, at the time . . . the registration statement became effective, that the statements therein were true. . . .” The standard for determining reasonableness is that of a prudent person in the management of his or her own property. The review performed by public accountants that helps in establishing their due diligence is often called an S-1 review, after SEC Form S-1, the basic registration form used by nonlisted companies.

Electronic Data Gathering and Retrieval System (EDGAR). A pilot SEC program to explore the ramifications of electronic filing. The SEC staff visualizes that use of EDGAR will permit many of the filings required by securities law to be made by direct electronic transmission from the issuer or perhaps his or her attorney, accountant, or printer.

Financial Accounting Standards Board (FASB). The board issues releases known as Statements of Financial Accounting Standards (SFAS) and interpretations thereof, both often referred to simply as FASBs. These pronouncements have explicitly been recognized by the SEC as constituting generally accepted accounting principles. In other words, financial statements submitted in filings to the SEC are expected to conform to the FASBs and to the SEC’s accounting rules expressed in Regulation S-X.

Financial Reporting Releases (FRR). FRRs have replaced Accounting Series Releases as the means by which the SEC communicates its views on accounting and auditing matters that need special treatment in financial statements filed with the commission.

Foreign Corrupt Practices Act (FCPA). The FCPA prohibits payments or offerings, by companies required to report to the SEC, of “anything of value” to foreign officials, political parties, or candidates for the purpose of influencing decisions of the foreign government. In order to facilitate the detection of illegal payments, the act requires that all companies reporting to the SEC keep their accounting records in reasonable detail and also mandates that they maintain an adequate system of internal accounting controls.

Independent public accountant. Accountants who, as auditors, provide reports on clients’ financial statements that are filed with the SEC are held to a high standard of independence. They violate the rules of the SEC if they

- Have any direct or material indirect financial interest in the enterprise whose statements they audit.
- Are connected with the enterprise as promoter, underwriter, voting trustee, director, officer, or employee.
- Post journal entries or perform *any* bookkeeping, accounting, or controllership functions.

These rules apply to

- All partners, shareholders, and other principals of the firm.
- Any professional employee providing any professional service to the client, its parent, subsidiary, or other affiliate.
- Any professional employee having managerial responsibilities and located in the engagement office or other office of the firm that participates in a significant portion of the audit.

A company filing financial statements with the SEC must report on Form 8-K within five business days of a change in independent accountants. No later than the date of filing with the SEC, the company must provide a copy of the 8-K form to the former accountants [Item 304, SEC Reg. S-K]. The AICPA's practice section has adopted a requirement that member firms directly notify the SEC within five business days by copy of a letter to the former client, confirming the date that the accountant resigned, declined to stand for re-election, or was dismissed. The company must also report whether, during the two most recent fiscal years, there were disagreements with the former accountant on a matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure, if that disagreement would have caused the former accountant to make reference to the matter of the disagreement in connection with the accountant's audit report. A copy of Form 8-K reporting the disagreement must be provided to the former accountants, who must file a letter indicating agreement or disagreement with the company's report [Item 304, SEC Reg. S-K].

Insider trading. Insider trading is trading and profiting while in the possession of information unavailable to the public, referred to in SEC rules as *material, nonpublic information*. Under Section 16(b) of the 1934 act, an *insider* who purchases and sells or sells and then purchases, within a six-month period, equity securities of a company that has a class of equity securities registered under the act will incur a liability to the corporation for any profit realized.

The SEC and the courts view the term "insider" as including a broader group than directors and officers of a corporation. Others, such as lawyers, accountants, investment bankers, and stock brokers can

be considered insiders in certain circumstances. The SEC brings charges when it is satisfied that the following four tests have been met:

- Does exchange surveillance indicate suspicious trading?
- Was the trading based on material, nonpublic information?
- Was the nonpublic information released by someone who had a fiduciary duty or other relationship of trust?
- Did the recipient know (or should he or she have known) that the source of information breached a duty?

SEC acts and regulations provide for sanctions in the form of disgorgement of profits, civil liability to other traders, payment of bounty to informants, and civil and criminal penalties. Independent accountants who, in the course of their professional practice, learn of significant corporate developments such as earnings reports or mergers must not communicate this information to others until *after* the developments are announced to the public. There are no definitive guidelines to determine the length of this waiting period, but the American Stock Exchange has suggested a twenty-four-hour wait after general publication of the release in a national medium or forty-eight hours when publication is less widespread.

Investment contract. See *Securities*.

Letter stock. Stock acquired by a buyer who furnished to the seller a letter stating that the buyer acquired the securities for investment and not with a view to distribution. (See section 4.6, herein, Secondary Transactions.)

Prospectus. Any offer made in writing to sell securities constitutes a prospectus and may fall within SEC jurisdiction (Sec. 2, 1933 act). As ordinarily used, the term refers to the document required by securities law to be provided to prospective buyers of securities that are the subject of a registration statement. It is unlawful to deliver securities subject to registration to a buyer through the mails or otherwise in interstate commerce without sending a prospectus along with them unless the buyer has previously received one. The prospectus must meet specifications of the 1933 act. An offering circular must be provided for filings made under Regulation A. The equivalent document under Regulation D is an abbreviated disclosure document described in Rule 502(b).

Proxy. A proxy allows someone entitled to vote on any corporate matter—for example, through ownership of common stock—to designate another party to be present and to cast the vote. Such matters as the creation of a proxy, its effective period, and means of revocation are ordinarily dealt with under state law. Proxies may be solicited by

incumbent management or by some other person. By Section 14(a) of the 1934 act the SEC regulates the solicitation of proxies directed to more than ten people.

Annual reports must accompany or precede proxy solicitations, made on behalf of management, that relate to an annual meeting in which directors are to be elected. Copies of this annual report must be mailed to the SEC for its information. Rules of the New York and the American Stock Exchanges and of the National Association of Securities Dealers must be consulted concerning transmittal of proxy material to customers whose stock is held in a broker's or banker's name (street name). See appendix 7 for disclosures required in proxy solicitation.

Proxies may also be solicited for proposals made by a person who is not a member of management. The SEC's Rule 14a-8 requires management to include such proposals along with their own proxy solicitation materials, subject to compliance with conditions relating to the timeliness, ownership of securities, and the subject of the proposal. The proposal must be made 120 days in advance, by a person owning for at least a year a minimum of one percent or one thousand dollars in market value of the securities to be voted. The subject of the proposal must be, under applicable state law, a proper subject for action by shareholders, not related to ordinary business operations, and not involving the appointment of an officer or election of a director.

Racketeer Influenced and Corrupt Organizations Act (RICO). RICO, intended to protect businesses against organized crime, has turned out to have a particularly broad reach. In the fifteen years since it was enacted, however, RICO has been used against legitimate businesses such as brokers, banks and investment bankers, lawyers, insurance companies, manufacturers, and public accountants, including General Motors, American Express, Prudential Insurance, and at least two international public accounting firms. (See section 6, Other Federal Securities-Related Acts, below.)

Red Herring. Essentially a preliminary offering prospectus. Every offer in writing of securities must contain information specified in Section 10 of the 1934 act. Some of this information may not yet be available when issuers and their underwriters desire to create interest in an upcoming issue that has been filed for registration but is not yet effective. In these circumstances, if a registration statement is on file with the SEC, a preliminary prospectus is authorized. This document includes on its face a legend in red ink stating that the registration statement has not become effective and that a formal offer to sell can only be made after the effective date of the registration. Ordinarily, information about offering price, commissions to dealers, and proceeds accruing to the issuer is excluded from this red herring prospectus.

The antifraud provisions of the 1934 act require that brokers or dealers must deliver, at least forty-eight hours prior to the mailing of the sale confirmation, a copy of the preliminary prospectus to any person who is expected to receive a confirmation of sale (SEC Rule 15c-2-8).

Registration. Registration is the process of filing with the regulatory authority adequate information about securities and the company that issues them. At the federal level, registration statements are filed with the SEC. The SEC neither approves nor disapproves of the company or its securities; it passes only on the adequacy of the disclosures. State laws may also require registration. Exemptions from state registration are frequently found for companies that report to the SEC—for example, for securities senior to or substantially equivalent to securities already traded on one of the principal stock exchanges. Full registration with the state is usually unnecessary where adequate information is already available. Although registration may not be required, a filing with the state may still be required. Both the 1933 act and the 1934 act deal with federal registration.

Registration by coordination. Most state laws allow registration by coordination—considerably abbreviated state registration (or none at all)—for securities registered in compliance with the federal securities acts.

Regulations and rules. For purposes of organization, many SEC rules are grouped within regulations. For example, Regulation D contains Rules 501 through 506.

Regulation A. Ostensibly, SEC Regulation A provides an exemption from registration for security issues of less than \$1.5 million per year. In fact, notification and disclosure requirements under this regulation make it more in the nature of a miniregistration, less complex and expensive than full registration. Financial statements included in a Regulation A filing generally need not be certified.

Regulation D. SEC Regulation D consists of a series of six Rules, 501 through 506, that became effective in April 1982. Rules 504, 505, and 506 establish three exemptions that replace the exemptions previously available under Rules 146, 240, and 242. Details of these exemptions may be found in section 4.5, Exemptions From Registration.

Regulation S-K. This regulation, copies of which are available free from the SEC, contains instructions for filing forms under the securities acts of 1933 and 1934. Specifically, Regulation S-K states the requirements applicable to the content of the nonfinancial-statement portions of registration statements filed under the 1933 act and registration

statements, annual reports, proxy statements, and “any other documents required to be filed” under the 1934 act.

Regulation S-X. The SEC details its accounting rules—matters of detail and presentation—in Regulation S-X. For example, Article 5 tells accountants to “State separately amounts receivable from (1) customers (trade); (2) related parties; (3) underwriters, promoters, and employees (other than related parties) that arose in other than the ordinary course of business; and (4) others.” In the case of substantive accounting matters the SEC expects conformity with generally accepted accounting
(Text continued on page 11)

principles (GAAP) as promulgated by the Financial Accounting Standards Board. The SEC considers these pronouncements to have “substantial authoritative support.” Regulation S-X may be obtained at no charge from the Publications Section, Securities and Exchange Commission, Washington, D.C. 20549.

Restricted securities. According to Rule 144 of the Securities Act, any of the following can be restricted securities:

- securities acquired directly or indirectly from the issuer, or from an affiliate of the issuer, in a transaction or chain of transactions not involving any public offering
- securities acquired from the issuer that are subject to the resale limitations of Regulation D
- securities that are subject to the resale limitations of Regulation D and are acquired in a transaction or chain of transactions not involving any public offering
- securities that are acquired in a transaction or chain of transactions meeting the requirements of Rule 144A (relating to private resales to institutions)

Subsequent sales of restricted securities will ordinarily require prior filings with the SEC unless an exemption can be found by the seller. (See also section 4.6 on Secondary Transactions and Rule 144, below.)

Scienter. A term frequently used in federal securities litigation, *scienter* roughly connotes guilty intent. It can be contrasted with the lesser degree of culpability called *negligence*, which implies carelessness or fault but no intent or knowledge of a deficiency in financial statements. For public accountants to be liable under the SEC’s Rule 10b-5, their scienter must be established; not so for liability under Section 11 of the 1933 securities act, which refers to a *due diligence* defense by an accountant. This defense, in effect, establishes a negligence standard. Whether or not *recklessness* or *reckless disregard of the consequences* will be held by the courts to constitute scienter is as yet unsettled.

Secondary transactions. Subsequent sales by persons who purchase from the issuer of securities are called secondary distributions (or transactions). Proceeds of secondary distributions do not benefit the issuer of the securities. In certain cases, secondary distributions must be registered with the SEC. For example, securities originally issued in an exempt transaction generally must be registered before they are resold publicly. Also, substantial blocks of securities sold by a controlling person must be registered. See also section 4.6 on Secondary Transactions and Rule 144, below.

Securities. Definitions of a security tend toward similarity in the various federal securities acts and the state blue sky laws. Since the securities laws are applicable only if a security is involved, it is imperative to know if a proposed financial transaction involves one. *Security* is defined in the 1933 act to include any

- Note, stock, treasury stock, bond, debenture, or evidence of indebtedness.
- Certificate of interest or participation in any profit-sharing agreement.
- Collateral-trust or preorganization certificate, or subscription.
- Transferable share, investment contract, voting-trust certificate, or certificate of deposit for a security.
- Fractional undivided interest in oil, gas, or other mineral rights.
- Put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities.
- Put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency.
- Any ownership interest or instrument known as a “security.”
- Certificate of interest or participation, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing (Section 2(1)).

The term *investment contract*, included in the definition, has been held by the courts to encompass a broad variety of transactions, including investment interests offered for sale in

- An orange grove and in other citrus and fruit trees
- A condominium to be included in a rental pool
- Chinchillas, mink, beavers
- Franchises
- Gold and silver bullion
- Limited partnerships
- Rights in oil, gas, and other mineral production
- Purchase-money mortgages
- Cemetery lots purchased for resale
- Self-improvement courses
- Whiskey warehouse receipts
- Variable annuities and variable life insurance policies, where related to performance of a securities portfolio

Interests as a general partner in a partnership are, in most cases, not securities. The Supreme Court has also held the following, although

similar to contracts that have been held to be securities, not to be securities:

- Shares in a nonprofit co-op housing corporation
- Interests in a noncontributory defined benefit pension plan

There have been apparently contradictory decisions among the different federal judicial circuits as to what constitutes a security. The issue is frequently litigated and no fail-safe test can be applied, particularly by the nonprofessional. Some guidance can be attained by asking whether the proposed transaction contemplates (1) an association of investors in a common enterprise and (2) the realization of profits solely through the efforts of third parties. An affirmative answer to both of these questions almost surely identifies an investment contract and, thus, a security. Whenever a client proposes to solicit funds from others for the purpose of managing or investing these funds to generate earnings or profits, the astute financial adviser will recognize that a security is probably involved and securities law must be considered.

Securities and Exchange Commission (SEC). The SEC was established by the Securities Exchange Act of 1934 to administer the various securities acts. There are regional offices and regional administrators at several locations. (See section 5.2, herein.)

Securities Investor Protection Corporation (SIPC). All broker-dealers registered with the SEC are members of SIPC, a public corporation. SIPC liquidates insolvent broker-dealers and assures payment of their customers' claims up to \$500,000 per account (subject to a limit of \$100,000 in "free credit balances" or cash).

Shelf registration. In the process known as a shelf registration the registration statement is filed with the SEC but the securities are "put on the shelf"—that is, delayed in their issuance for as long as two years. Shelf registration benefits issuers who wish to choose the most advantageous time for the offering, giving consideration to the effect of interest rate and stock exchange fluctuations. Requirements for shelf registration are spelled out in SEC Rule 415 that, in general, restrict this type of registration to issuers having at least \$150 million in voting stock outstanding or who are eligible to use Form S-3.

Small issues. The concept of small issues, particularly in relation to exemptions from federal securities registration, depends on context and does not have a definite quantification. The threshold amounts designated for exemption from registration under certain conditions are these:

- SEC Rule 504: \$500,000 (\$1 million if registered under state laws).
- SEC Rule 505: \$5 million.
- SEC Rule 506: no dollar limit if sales are to sophisticated and accredited investors.
- SEC Regulation A, which provides for simplified registration when the amount of securities offered is not over \$1.5 million.
- The intrastate exemption (Section 3(a)(11) and Rule 147) tends to result in relatively smaller offerings.
- Form S-18, which provides a simplified filing document for offerings up to \$7.5 million.

Tender offer. Although not defined in the securities acts, tender offer refers to an offer to buy, ordinarily, a significant portion of the shares of a corporation. The Williams Act added to the 1934 Act Sections 13(d), 13(e), 14(d), 14(e), and 14(f) dealing with tender offers. According to Section 13(d), any direct or indirect acquisition of more than a 5 percent beneficial interest in an equity security must file with the SEC, whether the interest is acquired by tender offer or otherwise. The term *takeover offer* more clearly specifies that control of the target corporation is desired. Any person planning such an offer for registered securities must file with the SEC, prior to the tender, copies of all advertisements and other documents to be used in the solicitation. Persons opposed to the tender must file their responses.

The SEC has suggested that the following characterize a tender offer.

- Public shareholders are actively and widely solicited.
- A substantial percentage of the issuer's stock is involved.
- The offer to purchase is made at a premium over the prevailing market price.
- The terms of the offer are firm rather than negotiable.
- The offer is contingent on a fixed number of shares, often a fixed maximum number of shares to be purchased.
- The offer is open for a limited period of time.
- The offeree is pressured to sell his stock.
- Public announcements are made of a purchasing program concerning the target company preceding or accompanying rapid accumulation of large amounts of the target's securities.

Tombstone ads. Black borders are sometimes placed around the brief advertisements authorized by SEC Rule 134. The borders and the

brevity of the ads have caused them to be labeled “tombstone ads.” Often they do not appear until after the effective date of the registration and sometimes after the issue is sold out. In that case they serve as testimony of the effectiveness of the underwriter in putting the issue to rest.

Underwriter. In the typical arrangement for distribution of newly issued securities, an investment banker will undertake the task of coordinating the distribution. He or she may organize a group or syndicate of underwriters to assist in the task. The underwriter may contract to take the issue for resale at his or her own risk (firm underwriting) or may promise only to use his or her best efforts. (See also section 4.2 on the Process of Registration, herein.)

3. FEDERAL SECURITIES REGULATION: OVERVIEW

The Securities and Exchange Commission (SEC) administers the five federal securities acts. The commission’s principal office is in Washington, D.C., and there are nine regional and eight branch offices. The

(Text continued on page 15)

SEC has considerable rule-making authority, which it has frequently exercised to expand upon or clarify the securities acts. Generally, the staff of the SEC has taken an expansive posture toward its role in the administration of securities law.

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

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

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

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

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

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

4. THE SECURITIES ACT OF 1933

4.1 The Purpose of Registration Under the 1933 Act

Registration of a new issue of securities with the SEC provides potential investors with a source of information about their investment. The 1933

act provides for civil and criminal penalties to discourage misrepresentation in connection with offerings of securities. The role of the Securities and Exchange Commission is to oversee the process of registration, essentially to determine if the registration documents are complete, without passing in any way upon the suitability or safety of the investment. Purchasers of securities who have scrutinized the mandated registration documents may be foolish in their investment, but they will not have been misinformed—at least, that is the intent of the 1933 act.

4.2 The Process of Registration

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

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

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

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

The reasonableness of compensation received by its members acting as underwriters is regulated by the National Association of Securities Dealers (NASD). A 1981 NASD survey reports typical compensation at about 12.5 percent for a firm underwriting of \$5 to \$6 million. Stated as a percentage, compensation is slightly higher for smaller offerings and for best-effort underwriting; slightly lower for larger offerings.

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

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

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

4.3 Contents of the Registration Statement

The three basic registration forms are SEC Forms S-1, S-2, and S-3. They differ in the amount of detail required, primarily because the latter two allow other filings with the SEC to be included by reference (that is, referred to but not attached to the S-2 or S-3 filing). Appendix 1 is a list of commonly used 1933 Act forms. Registration statements contain

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

4.4 Contents of the Prospectus

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

- Audited balance sheets for two years and statements of income and changes in cash flow for three years.
- Description of the business, its markets, sources of supply, and its competitive conditions.
- A plan of operations.
- A statement of whether it will be necessary to raise additional funds within six months.
- Use of the proceeds of the present offering.
- Plan of distribution, including names of selling security-holders and information about the underwriters.
- Revenue, operating income or loss, and identifiable assets attributable to different industry segments.
- Nature of dependence on a few customers.
- Amounts spent on research and development.
- Segment information by geographic area.
- Descriptions of properties.
- Legal proceedings.
- History of market prices and dividends for most recent two years.
- Number of holders of each class of equity securities.
- Description of securities to be registered.
- Selected financial data for the last five fiscal years.
- Selected quarterly financial data.
- Management's discussion and analysis of financial condition and results of operations.

- Disagreements with and changes in independent accountants.
- Identification of directors, executive officers, significant employees and their business experience, and involvement in bankruptcy and certain other legal proceedings.
- Executive compensation, stock options, and bonuses.
- Ownership by any group of more than 5 percent of any securities.
- Transactions with or indebtedness exceeding \$60,000 with directors, executive officers, and other related or selected persons.

4.5 Exemptions From Registration

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

Regulation D consolidates several *limited offering exemptions* and encompasses Rules 501 through 506. The first two of these define common terms and set out general conditions. Rule 503 describes the Form D filing that is required. The final three Rules describe the exemptions. The following are general conditions that govern circumstances for all Regulation D exemptions:

- Attempted compliance with a rule does not create an exclusive election, and other exemptions may be asserted.
- Compliance with a rule creates no exemption from other federal securities provisions, such as antifraud and civil liabilities, or from blue sky laws.
- The exemptions apply only to transactions by the issuer of the securities, not to the securities themselves or to resales, except that resales may be made for Rule 504 securities registered under blue sky laws.

Practitioners should be alert to advise their clients that exempt transactions and issues of exempt securities are still subject to state antifraud

and blue sky laws as well as to the antifraud portions of federal securities law whenever the telephone, mail, or other instrumentalities of interstate commerce are used to offer, sell, or buy securities. The relevant portions of federal regulation are Section 10b of the 1934 act and SEC Rule 10b-5, which discuss the most commonly encountered exemptions.

OVERVIEW OF EXEMPTIONS UNDER REGULATION D

| | Rule | | |
|-----------------------------------|----------------------------|---|------------|
| | <u>504</u> | <u>505</u> | <u>506</u> |
| Size of offering | \$1 million (12 months) | \$1 million (12 months) | No limit |
| Number of investors | No limit | 35 plus an unlimited number of "accredited" investors ⁽¹⁾ | |
| General solicitation | Not allowed | Allowed | Allowed |
| Information provided to investors | None specified | None required to be provided to accredited investors ⁽²⁾ | |
| Resale restrictions | None | Rule 144 covering restricted securities generally limits resale during a two-year holding period. | |

¹For Rule 506, unaccredited investors must be sophisticated investors themselves or with their advisers.

²For unaccredited investors, even those who are sophisticated, disclosures are mandated, and the nature of these disclosures depends upon whether the issuer is an SEC-reporting or nonreporting company.

4.5.1 Accredited investors

Various provisions of securities regulation confer special status and treatment for potential purchasers of securities who are designated "accredited investors." For example, accredited investors do not have to be counted when determining the thirty-five-purchaser limitation referred to in Rules 505 and 506. Certain institutional investors and certain large investors are called accredited investors for purposes of the exemptions under Rules 505 and 506 and Section 4(6). These institutional investors are

- Banks (including those acting as fiduciaries).
- Investment companies.
- Insurance companies.
- Small business investment companies.
- Practically all employee-benefit plans subject to Title I of ERISA.
- Tax-exempt organizations having assets exceeding \$5 million.
- Savings and loan associations supervised by a state or federal authority.

- Broker-dealers registered with the SEC under the 1934 act.
- Corporations, partnerships, or business trusts with total assets exceeding \$5 million, provided the entity has not been formed solely for the purchase.
- Trusts, other than business trusts, with assets that exceed \$5 million and that are directed by a “sophisticated” person.
- Governmental employee benefit plans having assets exceeding \$5 million.

These are also considered accredited investors:

- Directors, general partners, or executive officers of the issuer
- Natural (not corporate) persons whose net worth, individually or jointly with a spouse, exceeds \$1 million or whose annual income exceeds \$200,000 (individually) or \$300,000 (jointly)

The Small Business Investment Incentive Act of 1980 added Section 4(6) to the 1933 act to provide exemption from registration for transactions involving offers or sales solely to accredited investors if the offering price does not exceed \$5 million and there is no advertising or public solicitation. A single offer or sale to a nonaccredited investor will invalidate this exemption. Form D must be filed. This exemption appears to be equivalent to SEC Rule 506.

4.5.2 Intrastate offerings

For this exemption to apply, the issuer and all offerees (and purchasers) of the exempted securities must be residents of the same state. In the case of a corporate issuer, both its principal place of business and its incorporation must be in the state. For offerees who are noncorporate business entities, only their principal place of business need be located in the state; for individuals, their principal residence. SEC Rule 147 requires that 80 percent of the proceeds be used in the state. The exemption is lost if a resale to a nonresident takes place within nine months after the last sale made in the same state.

4.5.3 Judicially approved exchanges

A relatively narrow exemption from registration is available under the 1933 act, Section 3(a) (10), when a judicial or federal or state administrative authority approves, as for example in a reorganization. This exemption has been used for court-approved settlements of private litigation.

4.5.4 Private placements

Section 4(2) of the 1933 act exempts transactions when there is no public offering (that is, no general solicitation). Offerings relying on

this exemption will be made to sophisticated institutional and private investors who have access to the kind of information that would otherwise have to be provided in the registration documents. Since the statute itself does not identify what would constitute a nonpublic offering, the benefits of this section are of less certain operation than exemption under Rule 506, which is somewhat similar in its intent. For example, resale within a short period of time of the securities that were the subject of a private placement may cause the seller to be deemed an underwriter and may relate back and destroy the private placement exemption. The SEC's Rule 144 operates to provide protection against these unintended consequences. (See section 4.6, below.)

4.5.5 Rule 506

Characteristics of the securities offerings under Rule 506 include these:

- No limit on size of offering
- No limit on sales to accredited investors
- Sales to no more than thirty-five “sophisticated” investors
- Prohibition against solicitation to the general public
- Requirement of certain disclosures, unless all sales are made to the accredited investors
- Form D filing with the SEC

The “sophisticated” investors must be of sufficient business and investment acumen to be capable of evaluating the rewards and risks of the investments. In this task they may utilize the assistance of a personal financial adviser or a purchaser representative. According to Rule 506(b), each purchaser who is not an accredited investor either alone or with his purchaser representative(s) has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believes immediately before making any sale that such purchaser comes within this description.

Prior to sale of the securities, a disclosure document must be delivered to the prospective purchaser. Rule 506 provides a safe harbor for offerings that satisfy its requirements. Despite failure to qualify under some provision of Rule 506, an exemption under a similar provision, for example, Section 4(2) concerning private placements, may still be available.

4.5.6 Small issues

To facilitate access to the capital markets by small businesses, several avenues are available to the small issuer or to the issuer of small amounts

of securities. In addition to the rules discussed below, see the sections in this chapter that cover accredited investors, intrastate offerings, private placements, and simplified registration.

Rule 504. The exemption under Rule 504 carries these conditions:

- Issuer cannot be an investment company or any company otherwise required to report to the SEC.
- Issue is limited to \$1 million offering and sale within a twelve-month period.
- General solicitation is permitted if made in states that require registration and delivery of a disclosure document.
- Disclosure document need not be distributed if no general solicitation is made, unless required by state law.

Rule 505. The conditions for a Rule 505 exemption are

- Limitation to \$5 million in a twelve-month period.
- No restrictions on number of offerees to which offering can be made so long as there is no general solicitation or advertising.
- Purchasers limited to thirty-five except for accredited investors.
- No limit to the number of purchasers who are accredited investors.
- If any sale is made to a nonaccredited investor, disclosure documents must be provided to all purchasers.
- Not available to issuers who are investment companies or to those guilty of postal or securities fraud.
- Form D must be filed with the SEC.

Since the thirty-five nonaccredited investors have to meet no particular standards for sophistication or suitability, this exemption is popular for limited partnerships. Unless formed for the specific purpose of acquiring the offered securities, an entity such as a corporation or partnership counts as one purchaser.

4.5.7 Voluntary exchanges

When an issuer exchanges a new issue of securities exclusively with its existing security-holders, an exemption from registration is provided. Cash paid or received to effect an equivalency of value does not invalidate the exemption. This exemption is not available where

- Remuneration is paid for solicitation, promotion, or underwriting.
- The securities are exchanged in the course of a Bankruptcy Act proceeding.

Technically, such exchanges are exempt transactions (rather than exempt securities). Subsequent resales of these securities by a holder will thus require registration unless shielded by another exemption.

4.5.8 Other exemptions

Exemptions are also available under Section 3(a) of the 1933 act for securities of the following:

- Federal, state, and local governmental bodies and organizations (including certain industrial development bonds)
- Federal Reserve banks
- Certain insurance companies
- Qualified pension, profit, and stock plans and certain Keogh partnership plans
- Notes, drafts, and bankers' acceptances with an original maturity of not more than nine months
- Building and loan associations
- Farmers cooperatives
- Bankruptcy act certificates
- Many insurance and annuity contracts

These are not blanket exemptions, however, and the securities acts, SEC rules, and court cases may bear on a particular offering. In some cases only an experienced securities attorney can be relied upon for confirmation of the exemption. The Keogh exemption, for example, is available only to firms offering services in the investment banking, pension consulting, investment advising, legal, and accounting fields. In these fields an employer can be expected to have the requisite knowledge and experience to guard his or her own as well as employees' interests. Independent investment advice must nevertheless be secured in setting up the plan.

4.6 Secondary Transactions and Rule 144

Section 4(1) of the 1933 act exempts from registration transactions by "any person other than an issuer, underwriter, or dealer." The term *issuer* includes any person who directly or indirectly controls or is controlled by the issuer. *Underwriter* means any person who purchases from an issuer "with a view to, or offers or sells for an issuer in connection

with, the distribution of any security.” Thus nonissuers and nonunderwriters can distribute securities in transactions deemed exempt under this section.

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

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

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

Rule 144A provides a safe harbor from registration requirements for the resale of unregistered securities to a *qualified institutional investor*

acting for its own account. A qualified institutional investor is one that has \$100 million in securities under its discretionary management or, subject to certain conditions, a registered securities dealer, investment company, or bank.

Considerable litigation has resulted regarding Rule 144, and at least one book of substantial length has been devoted entirely to it. Because of varying judicial interpretation, clients must be advised not to place their reliance for an exemption entirely upon the two-year holding period, particularly if they are controlling persons within the context of the SEC rules. If the exemption of a resale transaction is challenged by the SEC, it is a question of fact to be decided by the courts whether a seller of securities originally purchased them with the intent to distribute them. Despite these possible pitfalls, however, most registered broker-dealers will have worked out procedures for safely handling Rule 144 securities and clients may be counseled to rely on these procedures.

4.7 Simplified Registration

Two methods of abbreviated registration are available. Form S-18 allows access to the capital markets by firms not required otherwise to report to the SEC without immediately incurring the full range of disclosure normally required. The salient aspects of a Form S-18 distribution are

- An aggregate offering price may not exceed \$7.5 million.
- Proceeds may be in the form of cash, installments for cash, or by assumptions of debt.
- It may be used by corporate or noncorporate issuers.
- It requires one year's audited balance sheet plus statements of income and of changes in financial conditions for the two most recent fiscal years.
- The registrant must not be required to report to the SEC under the 1934 act.
- Filing may be made at a regional SEC office (perhaps achieving faster and less costly service).
- Public advertising and solicitation are allowed.
- Sales may be made for the account of a person other than the registrant (for instance, in a secondary distribution) for an amount not to exceed \$1.5 million.
- It is not available for issuers that are investment companies or for most insurance companies.

Regulation A provides another type of simplified registration—in effect, a miniregistration. Its features are these:

- It allows aggregate offerings to \$5 million by the issuer, its affiliates that became such within the last two years, and its predecessors. Additionally, included in the \$5 million limitation are certain secondary distributions by affiliates and other exempt securities sold under Section 3(b) of the 1933 act (Rule 504 or 505).
- It provides for lower limits for securities offered on behalf of nonaffiliated persons other than the issuer. These are
 - \$100,000 on behalf of any person; \$300,000 for all such persons.
 - \$500,000 limit if offering person is an estate.
- Solicitation of investor interest allowed prior to filing of an offering statement.
- Filings are made with and reviewed by regional SEC offices.
- State registration will ordinarily be required.
- Financial statements need not be certified but must conform to generally accepted accounting principles.
- Financial statements must include a balance sheet prepared within ninety days of the filing and profit and loss statements for the two preceding fiscal years.
- Financial statement specifications can be found in SEC Form 1-A.
- An offering circular must be provided to prospective purchasers.

Many attorneys believe the costs of filing and the necessity for approval by the SEC, when compared to the small size of the allowed offering, argue against the use of Regulation A registration in cases where an exemption can be found within Regulation D.

5. THE SECURITIES EXCHANGE ACT OF 1934

5.1 Overview

The Securities Exchange Act of 1934, cited hereafter as the 1934 act, prescribes registration and reporting requirements for issuers of certain securities, by securities dealers, securities exchanges, and self-regulatory organizations (the only one to date being the National Association of Securities Dealers). The act in addition concerns itself with proxy solicitation, tender offers, insider profits, and manipulative and fraudulent practices. The 1934 act established the SEC.

5.2 Securities and Exchange Commission (SEC)

The SEC was established by the Securities Exchange Act of 1934 to administer and enforce the securities acts, and therefore has extensive rule-making authority. Documents required to be filed by the securities acts are filed with the SEC. Mail can be addressed to the Securities and Exchange Commission, Washington, D.C. 20549, to make a request from its Publications Section. The main telephone number is (202) 272-3100. The Office of Consumer Affairs and Information Services can be reached at (202) 272-7440. Additionally, these phone numbers within the Division of Corporation Finance have proved particularly helpful:

Office of Chief Accountant (202) 272-2553

Office of Chief Counsel (202) 272-2573

Office of Small Business (202) 272-2644

Regional offices of the SEC initiate investigations and enforcement proceedings and can be queried for informal advice about matters of securities regulation. The regional offices and their phone numbers are:

New York, New Jersey (212) 264-1614

Massachusetts, Connecticut,
Rhode Island, Vermont,
New Hampshire, Maine (617) 223-9900

Tennessee, North Carolina, South
Carolina, Georgia, Alabama, (404) 347-4768

(Text continued on page 27)

| | |
|--|----------------|
| Mississippi, Florida, Puerto Rico, Virgin Islands, Louisiana (east of the Atchafalaya River) | |
| Minnesota, Wisconsin, Iowa, Illinois, Missouri, Ohio, Michigan, Indiana, Kentucky, Kansas City, Kansas | (312) 353-7390 |
| Oklahoma, Arkansas, Texas, Kansas (except Kansas City), Louisiana (west of the Atchafalaya River) | (817) 334-3821 |
| Wyoming, Utah, Colorado, New Mexico, Nebraska, North Dakota, South Dakota | (303) 844-2071 |
| California, Nevada, Arizona, Hawaii, Guam | (213) 468-3098 |
| Washington, Oregon, Idaho, Montana, Alaska | (206) 442-7990 |
| Delaware, District of Columbia, Maryland, Pennsylvania, Virginia, West Virginia | (215) 597-3100 |

5.3 Registration of Brokers and Exchanges

The SEC oversees operation of the two national stock exchanges, the New York Stock Exchange and the American Stock Exchange, as well as the eight regional exchanges. (Some stocks are traded both on a national and a regional exchange.) The regional exchanges are these:

- Boston Stock Exchange
- Chicago Board Options Exchange
- Cincinnati Stock Exchange
- Inter Mountain Exchange
- Midwest Stock Exchange
- Pacific Stock Exchange
- Philadelphia Stock Exchange
- Spokane Stock Exchange

The largest number of stock issues are not listed for trading on an exchange but are traded over-the-counter—in direct exchange between

brokers. The National Association of Securities Dealers Automated Quotation System (NASDAQ) facilitates such trades. Possible advantages of listing on an exchange include

- Exemption from registration under some state blue sky laws.
- Increased attention from securities analysts, which increases investors' interest.
- Increased visibility and prestige in the business community.
- Price stability of shares because of readily available market quotations.
- Greater acceptance of shares as collateral by lending institutions.

Disadvantages include

- Necessity for providing more information to the SEC, the stock exchange, and shareholders.
- Initiation fees and annual charges.
- Restrictions imposed by the exchange.

5.4 Registration of Securities: General Issues

All securities traded on a national exchange must be registered with the SEC. The SEC may suspend trading in any improperly registered security. Over-the-counter securities must also be registered by issuers who have a class of equity securities with 500 or more shareholders and more than \$3 million in total assets. The data required are similar to those required for securities act registration; recent SEC policy has been to bring the two registration procedures into closer agreement. Following registration, reports must be filed to keep the information up-to-date. This information is available for inspection at the Washington office of the SEC. SEC filings are also available, for a fee, from Disclosure, Inc., reachable at (800) 638-8241. Exemptions from exchange act registration are provided for the security issues of savings and loan, not-for-profit, and cooperative associations, certain insurance companies, and certain employee stock bonus, pension, or profit-sharing plans.

The process of registration is being facilitated through a newly developing system called *integrated disclosure*. Integrated disclosure is designed to reduce the incidence of duplicative and overlapping filings required by the various securities acts. Registration statements and prospectuses will still be required to provide transaction-specific information (unless an exemption is available) for the issuance of securities. Information focusing on the registrant/issuer, however, will in most cases already be available under the periodic and continuous reporting

requirements of the 1934 act (through such Forms as 10-K, 10-Q, and 8-K).

The workings of the integrated disclosure system can be observed in the alternative use of these three different registration forms:

1. Form S-1 requires the most detail and is used by first-time registrants.
2. Form S-2 demands less detail and is available for use by issuers who have reported for three or more years under the 1934 Act.
3. Form S-3, exacting the least detail, is available for issuers meeting the same three-year test as for Form S-2 but also requires as a precondition a “market following” test that assures the securities are widely held.

If a registrant qualifies for S-3 registration, no registrant-specific information is required. Instead, data about the registrant/issuer are incorporated by reference in other exchange act filings (such as 10-Ks, for example).

See Appendix 2 for a list of common forms used in registrations under the 1934 Act.

5.5 Registration of Over-the-Counter Securities: Specifics

Section 12(g) of the 1934 Act, together with SEC Rule 12g, requires registration of the equity securities of issuers engaged in interstate commerce or in a business affecting interstate commerce or whose securities are traded by use of the mails or any means or instrumentality, if the issuer has total assets exceeding \$3 million and there are 500 or more shareholders of the equity securities. Equity securities are

- Stocks or similar securities or securities convertible into stocks or similar securities.
- Any security carrying a warrant or right to purchase a stock or similar security.
- Certificate of interest or participation in a profit-sharing agreement.
- Preorganization certificate or subscription.
- Transferable share.
- Voting-trust certificate or certificate of deposit for an equity security.
- Limited partnership interest.
- Interest in a joint venture.
- Certificate of interest in a business trust.
- Any put, call, straddle, or other option or privilege of buying or selling a security to another.

For the purposes of this section, a class includes all securities of substantially similar character and those whose holders enjoy substantially similar rights. Thus common and preferred shares are not members of the same class, but common shares designated Class A and Class B might be, depending on the similarities of the rights of their holders. As to the existence of 500 shareholders, the SEC normally accepts the issuer's records on this point, even to accepting a corporation, a partnership, or street name as one holder.

Total assets are determined after deducting such allowances as those for depreciation, depletion, and bad debts. To temporarily postpone registration by staying below the threshold for registration, these techniques might be employed (after first considering their income tax consequences):

- Pay off liabilities with available assets.
- Pay dividends or purchase treasury stock from shareholders.
- Increase allowance accounts if possible to do so while maintaining conformity with generally accepted accounting principles.
- Spin off assets to shareholders.
- Any other tactic reducing assets or number of shareholders below the threshold levels.

The asset and shareholder tests are determined at the end of the company's fiscal year. This allows some maneuvering space for a potential registrant who exceeds the threshold values during the year but desires to stave off registration. Continuing use of such tactics over several years, however, might stimulate the SEC to insist on registration.

Registration, if required, must become effective within 120 days following the fiscal-year end. Normally, a registration becomes effective sixty days after its filing, although the period may be shortened at the discretion of the SEC. Accountants whose clients are approaching the threshold at midyear should be warned they may have to register with the SEC. Projections of year-end data well in advance of year end—particularly regarding total assets and number of shareholders—can provide potential registrants time to plan their response to the 1934 Act requirements.

6. OTHER FEDERAL SECURITIES-RELATED ACTS

6.1 Foreign Corrupt Practices Act of 1977

The accounting provisions of the Foreign Corrupt Practices Act specify that all securities issuers who report to the SEC are required under Section 13(b)(2) of this act to

(A) Make and keep books, records, and accounts, that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer; and

(B) Devise and maintain a system of internal accounting controls sufficient to provide reasonable assurance that:

(i) Transactions are executed in accordance with management's general or specific authorization;

(ii) Transactions are recorded as necessary (I) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (II) to maintain accountability for assets;

(iii) Access to assets is permitted only in accordance with management's general or specific authorization; and

(iv) The recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any difference.

This Act was intended to subject to audit payments that heretofore had been disguised and that were being used by U.S. corporations to bribe foreign officials. Paragraph (7) was subsequently added as an amendment to section 13(b) to clarify certain terms questioned by corporate directors and accountants desirous of complying with the act.

(7) For the purposes of paragraph (2) of this subsection, the terms 'reasonable assurances' and 'reasonable detail' mean such level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs.

Fears of overzealous enforcement were further quieted by the SEC Commissioner's statements that inadvertent recordkeeping mistakes will not result in an enforcement action.

6.2 Investment Advisers Act of 1940

This act, according to a 1981 SEC staff report, may require registration as an "investment adviser" by "financial planners" and others who provide investment advice to their clients for compensation. Three exceptions from registration are provided under the act:

1. *Intrastate exception.* Section 203(b)(1) provides an exception for an investment adviser whose clients are all residents of the state within which the adviser maintains the principal office and place of business, as long as he or she does not furnish advice or issue analyses or reports about securities listed or admitted to unlisted trading privileges on any national securities exchange. (There may still be certain

state registration and reporting requirements.) An investment adviser is also subject to the act's antifraud provision. A person who is not an investment adviser (which includes the accountant's exception) is not subject to the act at all.

2. *Insurance company adviser.* This exception is for those advisers whose only clients are insurance companies. Section 203(b)(2) applies.
3. *Private investment advisers.* Section 203(b)(3) offers an exception for investment advisers who, during the course of the preceding twelve months, had fewer than fifteen clients and who neither hold themselves out generally to the public as investment advisers nor act as investment advisers to an investment company registered under the 1940 act or to a "business development company."

Accountants rendering investment advisory services may be required to register in certain circumstances. Persons or firms who engage for compensation in the business of advising others concerning securities transactions must register with the SEC. This includes advising directly or through publications or writings as to the value or advisability of purchasing or selling any security. Any "accountant whose performance of such services is solely incidental to the practice of his profession" is exempted (Section 202(a)(11)). Any form of recommendation to a client concerning a specific security made by a public account potentially could cross the "solely incidental" threshold.

6.2.1 Consequences of registering

Certain activities follow upon registration under the Investment Advisers Act.

Reporting. Reporting is done on Form ADV, which requires the adviser to give information about various practice aspects:

- The nature of the business
- Background, education, and experience of the principals and employees
- Whether there are grounds for disqualification from registration
- Amount of assets under management
- Type of clients advised
- Kinds of investment advisory services provided
- Methods of securities analysis

An annual report, Form ADV-S, is required within ninety days after the close of the adviser's fiscal year.

Record keeping. Certain records are required of registered advisers and may be inspected by the SEC:

- Journals and ledger accounts
- Memoranda or orders and instructions for purchase, sale, receipt, or delivery of securities
- Copies of certain communications received or sent
- Listings and records relating to discretionary accounts
- Copies of all written agreements
- Copies of publications and recommendations distributed to ten or more persons and information indicating the factual basis for the recommendations
- Records of certain securities transactions entered into

(Text continued on page 33)

Disclosure. The so-called “brochure rule” requires the adviser to furnish to prospective clients certain kinds of information. Generally, it is data of the sort included in Form ADV:

- Services provided
- Types of client served
- Methods of security analysis used by the adviser
- Standards of education and business background required of the adviser’s principals and employees
- Descriptions of the specific backgrounds of its principals and employees

Performance fees. Although the act itself prohibits a registered investment adviser from receiving compensation based on a share of the capital appreciation in a client’s account, under certain conditions this will be acceptable under a new SEC rule (SEC Investment Advisers Act Release No. 996 (November 14, 1985)).

Antifraud provisions. It is unlawful for an investment adviser to “employ any device, scheme, or artifice to defraud any client or prospective client” or to engage in any activity that operates as a fraud upon a client. Even persons excused from registration by one of the three exceptions from registration are subject to these antifraud provisions. Persons who rely on the exceptions from the definition of investment adviser, including the accountant’s exception, however, are not subject to these provisions.

6.2.2 Examples of situations involving public accountants

The following cases are based on examples presented in the book, available from the American Institute of Certified Public Accountants, titled *Personal Financial Planning Practice Aid No. 1: Issues Involving Registration Under the Investment Advisers Act of 1940*:

Case 1. John is a CPA with an active practice. He spends most of his time preparing and reviewing tax returns and in analyzing the tax consequences of proposed transactions for his clients. From time to time, in preparing a tax return for a particular client, John suggests the client might consider tax shelter, tax-exempt bonds, or mutual funds John will be able to rely on the accountant’s exception. He will not be required to register as an investment adviser because he meets the “solely incidental” test as stated by SEC staff. His exemption arises because

He is not holding himself out as an investment adviser.

The investment services he is rendering appear to be related to the accounting services he provides.

He appears not to be charging a special fee for his advisory services.

Case 2. After three years with a local firm, Margaret starts her own practice. She intends to advertise “planning services” as a special service available in her accounting practice. She hopes financial planning will be the major emphasis of her practice. Margaret will do comprehensive financial planning for a fee, will give opinions on, and recommend, specific investment vehicles, IRA plans, tax shelters, and pension arrangements . . . Margaret cannot rely on the act’s accountant’s exception, since she appears to be holding herself out as a financial planner who is providing investment advice.

Case 3. Fred, a CPA, holds himself out as providing personal financial planning services as well as accounting and tax services. Except in rare instances, the investment advice he provides is limited to discussing in general terms the role different sorts of investment vehicles might play in a client’s overall investment plan. Although Fred is holding himself out as a financial planner, the kind of advice he is providing appears not to be of the type that would cause him to meet the definition of investment adviser. (*Warning:* The SEC staff, however, might take a contrary position if confronted with these facts.)

Case 4. Banners and Croft, CPAs, is a medium-size firm that recently established a financial planning team. The team follows a four-step approach:

1. Presenting seminars addressing goal setting, money management, tax and estate planning, insurance, and investments.
2. Collecting data from clients about their assets, liabilities, and cash flows.
3. Using computer software to project net worth, tax liability, and cash flow for several investment alternatives.
4. Reviewing annually each client’s financial plan to judge whether progress is being made toward his or her goals and whether the goals should be adjusted.

Banners and Croft does not act as sales agent for any investment vehicles. Once a client indicates an interest in a particular vehicle—municipal bonds or equities, for example—the firm provides a list of local advisers and brokers who are rated by a national rating service. The issue is whether establishment of the team constitutes holding oneself out as being in the financial planning business because financial advising is not solely incidental to the firm’s accounting practice (and therefore not covered by the accountant’s exception). Even if the financial planning business is not covered by the accountant’s exception, the firm would not need to register under the act so long as the business did not result in meeting the definition of investment adviser. The firm does not meet this definition, since

- The securities advice is general and focused on the role of securities in a client’s overall plan.
- Advice is not directed toward specific securities.

6.3 Investment Company Act of 1940

An investment company is one engaged primarily in the business of investing, reinvesting, or trading in securities. The most commonly encountered example of an investment company is a mutual fund. The 1940 act requires registration of investment companies and spells out such safeguards over operations as ratification by shareholders of the selection of the independent public accountant [Sec. 32 of the act] and changes in investment policy. Unexpected consequences may derive from operation of the act: for example, an investment company that fails in its duty to register will find itself denied access to the courts if it should attempt to enforce a contract with another party. The act contains provisions for the independence of the board of directors and for separate investment advisers. Criminal penalties are set out for willful violations of the act. There are also antifraud provisions and private remedies, both of which supplement similar provisions in the 1933 and 1934 acts, which are also operative regarding investment companies.

6.4 Trust Indenture Act of 1939

The Trust Indenture Act of 1939 provides that evidences of indebtedness such as bonds may not be offered to the public unless they are issued under an agreement (called a trust indenture) that has been passed on by the SEC. Among its other provisions, this act specifies the requirements for persons who serve as trustees for the bondholders. Accountants ordinarily have no direct role in the preparation of the registration documents or the annual filings required under this act. It may be desirable, however, for the issuing debtor's public accountant to review the trust indenture to provide advice concerning covenants that impact the financial statements or operations of the issuer.

6.5 Public Utility Holding Company Act of 1935

The Public Utility Holding Company Act of 1935 requires registration of holding companies operating electric utility or retail gas businesses. Financial statements required with the registration documents and with annual reports to the SEC must be audited by independent public accountants.

6.6 Racketeer Influenced and Corrupt Organizations Act (RICO)

The Racketeer Influenced and Corrupt Organizations Act was promulgated as part of the Organized Crime Control Act of 1970 to protect

businesses against organized crime. RICO has been used against legitimate businesses such as brokers, banks and investment bankers, lawyers, insurance companies, manufacturers, and public accountants.

RICO makes it illegal to

- Use income derived directly or indirectly from a pattern of racketeering activity to acquire any interest in an enterprise.
- Acquire any interest in or control of an enterprise through a pattern of racketeering activity.
- Conduct or participate, directly or indirectly, in the affairs of an enterprise through a pattern of racketeering activity.
- Conspire to violate any of the above provisions.

A wide variety of conduct can constitute racketeering under this statute, including murder, arson, bribery, embezzlement, mail and wire fraud, securities fraud, and pornography and drug dealing. Mail fraud is a particularly broad offense, having as its essential elements the mailing of a letter while motivated by a deceitful thought. The act allows a private legal action by “any person injured in his business or property” by conduct that is punishable as a crime. Access to court is granted the injured party upon his or her allegation that the defendant committed the illegal conduct; no prior conviction need be shown. When a civil rather than a criminal remedy is sought, as for example, by an investor against a stockbrokerage firm, the civil standard of proof by a preponderance of evidence is required. This is a less rigorous standard of proof than that required in a criminal case, where the standard is proof beyond a reasonable doubt. To the successful plaintiff in a civil action, recovery of treble damages may be allowed together with costs of the suit, including attorneys’ fees. Numerous states have enacted their own RICO statutes. Because RICO has been used as an entree to court against legitimate businesses, including public accountants, both the American Institute of Certified Public Accountants (AICPA) and the National Advisory Council to the Senate’s Small Business Committee have urged that RICO be amended to require plaintiffs to show the defendant has been convicted of a prior criminal racketeering activity.

6.6.1 State RICO statutes

Simultaneous RICO litigation under the federal statute and one or more state statutes is possible. The federal statute clearly spells this out:

Nothing in this title shall supersede any provision of Federal, State, or other law imposing criminal penalties or affording civil remedies in addition to those provided for in this title.

A growing number of states have enacted RICO clones. These statutes mimic to a greater or lesser extent the federal statute. The provisions of these various state acts are shown in table I.

Twenty-one state RICO statutes specifically include fraud in the purchase or sale of securities as a racketeering act. Ten identify mail or wire fraud as predicate acts. These instrumentalities of interstate commerce are beyond the scope of state regulation. However, the states that identify these types of fraud as racketeering acts do so by reference to the federal statute, making the federal racketeering acts state racketeering acts as well.

Of the twenty-one state RICO laws that include securities fraud or mail and wire fraud as predicate acts, seventeen allow private remedy. Six of these jurisdictions provide for punitive damages in addition to damages for the injury (treble or double) and the recovery of court costs and reasonable attorney's fees. This is a civil remedy that is more liberal than that provided under the federal statute. (Federal RICO allows only treble damages plus court costs and reasonable attorney's fees.) Eight of the remaining eleven jurisdictions provide a measure of damages that is equivalent to damages allowed under federal law.

Although state statutes tend to reflect or expand on the federal measure of damages, they also frequently limit the applicability of RICO. Of the thirty-one jurisdictions with RICO clones, three states (Illinois, Louisiana, and Tennessee) limit predicate acts to narcotics law violations. Eight jurisdictions limit the application of RICO by not allowing private suits. In order to initiate a private RICO action under Delaware and Mississippi law, the defendant must have a previous criminal conviction for a racketeering act that was the source of the plaintiff's injury (action must be brought within one year of the defendant's conviction). North Carolina and Ohio require that in a private RICO action alleging securities fraud, one of the pattern acts must be an act other than fraud in the sale of securities. In a private RICO action alleging securities fraud under the Washington statute, the defendant must have been previously convicted on a criminal charge of securities fraud. Conviction for the pattern acts themselves is not required.

Fifteen jurisdictions have included in their definition of the pattern of acts the requirement that the predicate acts have the same (or similar) purposes, results, participants, victims, methods of commission, or be otherwise interrelated by distinguishing characteristics and not simply isolated events. Thus, these states have included in their statutes the continuity and relationship standard which, as result of the *Sedima (FPRL v. Imrex Co., 105 S. Ct. 3275)* decision, is now being applied in federal cases. Although, as pointed out in *H.J. Inc. et al. v. Northwestern Bell Telephone Co. et al.* (U.S. Sup. Ct. No. 87-1252, 6/26/89), a pattern "... might encompass multiple predicates within a single scheme that

TABLE I. STATE AND TERRITORIAL RICO STATUTES

| State/ Terr. | Private Remedy | Pattern of Acts | | | "Racketeering Acts" Include | | | Damages | | |
|-----------------|-------------------|-------------------|------------------------------------|---|--|-----------------------------|------------------|----------|--------------------|--|
| | | No. of Acts | Similar Not Isolated Acts | Maximum Time Allowable Between Pattern Acts | Fraud in Purchase/ Sale of Securities | Mail or Wire Fraud | Treble | Punitive | Costs + Fees | |
| AZ | Yes | 1 | N/A | N/A | Yes | No | Yes | No | Yes | |
| CA | No | 2 | Yes | last/10 yrs. of 1st | Yes | No | N/A | N/A | N/A | |
| CO | Yes | 2 | No | last/10 yrs. of 1st | Yes | Yes | Yes | No | Yes | |
| CT | No | 2 | Yes | last/5 yrs. of 1st | Yes | No | N/A | N/A | N/A | |
| DE | Yes ¹ | 2 | No | last/10 yrs. of 1st | Yes | Yes | Yes | Yes | Yes | |
| FL | Yes | 2 | Yes | last/5 yrs. of 1st | Yes | Yes | No ² | No | No | |
| GA | Yes | 2 | Yes | last/4 yrs. of 1st | Yes | Yes | Yes | Yes | Yes | |
| HI | Yes | 1 | N/A | N/A | No | No | No ² | No | Yes | |
| ID | Yes | 2 | Yes | last/5 yrs. of 1st | Yes | No | Yes | No | Yes | |
| IL | Yes | 2 | No | last/5 yrs. of 1st | No ⁴ | No ⁴ | Yes | No | Yes | |
| IN | Yes | 2 | Yes | last/5 yrs. of 1st | Yes | No | Yes | Yes | Yes | |
| LA | Yes | 2 | Yes | last/5 yrs. of 1st | No ⁴ | No ⁴ | Yes ⁵ | No | Yes | |
| MN | No | 3 | No ⁶ | within 10 yrs. of criminal proceeding | No | No | N/A | N/A | N/A | |
| MS | Yes ¹ | 2 | Yes | last/5 yrs. of 1st | Yes | No | Yes | Yes | Yes | |
| NV | Yes | 2 | Yes | last/5 yrs. of 1st | Yes ³ | No | Yes | No | Yes | |
| NJ | Yes | 2 | Yes | last/10 yrs. of 1st | Yes | Yes | Yes | No | Yes | |
| NM | Yes | 2 | No | last/5 yrs. of 1st | Yes | No | Yes | No | Yes | |
| NY | No | 3 | No ⁶ | last/10 yrs. of 1st | Yes | No | N/A | N/A | N/A | |

| | | | | | | | | | |
|----|-----|---|-----------------|---------------------|-------------------|-----------------|-----------------|-----|------------------|
| NC | Yes | 2 | Yes | last/4 yrs. of 1st | Yes ⁷ | Yes | Yes | No | Yes ⁸ |
| ND | Yes | 2 | No | last 10 yrs./1st | Yes | No | Yes | No | Yes |
| OH | Yes | 2 | No ⁶ | last/6 yrs. of 1st | Yes ⁷ | Yes | Yes | No | Yes |
| OK | No | 2 | No ⁶ | last/3 yrs. of 1st | Yes | No | N/A | N/A | N/A |
| OR | Yes | 2 | Yes | last/5 yrs. of 1st | Yes | Yes | Yes | Yes | Yes |
| PA | No | 2 | No | no limitation | No | No | N/A | N/A | N/A |
| PR | No | 2 | N/A | last/10 yrs. 1st | No | No | N/A | N/A | N/A |
| RJ | Yes | 1 | N/A | N/A | No | No | Yes | No | Yes |
| TN | No | 2 | Yes | last/2 yrs. of 1st | No ⁴ | No ⁴ | N/A | N/A | N/A |
| UT | Yes | 3 | Yes | last/5 yrs. of 1st | Yes | Yes | No ⁹ | No | Yes |
| VI | Yes | 2 | No ⁶ | last/5 yrs. of suit | No | No | Yes | No | Yes |
| WA | Yes | 3 | Yes | last/5 yrs. of 1st | Yes ¹⁰ | No | No ² | No | Yes |
| WI | Yes | 3 | No ⁶ | last/7 yrs. of 1st | Yes | Yes | No ⁹ | Yes | Yes |

¹ In order to initiate a private RICO action under Delaware law, the defendant must have a previous criminal conviction for a racketeering act that was the source of the plaintiff's injury. Action must be brought by the plaintiff within one year of the defendant's conviction. Mississippi law also requires that the defendant was previously convicted of a RICO violation.

² Florida, Hawaii, and Washington limit damages to the actual loss incurred. However, Washington courts, at their discretion, may impose treble damages.

³ Not directly defined as a racketeering activity. Nevada's statute includes within the definition of racketeering acts, "obtaining possession of money or property valued at \$250 or more, or obtaining a signature by means of false pretenses."

⁴ Racketeering Acts are limited to violations of narcotics laws.

⁵ Or \$10,000, whichever is greater.

⁶ Minnesota, New York, Ohio, Oklahoma, and the Virgin Islands require only that the pattern acts not be isolated. Wisconsin requires only the acts to be similar.

⁷ North Carolina and Ohio require that one of the pattern acts must be an act other than fraud in the sale of securities.

⁸ The North Carolina statute allows recovery of fees; however, no mention is made of costs.

⁹ Utah and Wisconsin limit damages to twice the actual loss incurred.

¹⁰ In a private RICO action alleging securities fraud, the defendant must have been previously convicted on a criminal charge of securities fraud (conviction for the pattern acts themselves is not required).

SOURCE: Analysis by Ralph E. Welton, Jr., Ph.D., Associate Professor of Accounting, Clemson University.

were related and that amounted to, or threatened the likelihood of, continued criminal activity.” The effect of this standard is to limit prosecution to offenders engaging in repeated criminal activity. States requiring similar, not isolated acts are identified in table I.

Another method of limiting the application of RICO is to adopt a narrower time limitation between the commission of the pattern acts. Under the federal statute, a pattern of racketeering acts is established if the time between the predicate acts does not exceed ten years. Nineteen jurisdictions have adopted time limitations that are stricter than the federal limitation. The most common reduction is to require that the last pattern act occur within five years of the first. Five states require that a pattern consists of three or more racketeering acts, allowing prosecution only when criminal intent is demonstrated through repetition. The time limitation and the number of predicate acts required to establish a pattern under each state statute is shown in table I.

However, not all states have attempted to narrow the application of RICO. Three states have cast the net wider than the federal law by defining a *pattern of racketeering* as the commission of only one prohibited act (see table I).

6.7 Securities Investor Protection Act of 1970

The Securities Investor Protection Act of 1970 requires almost all broker-dealers to be members of the Securities Investor Protection Corporation (SIPC). Through assessments of its members to create a fund of \$150 million, the possibility of levying a charge on stock exchange and over-the-counter transactions, and authority to borrow up to \$1 billion from the U.S. Treasury, the SIPC can advance funds to satisfy claims by customers of failed broker-dealers. SIPC coverage extends to a maximum of \$500,000 for each customer, but not more than \$100,000 for claims for cash held by a failed broker.

Notification to the SIPC originates with the broker-dealer, the SEC, or a self-regulatory organization such as the National Association of Securities Dealers. Customers of an SIPC member in financial difficulty have no rights, by themselves, to require the SIPC to act. Customers who suspect they may be damaged by a broker-dealer’s financial difficulties should contact an attorney or the SEC. Once the SIPC determines the financial status of a broker-dealer it may apply to the courts for customers’ protection under the act. The court then appoints a trustee and an attorney for the trustee who go about returning specifically identifiable property to customers, completing any open contractual commitments of the firm, selling the assets of the firm, and paying off customers and other creditors. It is a process similar to that of Chapter 10 of the bankruptcy act.

6.8 Small Business Incentive Act of 1980

The thrust of the Small Business Incentive Act of 1980 is to exempt companies that elect to qualify as business development companies from certain burdensome provisions of the Investment Company Act of 1940. Business development companies provide assistance in the form of capital and managerial expertise to small businesses, both those that are financially sound and those that are trying to regain their liquidity. Sections 54 through 65 of the Investment Company Act provide the details of qualification. Accountants who need a detailed analysis of this act should refer to Reginald L. Thomas and Paul F. Roye, "Regulation of Business Development Companies," 55 S. Cal. L. Rev. 895 (1981), an article that should be available through any law school library.

7. STATE SECURITIES REGULATION

Nearly all states register securities and broker-dealers. The wisest preliminary assumption, therefore, is that state registration will be required whenever securities are issued, although a majority allow for registration by coordination. In these states full registration may consist only of paying the fees, naming an agent, and filing with the state the same documents that are required at the federal level. When the federal registration becomes effective, so does the state's. States' antifraud statutes continue to be operative despite SEC registration (or exemption from registration). Additionally, most states' commissioners or administrators of securities (whatever the title) will retain power to suspend distribution in their states upon suspicion of fraud.

Despite the adoption of the Uniform Securities Act, or a portion of it, in a majority of states, considerable variation in detail still exists, particularly in the fifteen or so states that either have not adopted the act or have passed highly individualized versions of it. A few relatively common features can be cited. Except for the District of Columbia, all of the states and Puerto Rico require registration of securities in some circumstances. Securities already listed on the New York and American stock exchanges are exempt from further registration in most jurisdictions. Also, issuers of securities benefiting from a Regulation D exemption from SEC registration under Rule 505 or 506 will often find an equivalent exemption at the state level.

Although full enumeration of state variation would be impractical, and legal counsel must be consulted, the table in section 7.2 can be used to provide a preliminary assessment of the existence at the state level of a Regulation D exemption. The Uniform Limited Offering Exemp-

tion (ULOE) cited in the table represents a state administrator's rule, of increasing adoption, that offers a limited transaction exemption based on SEC Regulation D but with further restrictive conditions, subject to the discretion of the administrator. An annotated version of the relevant state statutes can be consulted for further detail. For comparative data on several states, refer to Commerce Clearing House's *Blue Sky Reporter*. Both sources can be found in law school libraries, lawyers' offices, county law libraries, and some public libraries.

7.1 Uniform Securities Act

The Uniform Securities Act was drafted as the result of a two-year study at Harvard Law School. It has been adopted, with minor variations, by all states, except these:

| | | |
|------------|--------------|--------------|
| Arizona | Louisiana | Rhode Island |
| California | Maine | South Dakota |
| Florida | New York | Texas |
| Georgia | North Dakota | Vermont |
| Illinois | Ohio | |

(Text continued on page 39)

Some of these states (California, Ohio, and Texas, for example) have adopted selected portions of the act. The act is divided into four parts.

Part I proscribes fraudulent practices in connection with the purchase or sale of securities and in connection with investment advisory activities. No exemptions are provided from the prohibitions against fraudulent practices.

Part II requires the registration of broker-dealers, investment advisers, and employees of securities issuers who act as agents for the issuer.

Part III requires registration, unless an exemption can be found, of issues of securities before they can be sold in the state. The process called registration by coordination allows the registration documents filed with the SEC, when also filed with the state, to fulfill the state's registration requirements. (This portion of the uniform act has been adopted by California, Texas, Ohio, and South Dakota, which otherwise have not adopted it.)

Part IV contains definitions and matters of general applicability.

7.2 States With Exemptions Equivalent to Federal Rules Under Regulation D

| 7.2 States With Exemptions Equivalent to Federal Rules Under Regulation D | | | | |
|---|----------|-----------------|-----------------|----------------|
| | Rule 504 | Rule 505 | Rule 506 | ULOE* |
| ALABAMA | | X | X | |
| ALASKA | | | | X |
| ARIZONA | | X | X | |
| ARKANSAS | | | X | |
| CALIFORNIA | | | X | |
| COLORADO ^{1,3} | X | X | X | |
| CONNECTICUT | | X | X | |
| DELAWARE | X | X | X | |
| DISTRICT OF COLUMBIA ² | X | X | X | |
| FLORIDA ³ | | X ^a | X ^{ab} | |
| GEORGIA ³ | | X | X | |
| HAWAII | | | X | |
| IDAHO | | X | X | |
| ILLINOIS | | X ^a | X ^{ab} | |
| INDIANA | X | X ^{ab} | X ^a | |
| IOWA | | X | X | X ^c |
| KANSAS | | | | |
| KENTUCKY | | X | X | |
| LOUISIANA | | | X ^b | |

Table 7.2 (Continued)

| | Rule 504 | Rule 505 | Rule 506 | ULOE* |
|---------------------------|----------|----------------|-----------------|-----------------|
| MAINE | | | X | |
| MARYLAND | | X | X | |
| MASSACHUSETTS | | | | X ^c |
| MICHIGAN | | X | X | X ^c |
| MINNESOTA | | X | X ^b | X ^c |
| MISSISSIPPI | | X ^a | X ^{ab} | |
| MISSOURI | | X | X | |
| MONTANA | | X | X | |
| NEBRASKA | | X | X | |
| NEVADA ^{1,3} | X | X | X | |
| NEW HAMPSHIRE | | | | X ^d |
| NEW JERSEY ^{1,3} | X | X | X | |
| NEW MEXICO | | | | X ^d |
| NEW YORK ^{1,3} | X | X | X | |
| NORTH CAROLINA | | | X | |
| NORTH DAKOTA | | | | X ^e |
| OHIO | | | X | |
| OKLAHOMA | X | X | X | |
| OREGON | X | X | X | |
| PENNSYLVANIA | | X | X | X ^c |
| RHODE ISLAND | | | | X ^d |
| SOUTH CAROLINA | | | | X |
| SOUTH DAKOTA | | X | X | X ^{ce} |
| TENNESSEE | | | X | X ^c |
| TEXAS | | | X | |
| UTAH | | X | X | |
| VERMONT | | X | X | |
| VIRGINIA | | X | X | |
| WASHINGTON | X | | X | |
| WEST VIRGINIA | | | | X |
| WISCONSIN | | X | X | |
| WYOMING | | | | X |

Sources of Data

Harold S. Bloomenthal, *Securities Law Handbook, 1986-1987 Edition*.

Blue Sky Reporter. Commerce Clearing House.

^aSimilar exemption existed prior to Regulation D

^bVariations apply in connection with accredited investors

^cModified ULOE to count purchasers rather than offerees

^dExemption for isolated transactions

^eState filing is required

¹Only intrastate offerings are regulated

²Does not register securities

³Full SEC regulation obviates state registration

*Uniform Limited Offering Exemption drafted by the North American Association of Securities Administrations.

8. ACCOUNTANTS' LIABILITY UNDER THE FEDERAL SECURITIES ACTS

This is a complex and evolving area, and this section merely suggests a few of the issues involved. For a detailed listing of SEC releases, see appendixes 3 and 4 of this chapter. An excellent treatment, directed to certified public accountants, may be found in the book by Denzil Causey listed in this chapter's references.

8.1 Securities Act of 1933

Two sections of the 1933 act deal with the independent public accountant's liability, Section 11 and Section 12. Section 11(a) provides that any person may sue "every accountant . . . who has with his consent been named as having prepared or certified any part of the registration statement." To establish a case, the plaintiff must allege that

- The financial statements were misleading because of a misstatement or omission.
- The misstatement or omission was material.
- The security was purchased within a time period during which the law presumes that purchase was made in reliance on the statements.
- A loss was suffered.

Legal action must be brought within one year after the error is or should have been discovered, but in no case outside a period beginning with the date of the offering and ending three years thereafter. Reliance on the statements is presumed: It is not necessary for the plaintiff to allege and prove reliance upon, or even that he or she saw, the financial statements. Among the several defenses that could be claimed by a public accountant, two are worth our discussion:

The statements are not untrue by a material amount.

The public accountant exercised due diligence.

Although materiality is a concept much discussed in accounting literature, in securities-related matters it effectively becomes a matter of fact within the context of each case. An SEC rule (12b-2) states that an item is material if "there is a substantial likelihood that a reasonable investor would attach importance in determining whether to buy or sell the securities registered." In *Escott v. BarChris Construction Corp.*, 283 F. Supp. 643 (SDNY 1968), the court did not consider to be material an erroneous misstatement of earnings from \$.65 to \$.75 per share but did hold that an error in the current ratio, incorrectly inflating it from 1.6 to 1.9, was material. Although generalizations are difficult, it is

probably safe to say that the threshold of materiality in a securities case will be low enough to allow the admission to court of a case that is not perceived by the court to be otherwise deficient or trivial.

The due-diligence defense provides that no person, other than the issuer, shall be liable who shall sustain the burden of proof that he or she had, “after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true . . .” (Section 11(b)(3)). The act goes on to say that the standard of reasonableness shall be that of a prudent person in the management of his or her own property. Liability under Section 11 extends to the effective date of the registration statement, so it behooves a public accountant to exercise due diligence by reviewing events until as close to this date as is practicable. In the appropriate circumstances resignation and disclaimer of all responsibility in writing to the issuer and to the SEC by the effective date should be sufficient to avoid liability.

An independent accountant who audits financial statements to be included in a registration must assure that his or her engagement is performed and the work documented

- By persons having training and proficiency as public accountants and who work under adequate supervision.
- In accordance with generally accepted auditing standards (GAAS).

SEC-related cases in which accountants have been held liable suggest that these areas should be given particular attention:

- Indications of less than complete candor on the part of management
- Any doubts whatsoever concerning management integrity
- Conflicting or unsatisfactory explanations for unusual transactions that have more than a trivial impact on the financial statements
- Nontypical patterns of sales particularly near year end, or typical patterns when economic or competitive conditions would predict the contrary

Section 12(2) imposes liability on any person who “offers or sells a security . . . by means of a prospectus or oral communication, that includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements . . . not misleading.”

In other contexts it has been held that any written offer constitutes a prospectus, so any writing and any oral communication could be the basis of a legal action. Presumably, unless they become sellers or offerors of securities, certified public accountants are not likely to be charged

under this rule. Accountants, however, could be charged with aiding and abetting such a violation. The courts are split as to whether silence and inaction on the part of an accountant can lead to a charge of aiding and abetting. Within the last half-dozen years one court has stated there is no aiding nor abetting in the absence of knowledge by the accountant of a securities violation (for example, a misstatement in a financial statement) together with “substantial assistance” by the accountant (*IIT v. Cornfeld*, 619 F.2d 909 (2d Cir. 1980)). On the other hand, another court held that silence and inaction were sufficient for the charge where the defendant accountant intended to further the fraud or had an independent duty to disclose the misbehavior (*Woodward v. Metro Bank of Dallas*, 522 F.2d 84, 97 (5th Cir. 1975)).

8.2 Securities Exchange Act of 1934 and SEC Rule 10b-5

Section 10(b) of the 1934 act and the SEC’s interpretation in Rule 10b-5 create grounds for legal action against independent accountants. For our purposes the essence of the act and the rule may be stated as follows: In connection with the purchase or sale of any security, no person shall use any device to defraud; no person shall make any untrue statement of (or omit to state) a material fact; no person shall engage in any act that would operate as a fraud or deceit. Jurisdiction of the SEC through the act and rule is established if the mails or the telephone is used in any part of the scheme or if a check is cleared; thus, practically all securities transactions, including those that might appear to be intrastate and not subject to SEC jurisdiction, may be included. There is no requirement that any filing of any sort with the SEC be made or fail to have been made. Criminal actions can be brought by the Justice Department acting on the request of the SEC, or injured private parties may enter a civil suit to recover damages.

Considerable anxiety arose among certified public accountants when it appeared that the rule might be applied against them as a consequence of their “mere” negligence. This fear was mitigated when the Supreme Court held that a showing of scienter was required—that is, that the CPA had acted with the intent to make a misstatement or to defraud (*Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976)). The courts have not resolved whether conduct by a CPA that could be described as “reckless,” although without guilty intent, would be sufficient to fulfill the requirement for scienter.

9. GOING PUBLIC

“Going public” means offering stock for sale to the public. The Securities Act of 1933 requires that a registration statement be filed with the

SEC before a public offering of securities is made in interstate commerce or through the mails, unless the offering qualifies for an exemption. The registration statement is available to the public from the SEC. Somewhat similar requirements are imposed by the Securities Exchange Act of 1934 for certain companies—those seeking to have their securities listed and registered for public trading on an exchange and those whose equity securities are traded over the counter, having at least \$3 million in assets and at least 500 shareholders.

9.1 Registration Statement

The registration statement is a document presented in narrative form, similar to a brochure. Registration serves to provide investors with a source of information and does not constitute approval of the investment by the SEC.

The registration statement does not become effective immediately upon its filing. No sales of securities may be made until it becomes effective, although expressions of interest can be solicited from investors by showing them a preliminary prospectus called a “red herring.” Only the securities subjected to the filing process are considered registered; previously issued and outstanding securities must comply with SEC regulations before being resold.

A registration statement consists of two principal parts:

- A prospectus, or selling document, that must be furnished to all purchasers of the securities and
- A supplemental part containing information that will be available subsequently at the SEC or by mail upon request and the payment of a small fee.

Each of several forms tailored to the type of issuing company specifies the information required for registration. Form S-1 is the basic and most commonly used form for full registration of an initial public offering (IPO). Instructions for the financial statement portions of the forms are found in Regulation S-X. Regulation S-K gives instructions for the nonfinancial aspects of a registration. These regulations and forms are available from the publications section of the SEC. Registration statement requirements are discussed in sections 4.4, 5.4, and 5.5 of this chapter.

The company must provide whatever information is necessary to make the statement complete and not misleading. The SEC will not pass judgment on the value of the offering as an investment, but will frequently require amendments to the registration documents to improve disclosure.

9.2 Alternative Registration for Small Issues

Simplified registration on Form S-18 is available for securities to be sold to the public for cash at a price not exceeding \$7.5 million, provided the issuer is not subject to the continuous reporting requirements of the Securities Exchange Act of 1934. The issuer must have its principal place of business in the United States or Canada. The requirements for simplified registration are set forth in section 4.7 of this chapter.

9.3 Selling Securities Without Registration

Exempt transactions relate to securities sales that are technically not public offerings in that they are private or otherwise limited. As with all securities sales, antifraud laws apply and disclosures made to investors must be truthful. Despite federal exemption from registration, a “notification” must be filed with the SEC, and state securities laws may similarly require a filing. Issuing securities without registration and under an exemption may not fulfill company goals in that subsequent sales of the securities will be restricted by SEC rules.

Section 4.5 of this chapter deals with conditional exemptions under SEC Regulation A, as well as with exemptions under Regulation A, SEC Rule 147, and Section 4(6) of the 1933 Securities Act.

9.4 State Securities Laws

The term “blue sky laws” refers to laws governing securities sales in each of the fifty states. In some states, an effective federal registration fulfills all state requirements. In others, the registration statement or other disclosure document must be submitted to the state commissioner of securities. Most states have a system of merit review through which offerings are scrutinized for compliance with criteria such as the size of the underwriters’ commissions and fees. Most states require that sales reports be filed after the offering is complete since fees are based on sales within the state. State securities administrators can provide information. Section 7 of this chapter discusses state securities regulation.

9.5 Advantages and Disadvantages of Going Public

9.5.1 Advantages

A company’s prestige and image are usually enhanced by public sale of stock. Often greater respect will be accorded to the company and its management by customers, competitors, and associates.

CEOs report that employee morale significantly increases. Going public is an immediate wealth-builder for present owners, who could see a hundred-fold increase in documented personal wealth. Establishing a market valuation on stock makes stock options a more attractive benefit to executives and managers and is a less costly incentive than salary increases. Enhanced liquidity rewards company founders with a market for their stock. Pledging publicly offered stock makes personal borrowing easier. Liquidity of publicly held stock aids in estate planning.

A growing company needs a strong source of capital. A higher price per share can be commanded in a public offering than in a venture capital arrangement or private placement because the promised rate of return can be lower. Alternatively, a necessary amount of capital can be raised with less ownership dilution.

Good market performance of stock issued now will make it easier to raise capital in the future. An IPO improves the debt-to-equity ratio; future borrowings can be made on more favorable terms. Finally, a company's growth through acquisitions of other companies is facilitated by exchange of publicly traded stock.

9.5.2 Disadvantages

If significant percentages of stock are sold, loss of effective control of the company could result. Entrepreneurs accustomed to running their own show may find it difficult to work with a board of directors. Management flexibility will be lost; many desirable corporate maneuvers such as mergers and acquisitions must first gain shareholder approval.

Only shares registered and issued in an offering are freely tradable. Controlling shareholders may not freely sell their shares in the market without registration except under specified conditions. Shares previously issued, for example as management compensation, or issued to accredited investors in reliance on an exemption, are "restricted" and may be resold only in conformity with SEC regulations (SEC Rule 144).

Registration of even the smallest IPO may cost several hundred thousand dollars out-of-pocket. Much of this expense will be incurred even if the public issuance is not completed, for example, as a result of adverse market conditions. Further, ongoing operating expenses will increase as a result of statutorily mandated filings with the SEC, more complex legal and auditing requirements, and the record keeping and public relations costs of dealing with public shareholders.

Public disclosures must be made of the identity, business connections, and compensation of directors, officers, and major shareholders. Major customers and products, as well as their profitability, may have to be revealed. A spotlight will be turned on decisions and actions the

company founders will have become accustomed to keeping private. No longer can the company serve as a tax shelter for the owners.

The company's apparent worth—its market value—will be made visible, yet will vary subject to market conditions outside the control of management. “Bottom-line-itis” will focus pressure on short-range operating results. Long-term planning and prudent decision making may be more difficult to sustain. Lack of steady improvement in operating results may cause public stockholders to lose confidence and to sell their stock. Depressed stock prices cancel many of the advantages of going public.

9.6 Costs of Going Public

Because costs vary so widely from offering to offering, it is difficult to estimate typical fees. Excluding the underwriter's commission, which ranges from \$700,000 to \$1.2 million and is deducted from the sales proceeds, a \$10 million offering might incur these representative out-of-pocket costs:

| | |
|---|---------------------|
| Legal fees | \$ 50,000–\$200,000 |
| Accounting and auditing | \$ 50,000–\$200,000 |
| Printing | \$ 50,000–\$200,000 |
| Filing fees (SEC, NASD, state) | \$ 25,000 |
| Transfer agent, registrar fees, other costs | \$ 25,000 |

Accounting and auditing costs can be less for the company with good internal control, well-kept records, and a several-year history of physical inventory counts observed by an independent CPA. Legal fees vary widely and must be closely monitored. Printing costs depend upon the number of and the length of the prospectus(es); the necessity for corrections, use of drawings, photos, or maps; and the number of stock certificates. Ongoing costs for stock transfers, SEC filings, and added accounting and legal work can be estimated at \$50,000 to \$100,000 annually. Additionally, CEOs report that the process of registration consumes management time, significantly diverting attention from operations for six months to a year. Afterwards, many companies find they must staff an ongoing “department of stockholder relations” to act as a communications buffer between shareholders and officers.

Costs are considerably less for nonpublic sales under an exemption from registration. However, against this must be balanced the likely restrictions on subsequent public trading of the issued shares.

9.7 Deciding to Go Public

The decision to go public is best made by balancing the benefits of market valuation and liquidity against the loss of privacy in management.

Underwriters report that the equities market seems most receptive to IPOs having these parameters:

- An operating history of five years or more
- Annual sales of at least \$20 million
- Net income of \$1 million or more
- A demonstrated annual growth rate of at least 25 percent
- A justified need for at least \$5 million in capital, since many of the costs of the offering itself are fixed
- Promise of a “niche” position in their industry as a result of a unique product or technological process, the value of which can be readily perceived by the investment community
- A management team having breadth and credibility, preferably with one or two executives who have been successful in taking a company public

If a public offering is made prematurely and the stock flounders because growth is not sustained, permanent damage may be done to the issuer’s credibility among employees, investors, and customers. Raising capital in the public market afterward may be nearly impossible; “too public, too soon” is a refrain heard often from CEOs.

9.8 Planning and Assistance

Much work must be done before going public. Assistance to the company by several kinds of business advisers, including CPAs, will be needed to evaluate and carry out numerous steps:

- Prepare a business plan.
- Prepare a capital forecast of needs for several years.
- Calculate the effect that alternative offerings of various sizes and prices would have on earnings per share and book value.
- Improve internal accounting control to allow for efficient auditing.
- Begin audits of financial statements in anticipation of SEC requirements, keeping in mind that auditor independence is defined by SEC rules that are more stringent in one respect than those of the AICPA; independence is lost for the CPA firm when it, its partners, or its employees perform any general accounting or bookkeeping functions for the client. Advise changes to generally accepted accounting principles. (One-time changes for the purpose of going public are presented as retroactive restatements.)

- Review present shareholder records for accuracy.
- Discuss implications of related party transactions and arrangements.
- Call in loans to management and other insiders.
- Restructure contracts, particularly with insiders or other related parties, to conform to good business practices.
- Determine that significant contracts and employment agreements have been reduced to writing.
- Reevaluate existing plans or implement stock option plans that may be easier to pass before going public.
- Authorize additional shares for the public offering and future acquisitions or sales.
- Formalize record keeping of minutes of stockholders' and directors' meetings.
- Consider desirability of splitting stock, adjusting par value, retiring preferred or special classes of stock, eliminating the preemptive right, or otherwise adjusting capital accounts to create a simple and understandable capital structure.
- Combine affiliated companies to consolidate interrelated entities.
- Amend articles of incorporation and bylaws to be consistent with needs of a public company.
- Restructure the board of directors to replace family members with persons having widely recognized business credentials, such as bankers, retired executives, attorneys, and certified public accountants.
- Consider election of an outside director who has experienced the process of going public.
- Establish an audit committee of the board of directors.
- Evaluate the need for a more experienced management team.
- Begin providing information to the financial community before entering the registration pipeline, since to begin doing so during registration will violate SEC rules.
- Compromise, or otherwise settle litigation, since investors will avoid “buying a lawsuit.”

The assistance of a variety of professionals will be required in the course of a public offering of securities. Some of the more prominent participants in the process are discussed below.

9.8.1 Underwriters and Investment Bankers

There are three types of underwriting:

- Firm
- Best-efforts
- Standby

In a firm underwriting, the lead or managing underwriter puts together a syndicate of underwriters and a selling group of brokers and dealers. When the registration becomes effective, the lead underwriter, backed by the members of the syndicate, presents a check to the issuing company for the securities and then undertakes to sell them to the public.

Except in rare instances involving entrepreneurs with an extraordinary record of past successes, major underwriting firms will not undertake to raise “seed” money to develop unproven concepts. In every state, however, there are local investment firms that will tackle speculative offerings on a “best efforts” basis.

When the investment banker promises only to use his best efforts to sell the securities, the issuing company bears the risk that the securities may not sell. The issuer and the best-efforts underwriter may agree that no shares will be issued unless a minimum number or, perhaps, “all or none” are sold. This arrangement avoids the danger that too few shares will be sold for the company to benefit while being saddled with the chores and costs of public ownership. A firm underwriting by a major investment banker is testimony to the importance of the issuing company.

For large offerings, syndicates of underwriters and broker-dealers are formed by the lead underwriter to limit individual firms’ risk and to assure a broad distribution of the securities. The managing underwriter determines the allocation of shares to members of the syndicate and selling group.

In a standby underwriting, the underwriter stands ready to purchase securities that have been the subject of a rights offering to existing shareholders who choose not to buy them.

Choosing an investment banker is a critical decision. Investment bankers are recommended and introductions are arranged by accountants, attorneys, officers of public companies, or commercial bankers. Several should be interviewed before the lead underwriter is chosen. The firm should be chosen for its professional reputation, its client base, and its success with similar underwritings.

The business relationship between the issuer and the banker will be a continuing one. After the successful underwriting, the investment

banker will make a market in the company's securities, provide investment analysis to the financial community, and contribute ongoing advice to the company. Surveys show CEOs' dissatisfaction with an underwriter is frequently related to a lack of continuing service after the underwriting. A company planning an IPO should check out the experiences of others who have used the same underwriter.

Compensation to the underwriter is in the form of sales commissions and, sometimes, warrants for the purchase of securities and expense allowances for which no accounting is required. State securities commissioners and the National Association of Security Dealers have guidelines for reasonableness of the compensation.

9.8.2 Law Firms

Preparing the legal documents for filing with the SEC and state authorities is a highly specialized task. It should be entrusted only to a law firm having SEC experience or able to acquire it by association. Some state bar associations establish criteria for specialization in securities law. The company's present legal counsel may give recommendations, as may the underwriter, but the final choice is the company's.

9.8.3 Financial Public Relations Firms

The company going public must have its story put before the public, but the SEC restricts publicity that may be issued during the crucial "quiet period" beginning when a preliminary understanding has been reached with the underwriter and ending 90 days after the effective date of the registration. A financial public relations firm that is knowledgeable about the registration process can create a plan to develop public recognition. Mailing lists will be utilized to get the story to business analysts and journalists. Business magazines and major newspapers in the closest metropolitan area will be solicited for interviews. Presentations will be scheduled and publicized for delivery at appropriate trade shows; for example, at COMDEX for companies in computer-related fields.

9.8.4 Certified Public Accountants

Certified public accountants occupy a unique position. According to a recent small business survey, most CEOs reported their first advice regarding going public came from their CPAs.

Audits such as those required for S-1 and S-18 filings must be performed by an independent public or independent certified public accountant. Many disciplinary proceedings have been brought by the

SEC against accountants who were not in fact independent. Instances of violation of independence have been reported in these SEC releases: Financial Reporting Release (FRR) No. 1, Section 600, FRR No. 4, and in Accounting and Auditing Enforcement Releases (AAER). Accountants involved in SEC filings must familiarize themselves with the FRRs, AAERs, Regulation S-X, and the SEC's Staff Accounting Bulletins, as well as be knowledgeable concerning generally accepted accounting principles.

Major investment bankers underwriting an IPO of national scope will insist upon a CPA firm that has a national reputation. There is no SEC rule on this, but statements audited by CPA firms unknown to the SEC are given extra scrutiny.

The form and content for the auditor's opinion letter (or report) is set forth in Rule 2-02 of the SEC's Regulation S-X. Generally accepted auditing standards must be adhered to. The report contained in a Securities (1933) Act filing must not be qualified as to scope or fairness of presentation unless the qualification relates solely to material uncertainties concerning future events beyond the control of the registrant. The report must be manually signed and the independent accountant's written consent for its use must accompany the registration statement.

The accountant may assist in preparing tabular and other data contained in the registration statement aside from the audited statements, but must make it clear he or she does not assume responsibility for any matters not within his or her expertise as an accountant.

9.9 Pricing the Securities

The underwriter will seek a market price that will accomplish several objectives, the first of which is the rapid sale of the securities. Offerings are usually structured so that at least 500,000 shares can be sold at a price between \$10 and \$20. Prices below \$10 suggest speculative stocks; shares of unusual attractiveness might be priced higher than \$20. Major considerations are market conditions, the company's capital needs, and such factors as book value, return on assets and sales, and the history and likely stability of earnings growth. The banker will not recommend the highest possible price but instead a price that will be sustained once the market's initial enthusiasm wears off. Bankers try to underprice offerings slightly below the after-market price in order to reward those investors who purchase on the initial offering. This creates a loyal following for the underwriter. An often expressed goal is that the shares should increase 10 to 15 percent in market price in the 30 days following the issuance. Considerable fluctuation may be encountered, ranging

from -50 to +400 percent on a representative group of IPOs in a recent six-month period.

After notifying the SEC and conforming with strict guidelines, the underwriter is allowed to stabilize the price of the newly issued stock by entering buy orders just below the offering price. Resales of stock obtained by the underwriter through stabilization must be made below the stabilization price.

9.10 Public Trading

The following are the New York Stock Exchange minimum listing requirements:

- At least 1 million shares publicly held
- At least 2,000 shareholders
- Total market value of shares, \$16 million
- Net assets, at least \$18 million
- Pretax net income, \$2.5 million

The following are the American Stock Exchange minimum listing requirements:

- At least 300,000 shares publicly held
- At least 900 shareholders
- Total market value of shares, \$2.5 million
- Net assets, at least \$4 million
- Pretax net income, \$750,000

The following are the National Association of Securities Dealers Automated Quotation System (NASDAQ) requirements:

- At least 100,000 shares publicly held
- At least 300 shareholders
- \$1 million corporate net worth
- \$2 million assets
- Two or more market makers

There are no formal requirements for listing in the pink sheets—a daily service offered by the National Quotation Bureau. Quotes in the sheets are gathered from market makers on each of about 15,000 unlisted stocks.

REFERENCES

- Afterman, Allan B. *Handbook of SEC Accounting and Disclosure*. Boston: Warren, Gorham & Lamont, 1993. Annual.
- AICPA. *SEC Reporting*. CPE Course Manual. New York: American Institute of Certified Public Accountants, 1994.
- Bloomenthal, Harold S. *Emerging Trends in Securities Law, 1992*. New York: Clark Boardman Callaghan, 1992.
- . *Going Public Handbook, 1993*. New York: Clark Boardman Callaghan, 1993.
- . *Securities and Federal Corporate Law*. 4 vols. Revision. New York: Clark Boardman Callaghan. Looseleaf service.
- . *Securities Law Handbook*. 1992–1993 ed. New York: Clark Boardman Callaghan. Supplemented.
- Blue Sky Law Reports*. 4 vols. Chicago: Commerce Clearing House. Looseleaf service.
- Capital Changes Reports*. Chicago: Commerce Clearing House. Looseleaf service.
- Causey, Denzil Y., Jr. *Duties and Liabilities of Public Accountants*. State College, Miss.: Accountant's Press, 1991.
- . *RICO Business Disputes Guide*. Chicago: Commerce Clearing House, 1984. Looseleaf service.
- Federal Securities Law Reports*. Chicago: Commerce Clearing House. Looseleaf service.
- Fippinger, Robert A. *The Securities Law of Public Finance*. New York: Practising Law Institute, 1988.
- Gadsby, Edward N. *Federal Securities Exchange Act of 1934*. 8 vols. New York: Matthew Bender. Looseleaf service.
- Graham, John W. *The U.S. Securities and Exchange Commission: A Research and Information Guide*. New York: Garland Publishing, Inc., 1993.
- Hazen, Thomas Lee. *Law of Securities Regulation: The Pocket Parts, 1992*. St. Paul, Minn.: West Publishing Company, 1993.
- . *The Law of Securities Regulation; Practitioner's Edition*. 2 vols. 2d ed. St. Paul, Minn.: West Publishing Company, 1993.
- Janvey, Ralph S. *Regulation of the Securities and Commodities Markets*. Boston: Warren, Gorham & Lamont, 1992.

- Jennings, Richard W. *Federal Securities Laws, Selected Statutes, Rules and Forms, 1991*. Westbury, N.Y.: Foundation Press, Inc., 1992.
- . *Securities, Regulation, Cases and Materials, 1993 Supplement (Continuing Selected Cases, Releases, and Other Materials Under the Federal Securities Laws)*, 7th ed. Westbury, N.Y.: Foundation Press, 1993.
- Langevoort, Donald C., ed. *Securities Law Review—1992*. New York: Clark Boardman Callaghan, 1992.
- Loss, Louis, and Joel Seligman. *Securities Regulation*. 3 vols. 3d ed. New York: Little, Brown, 1988. Supplemented.
- Pessin, Allan H. *Securities Law Compliance: A Guide for Brokers, Dealers and Investors*. Burr Ridge, Ill.: Irwin Professional Publishing, 1989.
- Pointer, Larry G., and Richard G. Schroeder. *An Introduction to the Securities and Exchange Commission*. Homewood, Ill.: Richard D. Irwin, Inc., 1986.
- Poloway, Morton, and Thomas B. Wall. *Accountant's SEC Practice Manual*. Chicago: Commerce Clearing House. Looseleaf service.
- Prifti, William A. *Securities Law Handbook for Financial Planners*. New York: Clark Boardman Callaghan, 1991.
- . *Securities: Public and Private Offerings*. Clark Boardman Callaghan, 1990.
- Ratner, David L. *Securities Regulation, 1991 Supplement*. 4th ed. St. Paul, Minn.: West Publishing Company, 1991.
- . *Securities Regulation in a Nutshell, 4th ed.* St. Paul, Minn.: West Publishing Company, 1992.
- Rice, Denis T. *Securities Regulation Forms*. New York: Clark Boardman Callaghan, 1988.
- SEC Accounting and Reporting Manual*. New York: Warren, Gorham & Lamont. Looseleaf service.
- SEC Accounting Rules*. Chicago: Commerce Clearing House. Looseleaf service.
- SEC Compliance—Financial Planning and Forms*. Warren, Gorham & Lamont. Looseleaf service.
- SEC Enforcement Reporter*. Washington, D.C.: Washington Service Bureau, Inc. Looseleaf service.
- SEC Guidelines, Rules & Regulations, 1994*. New York: Warren, Gorham & Lamont. Annual.

- SEC Service*, 5th ed. New York: Pandick Press. Looseleaf service.
- Securities Law Techniques*. 5 vols. New York: Matthew Bender. Looseleaf service.
- Securities Regulation and Law Report*. Washington, D.C.: Bureau of National Affairs. Looseleaf service.
- Skousen, Fred K. *An Introduction to the SEC*, 5th ed. Cincinnati: South-Western College Division, 1990.
- Soderquist, Larry D. *Securities Regulation*, 1991 Supplement (Containing Statutes, Rules and Forms, and Selected New Material), 2d ed. Westbury, N.Y.: Foundation Press, 1991.
- . *Understanding the Securities Laws*. New York: Practising Law Institute, 1990.
- Sowards, Hugh L., and Neil H. Hirsch. *Blue Sky Regulation*. 3 vols. New York: Matthew Bender. Looseleaf service.
- . *Federal Securities Acts—Treatise and Primary Source Manual*. 5 vols. New York: Matthew Bender. Looseleaf service.
- Steinberg, Marc I., and Ralph C. Ferrara. *Securities Practice—Federal and State Enforcement*. 2 vols. Wilmette, Ill.: Callaghan & Company, 1990. Looseleaf service.
- Steinberg, Marc I. *Securities Regulation*, 2d ed. New York: Matthew Bender, 1993.
- U.S. Securities and Exchange Commission. *Decisions and Reports*, Vol. 49, July 1, 1988, to May 30, 1989. Washington, D.C.: U.S. Government Printing Office, 1993.
- Wang, P. *Fundamentals of Securities Law and Compliance*. New York: New York Institute of Finance, 1989.

APPENDIX 1: Common 1933 Act Forms for Registration of Securities

| <u>Form</u> | <u>For Registration of Securities</u> |
|----------------|---|
| S-1 | Used when no other form is applicable. Used primarily by first-time registrants and those who have been publicly held companies for fewer than three years. Requires inclusion of all specified information in the prospectus. (Foreign governments use Form F-1.) |
| S-2 | Available to companies that are subject to 1934 Act reporting requirements for at least three years but don't meet the requirements to use Form S-3. Requires incorporating by reference registrant's 1934 Act reports. Must furnish to investors certain registrant-related information either by including it in the prospectus or by delivering with the prospectus the annual shareholder report and subsequent interim reports. |
| S-3 | Available to companies subject to the 1934 Act reporting requirements for at least three years and meeting certain market value, trading, or debt-rating tests. Requires incorporating by reference the registrant-related information from the 1934 Act reports. Disclosure generally is limited to information about the offering. |
| S-4 | Registration of securities to be issued in a business combination. Permits, in certain cases, incorporating by reference information included in 1934 Act filings of the issuer and the target company. |
| S-6 | For unit investment trusts. |
| S-8 | Securities offered to employees under various employee stock plans. |
| S-11 | For certain real estate companies. |
| S-18 | Optional simplified form to register securities up to \$7.5 million during any twelve-month period. Available to companies not subject to the periodic reporting requirements of the 1934 Act. May be filed in a regional office. Audited financial statements prepared in accordance with GAAP are required, but Regulation S-X requirements do not apply. In general, requires a balance sheet as of the latest fiscal year, as well as an income statement and statement of cash flows for the last two fiscal years. It requires less detailed disclosure of segment information and pension matters. No management's discussion and analysis discussion is required. |
| <u>Form</u> | <u>For Exemptions From Registration</u> |
| I-A (Reg A) | Available for an offering under the "small issues" exemption (Reg A). Maximum offering is \$1.5 million (and up to an additional \$300,000 for selling shareholders) during any twelve-month period. Offering statement to be filed with regional office containing an Offering Circular that includes financial statements, risk factors, and other information. Financial statements must comply with GAAP but not Regulation S-X. Balance sheet as of ninety days prior to filing; statements of income, cash flows, and stockholder's equity for two fiscal years. Need not be audited unless issuer filed (or was required to file) audited financial statements with the SEC during the year. There are many advantages to this type of offering. |

| <u>Form</u> | <u>For Exemptions From Registration</u> |
|--------------|---|
| D (Reg D) | <p>For offerings under Reg D (Rules 501–506). Due fifteen days <i>after</i> the first sale of securities. Regulation D consists of Rules 501–506.</p> <ul style="list-style-type: none"> ● Rule 504—may offer up to \$1 million during any twelve-month period. Cannot be used by investment companies or by issuers subject to section 13 or 15(d) of the 1934 Act. Registration and disclosures generally are not required. ● Rule 505—may offer up to \$5 million during any twelve-month period. Offer limited to thirty-five non-“accredited” investors and to unlimited “accredited” investors (see definition following). ● Rule 506—allows the “private placement” of securities with an unlimited number of accredited investors and up to thirty-five nonaccredited persons. However, under this rule, each nonaccredited purchaser of the issuer must reasonably believe he or she is “sophisticated” (can evaluate merits and risks of offered securities). No limit is set to the amount that may be offered. <p>(Form D is also used for offerings pursuant to Rule 4(6).)</p> |

Financial Statement Requirements for Regulation D Offerings

- Nonreporting companies:
 - Offerings up to \$2 million—GAAP financial statements for the last two years. Latest balance sheet must be audited.
 - Offerings up to \$7.5 million—GAAP financial statements for last two years. Latest year must be audited.
 - Offerings over \$7.5 million—Regulation S-X financial statements required.
- Reporting companies: Irrespective of offering size, present either (1) Proxy statement and annual shareholders’ report, or (2) Form 10-K or 10, or Part I of Form S-1, S-11, or S-18.

Distribution of Prospectus

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

Definition of Accredited Investor

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

APPENDIX 2: Commonly-Used 1934 Act Forms for Registration of Securities

| <u>Form</u> | <u>Annual Reports</u> |
|----------------|---|
| 10-K | Form used by most domestic (and Canadian) registrants for which no other form is prescribed |
| 11-K | Employee stock purchase, saving, and similar plans |
| 18-K | Foreign governments and their political subdivisions |
| 20-F | Foreign private issuers. Also used for registration under the 1940 Act |
| | <u>Interim and Current Reports</u> |
| 10-Q | Quarterly report for each of the first three quarters of the fiscal year |
| 8-K | Current report filed when certain significant events occur |
| 6-K | Periodic reports by foreign issuers |
| | <u>Registration of Securities Under the 1934 Act</u> |
| 10 | Securities for which no other form is prescribed |
| 18 | Securities of foreign governments and their political subdivisions |
| 8-A | Short form for certain classes of securities |
| 8-B | Securities issued in certain cases on succession to an issuer of previously registered securities |
| | <u>Other</u> |
| 8 | To amend reports or registration statements |
| 12b-25 | Notification to SEC when unable to file periodic reports on a timely basis |
| 15 | To terminate registration under the 1934 Act or suspend periodic reporting obligations |
| Schedule 13D | Report by any person who becomes a 5 percent equity security holder of a public company. Also used to report material changes in beneficial ownership |
| Schedule 13E-3 | To report a going private transaction |
| Schedule 13E-4 | To report a tender offer for one's own equity securities |
| Schedule 14D-1 | For tender offers if offeror would end up with more than 5 percent of target company |

APPENDIX 3: SEC Accounting and Reporting Requirements

Regulation S-X

Regulation S-X contains the uniform instructions for financial statements included in most SEC filings. Briefly, it states the periods for which financial statements are required, the form and content of those statements including note disclosures and supplemental schedules, and discusses the qualification of accountants' and auditors' reports. Regulation S-X should be considered a *minimum* standard. Amendments to S-X are announced in the financial reporting releases (FRRs).

Financial statement requirements for 1933 and 1934 Act filings include—

- *Audited Balance Sheets*—as of the end of each of the two latest fiscal years.
- *Audited Statements of Income, Cash Flows, and Stockholder's Equity*—for each of the three latest fiscal years.
- *Audited Financial Statement Schedules*—as applicable in support of primary financial statements. (If the registrant is inactive (Reg S-X, Rule 3-11), the financial statements may be unaudited.)

Financial statements are generally required for—

- Registrant and its consolidated subsidiaries.
- Registrant alone (parent company).
- Unconsolidated subsidiaries and 50-percent-or-less-owned persons.
- Affiliates whose securities are pledged as collateral.
- Guarantors of securities registered.

A summary of each of the Articles of Reg S-X follows.

| <u>Article</u> | <u>Subject</u> | <u>Summary of Contents</u> |
|----------------|--|---|
| 1 | Application of Regulation S-X | Specifies the registration statements and reports to which Regulation S-X is applicable and defines terminology used in the Regulation. |
| 2 | Qualifications and reports of accountants | Contains the requirements as to the qualifications (independence) of accountants and the contents of their reports. |
| 3 | General instructions for financial statements | Sets forth instructions for (1) the nature of financial statements required and the persons, dates, and periods they must cover and (2) the age of interim financial statements required to be included in registration and proxy statements. |
| 3A | Consolidated and combined financial statements | Contains the requirements for the presentation of consolidated and combined financial statements. |
| 4 | Rules of general application | Contains the rules for form, order, and terminology, and for certain of the notes required to be furnished as part of the financial statements. |
| 5 | Commercial and industrial companies | Sets forth the information to be included in balance sheet and statement of income captions for commercial and industrial companies. Also specifies the schedules that are to be filed. |

| <u>Article</u> | <u>Subject</u> | <u>Summary of Contents</u> |
|----------------|---|--|
| 6 | Registered investment companies | These articles set forth the information to be included in financial statements of special types of entities. |
| 6A | Employee stock purchase, savings, and similar plans | |
| 7 | Insurance companies | |
| 9 | Bank holding companies | |
| 10 | Interim financial statements | |
| 11 | Pro forma financial information | Sets forth the form and content of interim financial statements and the period for which such statements must be presented in Form 10-Q. |
| 12 | Form and content of schedules | Specifies the form and content of pro forma financial disclosures and when such disclosures are required. Also provides guidance for the presentation of financial forecasts that may be furnished in lieu of pro forma disclosures. |
| | | Sets forth the form and content of schedules required in accordance with Rule 5-04 (and certain other rules for special types of entities). |

Financial Reporting Releases

In 1982 the SEC replaced the Accounting Series Releases (ASRs) with the Financial Reporting Releases (FRRs) and AAERs. FRRs serve to—

- Communicate the SEC's views on accounting, disclosure, and auditing matters, and
- Announce changes to Regulations S-X and S-K and forms.

A listing of FRRs issued to date follows.

| <u>FRR No.</u> | <u>Date</u> | <u>Summary of Contents</u> |
|----------------|-------------|---|
| 1 | 4/82 | Codification of financial reporting policies. |
| 2 | 6/82 | Instructions for presenting and preparing pro forma financial information and requirements for financial statements of businesses acquired or to be acquired. |
| 4 | 10/82 | Public availability of correspondence about accountants' independence. |
| 5 | 10/82 | Accountants' liability for reports on unaudited supplementary financial information. |
| 6 | 11/82 | SEC encourages experimentation with disclosure of foreign operations and foreign currency translation effects. |
| 7 | 11/82 | Adoption of foreign issuer integrated disclosure system. |
| 8 | 12/82 | Financial statement requirements for registered investment companies. |
| 9 | 12/82 | Supplemental disclosures of oil- and gas-producing activities. |
| 10 | 2/83 | Qualifications and reports of accountants; amendment of rules on accountants' independence relating to certain company employees. |

| <i>FRR No.</i> | <i>Date</i> | <i>Summary of Contents</i> |
|----------------|-------------|--|
| 11 | 3/83 | Revision of financial statement requirements and industry guide disclosure for bank holding companies. |
| 12 | 8/83 | Accounting for costs of internally developing computer software for sale or lease to others. |
| 13 | 8/83 | Revision of industry guide disclosures for bank holding companies. |
| 14 | 9/83 | Oil and gas producers—Full cost accounting practices; amendment of rules. |
| 15 | 12/83 | Interpretive release on accounting for extinguishment of debt. |
| 16 | 3/84 | Rescission of interpretation on qualified auditors' reports in 1933 Act registration statements. |
| 17 | 4/84 | Oil and gas producers—Full cost accounting practices relating to revenue recognition. |
| 18 | 4/85 | Business combination transactions—Adoption of registration form. |
| 19 | 4/85 | Business combination transactions—Adoption of registration form; foreign registrants. |
| 20 | 11/84 | Rules and guide for disclosures concerning reserves for unpaid claims and claim-adjustment expenses of property-casualty underwriters. |
| 21 | 6/85 | Technical amendments to rules and forms. |
| 22 | 11/85 | Technical amendments to rules and forms. |
| 23 | 12/85 | The significance of oral guarantees to the financial reporting process. |
| 24 | 1/86 | Disclosure amendments to Regulation S-X regarding repurchase and reverse repurchase agreements. |
| 25 | 5/86 | Technical amendments to Rule 3A-02. |
| 26 | 10/86 | Interpretive release about disclosures of the effect of the Tax Reform Act of 1986. |
| 27 | 10/86 | Amendment to Industry Guide—Disclosures by Bank Holding Companies. |
| 28 | 12/86 | Accounting for loan losses by registrants engaged in lending activities. |
| 29 | 6/87 | Accounting for distribution expenses. |
| 30 | 8/87 | Disclosure of the effects of inflation and other changes in prices. |
| 31 | 4/88 | Disclosure amendments to Regulation S-K, Form 8-K, and Schedule 14A regarding changes in accountants and potential opinion-shopping situations. |
| 32 | 8/88 | Disclosure obligations of companies affected by the government's defense contract procurement inquiry and related issues. |
| 33 | 10/88 | Public availability of correspondence about accountants' independence. |
| 34 | 3/89 | Acceleration of the timing for filing Forms 8-K relating to changes in accountants and resignations of directors; amendments to Regulation S-K regarding changes in accountants. |

| <u>FRR No.</u> | <u>Date</u> | <u>Summary of Contents</u> |
|----------------|-------------|--|
| 35 | 3/89 | Amendments to reporting requirements for issuer's change of fiscal year; financial reporting changes; period to be covered by first quarterly report after effective date of initial registration statement. |
| 36 | 3/89 | Management's discussion and analysis of financial condition and results of operations; certain investment company disclosures. |

Accounting and Auditing Enforcement Releases

The Accounting and Auditing Enforcement Releases (AAERs) announce SEC enforcement actions involving accountants. They discuss SEC investigations and conclusions regarding violations of GAAS and GAAP, and any disciplinary actions taken against the accountants. These matters were announced in the ASRs until 1982. As of the end of October 1990, 283 AAERs were issued.

Staff Accounting Bulletins

Staff Accounting Bulletins (SABs) are interpretations of and practices followed by the Division of Corporation Finance and the Office of the Chief Accountant in administering the accounting and disclosure requirements of the federal securities laws. SABs are not official releases of the Commission and are not part of Regulation S-X, but should be considered when preparing financial statements to be included in SEC filings. A listing of SABs issued to date follows.

| <u>SAB No.</u> | <u>Date of Release</u> | <u>Summary of Contents</u> | <u>Topical Listing Reference</u> |
|----------------|------------------------|--|----------------------------------|
| 40 | 1/81 | Codification of SAB Nos. 1-38 (SAB No. 39 was superseded by ASR No. 29). | various |
| 42 | 12/81 | SEC concern about the application of existing accounting standards to business combinations accounted for by the purchase method involving financial institutions. | 2-A3 |
| 42A | 12/85 | Amortization of goodwill by financial institutions upon becoming SEC registrants. | 2-A4 |
| 43 | 1/82 | Early adoption of the new rules for separate financial statements required by Regulation S-X. | 6-K |
| 44 | 3/82 | Implementation of Accounting Series Release No. 302 (FRR No. 1, Section 213) and deletion of topics no longer relevant. | 6-K |
| 45 | 5/82 | Presentation of pro forma financial information for a pooling of interests. | 2-C |
| 46 | 5/82 | Requirements for interim financial reporting. | 6-G1; 6-G2 |
| 47 | 9/82 | Oil- and gas-producing activities. | 2-D; 12 |
| 47A | 9/82 | Correction of SAB No. 47 concerning minimum property conveyances. | 12-D4 |
| 48 | 9/82 | Assets acquired from promoters and shareholders prior to an IPO, in exchange for stock, should be recorded at cost to promoter or shareholder. | 5-G |

| <u>SAB No.</u> | <u>Date of Release</u> | <u>Summary of Contents</u> | <u>Topical Listing Reference</u> |
|----------------|------------------------|--|----------------------------------|
| 49 | 10/82 | Disclosure by bank holding companies about loans in countries experiencing liquidity problems. | 11-H |
| 49A | 1/83 | Additional disclosures by bank holding companies about certain foreign loans. | 11-H |
| 50 | 3/83 | Financial statement requirements in filings involving the formation of a one-bank holding company. | 1-F |
| 51 | 3/83 | Accounting for sales of stock by a subsidiary. | 5-H |
| 52 | | Deleted. | |
| 53 | 6/83 | Financial statement requirements in filings involving the guarantee of securities by a parent or subsidiary. | 1-G; 1-H |
| 54 | 11/83 | Push-down basis of accounting required in certain limited circumstances. | 5-J |
| 55 | 11/83 | Allocation of expenses and related disclosure in financial statements of subsidiaries, divisions, or lesser business components of another entity; cheap stock; 1933 Act registration statement of a subsidiary should reflect all costs incurred by parent on its behalf. | 1-B; 4-D |
| 56 | 1/84 | Reporting of an allocated transfer risk reserve in filings under the federal securities laws. | 11-I |
| 57 | 7/84 | Value of contingent stock purchase warrants not to be measured on date agreement is executed. Measure cost after warrants are exercised. Cost is difference between quoted market price on date on which warrants are earned and the amount customer must pay. | 5-K |
| 58 | 3/85 | Last-in, first-out (LIFO) inventory practices. | 5-L |
| 59 | 9/85 | Accounting for noncurrent marketable equity securities. Charge realized loss for decline below market value. | 5-M |
| 60 | 12/85 | Financial guarantees. | 11-J |
| 61 | 5/86 | Loan losses. | 2-A5 |
| 62 | 7/86 | Discounting by property-casualty insurance companies. | 5-N |
| 63 | 9/86 | Research and development arrangements. | 5-O |
| 64 | 10/86 | Applicability of guidance in Staff Accounting Bulletins; reporting of income or loss applicable to common stock; accounting for redeemable preferred stock; issuance of shares prior to an initial public offering. | 6-C; 6-B; 3-C; 4-D |
| 65 | 11/86 | Risk sharing in pooling of interests. | 2-E |
| 66 | 11/86 | Disclosures by certain bank holding companies regarding certain foreign loans. | 11-H |
| 67 | 12/86 | Income statement presentation of restructuring charges. | 5-P |
| 68 | 5/87 | Increasing rate preferred stock. | 5-Q |
| 69 | 5/87 | Application of Article 9 and Guide 3; income statement presentation of casino-hotel activities. | 11-K; 11-L |

| <u>SAB No.</u> | <u>Date of Release</u> | <u>Summary of Contents</u> | <u>Topical Listing Reference</u> |
|--------------------|----------------------------|---|--|
| 70 | 6/87 | Accounting for nonrecourse debt collateralized by lease receivables and/or leased assets. | 5-R |
| 71 | 8/87 | Financial statements of properties securing mortgage loans. | 1-I |
| 71A | 12/87 | Financial statements of properties securing mortgage loans. | 1-I |
| 72 | 11/87 | Classification of charges for abandonments and disallowances. | 10-E |
| 73 | 12/87 | Push-down basis of accounting required in certain limited circumstances. | 5-J |
| 74 | 12/87 | Disclosure of the impact that recently issued accounting standards will have on the financial statements of the registrant when adopted in a future period. | 11-M |
| 75 | 1/88 | Disclosures by bank holding companies regarding certain foreign loans. | 11-H2 |
| 76 | 1/88 | Risk sharing in pooling of interests. | 2-E2 |
| 77 | 3/88 | Debt issue costs. | 2-A6 |
| 78 | 8/88 | Quasi-reorganization. | 5-S |
| 79 | 9/88 | Accounting for expenses or liabilities paid by principal stockholder(s). | 5-T |
| 80 | 11/88 | Financial statements of businesses acquired or to be acquired. | 1-J |
| 81 | 4/89 | Gain recognition on the sale of a business or operating assets to a highly leveraged entity. | 5-U |
| 82 | 7/89 | Transfers of nonperforming assets; disclosure of the impact of financial assistance from regulators. | 5-V; 11-N |
| 83 | 8/89 | Earnings per share computations in an initial public offering. | 4-D |
| 84 | 8/89 | Accounting for sales of stock by a subsidiary. | 5-H |
| 85 | 9/89 | Gross revenue method of amortizing capitalized costs. | 12-F; 12-G |
| 86 | 9/89 | Quasi-reorganization. | 5-S |
| 87 | 12/89 | Uncertainties concerning property and casualty loss reserves may require FASB No. 5 contingency disclosures. | 5-W |
| 88 | 8/90 | Certain disclosures required of foreign private issues. | 1-D1 |

APPENDIX 4: SEC Industry Guides

The SEC issued several guides under the 1933 and 1934 Acts dealing with certain industry-specific disclosures. The guides are not official Commission releases but should be considered when filing registration statements and periodic reports. The guides are listed in subpart 800 of Regulation S-K.

| <u>Industry Guide No.</u> | <u>1933 Act Industry Guides</u> |
|---------------------------|---|
| 1 | Disclosure of principal sources of electric and gas revenues. |
| 2 | Disclosure of oil and gas operations. |
| 3 | Statistical disclosure by bank holding companies. |
| 4 | Prospectuses relating to interests in oil and gas programs. |
| 5 | Preparation of registration statements relating to interests in real estate limited partnerships. |
| 6 | Disclosures concerning unpaid claims and claim adjustment expenses of property-casualty insurance underwriters. |

| <u>Industry Guide No.</u> | <u>1934 Act Industry Guides</u> |
|---------------------------|---|
| 1 | Disclosure of principal sources of electric and gas revenues. |
| 2 | Disclosure of oil and gas operations. |
| 3 | Statistical disclosure by bank holding companies. |
| 4 | Disclosures concerning unpaid claims and claim adjustment expenses of property-casualty insurance underwriters. |

APPENDIX 5: State Securities Regulators**Alabama**

Securities Commission
166 Commerce Street,
2nd floor
Montgomery, AL 36130
205/261-2984

Alaska

State of Alaska
Division of Banking and
Securities
Dept. of Commerce
P.O. Box D
Juneau, AK 99811
907/465-2521

Arizona

Securities Division
Corporation Commission
1200 W. Washington, Suite 201
Phoenix, AZ 85007
602/542-4242

Arkansas

Securities Department
201 E. Markham, 3rd floor
Heritage West Building
Little Rock, AR 72201
501/371-1011

California

Department of Corporations
1115 Eleventh St.
Sacramento, CA 95814
916/445-7205

Colorado

Division of Securities
1580 Lincoln St., Suite 420
Denver, CO 80203
303/894-2320

Connecticut

Dept. of Banking
44 Capitol Ave
Hartford, CT 06106
203/566-4560

Delaware

Department of Justice
Division of Securities
820 N. French St., 8th floor
Wilmington, DE 19801
302/571-2515

District of Columbia

Public Service Commission,
Securities Division
450 5th Street, N.W., 8th floor
Washington, DC 20001
202/626-5105

Florida

Division of Securities
Office of the Comptroller,
LL-22
The Capitol Building
Tallahassee, FL 32399-0350
904/488-9805

Georgia

Securities Division
Business Services and
Regulations
2 Martin Luther King, Jr. Dr.,
S.E., Suite 306
West Tower
Atlanta, GA 30334
404/656-2894

Hawaii

Securities Enforcement
P.O. Box 40
Honolulu, HI 96810
808/548-6134

Idaho

Securities Division
700 W. State Street
Boise, ID 83720
208/334-3313

Illinois

Secretary of State
Securities Department
900 S. Spring Street
Springfield, IL 62704
217/782-2256

Indiana

Securities Commission
1 N. Capitol Street, Suite 560
Indianapolis, IN 46204
317/232-6681

Iowa

Securities Bureau
Lucas State Office Building
Des Moines, IA 50319
515/281-4441

Kansas

Securities Commission
618 S. Kansas Ave., 2nd floor
Topeka, KS 66603-3804
913/296-3307

Kentucky

Financial Institutions Dept.
Division of Securities
911 Leewood Drive
Frankfort, KY 40601
502/564-2180

Louisiana

Securities Commission
315 Louisiana State Office
Bldg.
325 Loyola Avenue
New Orleans, LA 70112-1878
504/568-5515

Maine

Bureau of Banking
Securities Division
State House Station 121
Augusta, ME 04333
207/582-8760

Maryland

Division of Securities
200 St. Paul Place, 20th floor
Baltimore, MD 21202-2020
301/576-6360

Massachusetts

Secretary of State Office
Securities Division
1 Ashburton Place, Suite 1701
Boston, MA 02108
617/727-3548

Michigan

Securities Division
Department of Commerce
6546 Mercantile
Lansing, MI 48909
517/334-6209

Minnesota

Registration and Licensing
Division
Department of Commerce
133 East Seventh St.
St. Paul, MN 55101
612/296-2594

Mississippi

Office of Secretary of State
Securities Division
P.O. Box 136
Jackson, MS 39205
601/359-1350

Missouri

Division of Securities
Office of Secretary of State
301 W. High Street
Truman Building, 8th floor
Jefferson City, MO 65102
314/751-2302

Montana

Securities Division
Office of State Auditor
P.O. Box 4009
Helena, MT 59604-4009
406/444-2040

Nebraska

Department of Banking
and Finance
Securities Bureau
P.O. Box 95006
301 Centennial Mall S.
Lincoln, NB 68509-5006
402/471-3445

Nevada

Secretary of State
Securities Division
2501 E. Sahara Ave
Suite 201
Las Vegas, NV 89158
702/486-4400

New Hampshire

Office of Securities Regulation
157 Manchester Street
Concord, NH 03301
603/271-1463

New Jersey

Bureau of Securities
Department of Law and Public
Safety
Two Gateway Center, 8th floor
Newark, NJ 07102
201/648-2040

New Mexico

Securities Division
725 St. Michaels Drive
Santa Fe, NM 87501
505/827-7140

New York

Department of Law
Bureau of Securities
120 Broadway, 23rd floor
New York, NY 10271
212/341-2222

North Carolina

Office of Secretary of State
Division of Securities
300 N. Salisbury St., Suite 404
Raleigh, NC 27611
919/733-3924

North Dakota

Securities Commissioner's
Office
600 East Blvd., 5th floor
Bismarck, ND 58505
701/224-2910

Ohio

Division of Securities
State Office Tower Two,
22nd floor
77 South High Street
Columbus, OH 43266-0548
614/466-3001

Oklahoma

Department of Securities
P.O. Box 53595
Oklahoma City, OK 73152
405/521-2451

Oregon

Department of Insurance and
Finance
Securities Section
21 Labor and Industries Bldg.
Salem, OR 97310
503/378-4387

Pennsylvania

Securities Commission
1010 North Seventh Street
Eastgate Office Building,
2nd floor
Harrisburg, PA 17102
717/787-6828

Puerto Rico

Securities Office
Office of the Commissioner of
Financial Institutions
P.O. Box 70324
San Juan, PR 00936
809/751-7837

Rhode Island

Securities Division
Dept. of Business Regulation
233 Richmond Street
Suite 232
Providence, RI 02903-4232
401/277-3048

South Carolina

Secretary of State
Securities Division
Edgar Brown Building
1205 Pendleton St., Suite 501
Columbia, SC 29201
803/734-1087

South Dakota

Department of Commerce &
Regulations
Division of Securities
910 East Sioux
Pierre, SD 57501
605/773-4823

Tennessee

Securities Division
Department of Commerce and
Insurance
500 James Robertson Parkway
Suite 680
Nashville, TN 37243
615/741-2947

Texas

Securities Board
1800 San Jacinto Street
Austin, TX 78701
512/474-2233

Utah

Securities Commissioner's
Office
The Department of Commerce
P.O. Box 45802
Salt Lake City, UT 84145-0802
801/530-6600

Vermont

Securities Division
The Department of Banking
and Insurance
120 State Street
Montpelier, VT 05602
802/828-3420

Virginia

Division of Securities and Retail
Franchising
State Corporation
Commissioner
P.O. Box 1197
Richmond, VA 23209
804/786-7751

Virgin Islands of the U.S.

Office of the Lieutenant
Governor
Division of Banking and
Insurance
Kongens Gade #18
St. Thomas, VI 00802
809/774-2991

Washington

Securities Division
Department of Licensing
P.O. Box 648
Olympia, WA 98504
206/753-6928

West Virginia

Securities Division
Office of State Auditor
State Capitol, Room W-118
Charleston, WV 25305
304/348-2257

Wisconsin

Commissioner of Securities
P.O. Box 1768
Madison, WI 53701
608/266-3431

Wyoming

Securities Division
Secretary of State
State Capitol Building
Cheyenne, WY 82002
307/777-7370

Other Agencies**Exchanges**

New York Stock Exchange
Arbitration Dept.
20 Broad Street, 5th floor
New York, NY 10005
212/656-2772

National Assoc. of Securities
Dealers
Contact your district office or
write to:
Surveillance Dept.
1735 K Street, NW
Washington, DC 20006

Chicago Board of Trade
Office of Investigation and
Audit
141 W Jackson Blvd., B Level
Chicago, IL 60604
312/435-3679

American Stock Exchange
Investor Inquiries
86 Trinity Place
New York, NY 10006
212/306-1452

Chicago Board Options
Exchange
Dept. of Market Regulation
400 S. LaSalle Street
Chicago, IL 60605
312/786-7705

Chicago Mercantile Exchange
Compliance Department
30 S. Wacker Drive
Chicago, IL 60606
312/930-1000

APPENDIX 6: SEC Regulation S-X (Excerpts on Accountants' reports and general instructions regarding financial statements)

From Rule 1.02 Article 1, Application of Regulation S-X

Accountant's Report. The term "accountant's report," when used in regard to financial statements, means a document in which an independent public or certified public accountant indicates the scope of the audit (or examination) which he has made and sets forth his opinion regarding the financial statements taken as a whole, or an assertion to the effect that an overall opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefor shall be stated.

From Rule 2-02, Accountants' Reports

(a) *Technical Requirements.* The accountant's report (1) shall be dated; (2) shall be signed manually; (3) shall indicate the city and State where issued; and (4) shall identify without detailed enumeration the financial statements covered by the report.

(b) *Representations as to the Audit.* The accountant's report (1) shall state whether the audit was made in accordance with generally accepted auditing standards; and (2) shall designate any auditing procedures deemed necessary by the accountant under the circumstances of the particular case, which have been omitted, and the reasons for their omission.

Nothing in this rule shall be construed to imply authority for the omission of any procedure which independent accountants would ordinarily employ in the course of an audit made for the purpose of expressing the opinions required by paragraph (c) of this rule.

(c) *Opinion to be Expressed.* The accountant's report shall state clearly: (i) the opinion of the accountant in respect of the financial statements covered by the report and the accounting principles and practices reflected therein; and (ii) the opinion of the accountant as to the consistency of the application of the accounting principles, or as to any changes in such principles which have a material effect on the financial statements.

(d) *Exceptions.* Any matters to which the accountant takes exception shall be clearly identified, the exception thereto specifically and clearly stated, and, to the extent practicable, the effect of each exception on the related financial statements given.

From **Article 2. Qualifications and Reports of Accountants**

Rule 2-01, Qualifications of Accountants

(a) The Commission will not recognize any person as a certified public accountant who is not duly registered and in good standing as such under the laws of the place of his residence or principal office. The Commission will not recognize any person as a public accountant who is not in good standing and entitled to practice as such under the laws of the place of his residence or principal office.

(b) The Commission will not recognize any certified public accountant or public accountant as independent who is not in fact independent. For example, an accountant will be considered not independent with respect to any person or any of its parents, its subsidiaries, or other affiliates (1) in which, during the period of his professional engagement to examine the financial statements being reported on or at the date of his report, he, his firm, or a member of his firm had, or was committed to acquire, any direct financial interest or any material indirect financial interest; or (2) with which, during the period of his professional engagement to examine the financial statements being reported on, at the date of his report or during the period covered by the financial statements, he, his firm, or a member of his firm was connected as a promoter, underwriter, voting trustee, director, officer, or employee. A firm's independence will not be deemed to be affected adversely where a former officer or employee of a particular person is employed by or becomes a partner, shareholder or other principal in the firm and such individual has completely disassociated himself from the person and its affiliates and does not participate in auditing financial statements of the person or its affiliates covering any period of his employment by the person. For the purposes of Rule 2-01(b), the term "member" means: (i) all partners, shareholders, and other principals in the firm, (ii) any professional employee involved in providing any professional service to the person, its parents, subsidiaries, or other affiliates, and (iii) any professional employee having managerial responsibilities and located in the engagement office or other office of the firm which participates in a significant portion of the audit.

(c) In determining whether an accountant may in fact be not independent with respect to a particular person, the Commission will give appropriate consideration to all relevant circumstances, including evidence bearing on all relationships between the accountant and that person or any affiliate thereof, and will not confine itself to the relationships existing in connection with the filing of reports with the Commission.

From **Article 3, General Instructions as to Financial Statements**

Rule 3-01, Consolidated Balance Sheets

(a) There shall be filed, for the registrant and its subsidiaries consolidated, audited balance sheets as of the end of each of the two most recent fiscal years. If the registrant has been in existence for less than one fiscal year, there shall be filed an audited balance sheet as of a date within 135 days of the date of filing the registration statement.

(b) If the filing, other than a filing on Form 10-K or Form 10, is made within 45 days after the end of the registrant's fiscal year and audited financial statements for the most recent fiscal year are not available, the balance sheets may be as of the end of the two preceding fiscal years and the filing shall include an additional balance sheet as of an interim date at least as current as the end of the registrant's third fiscal quarter of the most recently completed fiscal year.

(c) The above instruction is also applicable to filings, other than on Form 10-K or Form 10, made after 45 days but within 90 days of the end of the registrant's fiscal year, *provided* that the following conditions are met:

(1) The registrant files annual, quarterly and other reports pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934 and all reports due have been filed;

(2) For the most recent fiscal year for which audited financial statements are not yet available the registrant reasonably and in good faith expects to report income, after taxes but before extraordinary items and cumulative effect of a change in accounting principle; and

(3) For at least one of the two fiscal years immediately preceding the most recent fiscal year the registrant reported income, after taxes but before extraordinary items and cumulative effect of a change in accounting principle.

(d) For filings made after 45 days but within 90 days of the end of the registrant's fiscal year where the above conditions are not met, the filing must include the audited balance sheets required by the first paragraph of this rule.

(e) For filings made after 134 days subsequent to the end of the registrant's most recent fiscal year the filing shall also include a balance sheet as of an interim date within 135 days of the date of filing.

(f) Any interim balance sheet provided in accordance with the requirements of this rule may be unaudited and need not be presented in greater detail than is required by Rule 10-01. Notwithstanding the requirements of this rule, the most recent interim balance sheet

included in a filing shall be at least as current as the most recent balance sheet filed with the Commission on Form 10-Q.

Rule 3-02, Consolidated Statements of Income and Changes in Financial Position

(a) There shall be filed, for the registrant and its subsidiaries consolidated and for its predecessors, audited statements of income and changes in financial position for each of the three fiscal years preceding the date of the most recent audited balance sheet being filed, or such shorter period as the registrant (including predecessors) has been in existence.

(b) In addition, for any interim period between the latest audited balance sheet and the date of the most recent interim balance sheet being filed, and for the corresponding period of the preceding fiscal year, statements of income and changes in financial position shall be provided. Such interim financial statements may be unaudited and need not be presented in greater detail than is required by Rule 10-01.

Rule 3-04, Changes in Other Stockholders' Equity

An analysis of the changes in each caption of other stockholders' equity presented in the balance sheets shall be given in a note or separate statement. This analysis shall be presented in the form of a reconciliation of the beginning balance to the ending balance for each period for which an income statement is required to be filed with all significant reconciling items described by appropriate captions. State separately the adjustments to the balance at the beginning of the earliest period presented for items which were retroactively applied to periods prior to that period. With respect to any dividends, state the amount per share and in the aggregate for each class of shares.

From **Rule 4-08, General Notes to Financial Statements** (Topics)

Principals of Consolidation or Combination

Assets Subject to Lien

Defaults on Debt

Preferred Shares

Restrictions Which Limit the Payment of Dividends by the Registrant

Significant Changes in Bonds, Mortgages, and Similar Debt

Summarized Financial Information of Subsidiaries not Consolidated
and 50 percent-or-less owned persons

Income Tax Expense

Warrants or Rights Outstanding

**Leased Assets and Lease Commitments of Regulated Enterprises Subject
to the Rate-Making Process
Related Party Transactions Which Affect the Financial Statements
Repurchase and Reverse Repurchase Agreements**

APPENDIX 7: Solicitation of Proxies

Securities Exchange Act of 1934, Regulation 14A

Rule 14a-3 of the regulation states that “no solicitation subject to this regulation shall be made unless each person solicited is concurrently furnished, or has previously been furnished, with a written proxy statement containing the information specified in Schedule 14A.”

Information Required in a Proxy Statement (Schedule 14A)

- Date, time, and place information.
- Revocability of proxy.
- Dissenters’ rights of appraisal.
- Names of persons making the solicitation.
- Description of interest of certain persons in matters to be acted upon.
- Voting securities and principal holders thereof.
- Names of directors and executive officers.
- Compensation of directors and executive officers.
- Names of independent public accountants.
- Compensation plans.
- Authorization or issuance of securities otherwise than for exchange.
- Modification or exchange of securities.
- Financial and other information (including financial statements meeting the requirements of Regulation S-X).
- Mergers, consolidations, acquisitions, and similar matters.
- Acquisition or disposition of property.
- Restatement of accounts.
- Action to be taken with respect to reports.
- Matters not required to be submitted to a vote of securityholders.
- Amendment of charter, by-laws, or other documents
- Other proposed action.
- Vote required for approval.

OBTAINING FINANCING

1. INTRODUCTION

2. PRELIMINARY CONSIDERATIONS

- 2.1 Analysis of Needs
- 2.2 The Effects of Borrowing
- 2.3 Preparing Financial Projections and Client Information

3. SHORT-TERM FINANCING

- 3.1 Trade Credit
 - 3.1.1 Trade credit terms
 - 3.1.2 Sight drafts and time drafts
 - 3.1.3 Letters of credit
 - 3.1.4 Advantages and disadvantages
- 3.2 Short-Term Financing Through Commercial Banks
 - 3.2.1 Characteristics
 - 3.2.1.1 Security agreements
 - 3.2.1.2 Cosigners
 - 3.2.2 Bank credit cards
 - 3.2.3 Line of credit
 - 3.2.4 Character loans
 - 3.2.5 Choosing a lender
 - 3.2.6 Advantages and disadvantages
- 3.3 Commercial Paper
- 3.4 Commercial Finance Companies
 - 3.4.1 Financing accounts receivable
 - 3.4.2 Factoring accounts receivable
 - 3.4.3 Collection
 - 3.4.4 Security interest
 - 3.4.5 Advantages and disadvantages
- 3.5 Inventory Financing
 - 3.5.1 Field warehouse financing
 - 3.5.2 Trust receipts financing
 - 3.5.3 Chattel mortgage security financing
 - 3.5.4 Advantages and disadvantages

4. INTERMEDIATE-TERM FINANCING

- 4.1 Term Loans
- 4.2 Installment Equipment Financing
- 4.3 Lease Financing
 - 4.3.1 Lease accounting rules: FASB 13
 - 4.3.2 Analysis of leasing costs

OBTAINING FINANCING

- 4.4 Government Lending Programs
 - 4.4.1 The Small Business Administration (SBA)
 - 4.4.2 SBICs and MESBICs
 - 4.4.3 VA and FmHA
 - 4.4.4 Industrial revenue bonds
 - 4.4.5 State and local programs
- 4.5 Business Development Corporations
- 4.6 Community Development Companies

5. LONG-TERM DEBT FINANCING

- 5.1 Instruments of Long-Term Debt Financing
 - 5.1.1 Bonds
 - 5.1.2 Mortgages
 - 5.1.2.1 Points
 - 5.1.2.2 Adjustable rate mortgages (ARMs)
 - 5.1.3 Common and preferred stock
 - 5.1.3.1 Initial public offerings (IPOs)

6. EMPLOYEE STOCK OWNERSHIP PLANS (ESOPs)

- 6.1 Stock Bonus Plans (SBPs)
- 6.2 Leveraged ESOPs

7. VENTURE CAPITALISTS

8. THE ECONOMICS OF REFINANCING

9. THE IMPORTANCE OF FINANCIAL STATEMENTS

- 9.1 Procedure of Creditor Analysis
- 9.2 Creditor Analysis of Financial Ratios
 - 9.2.1 The current ratio
 - 9.2.2 Debt-to-total-assets ratio
 - 9.2.3 Debt-to-equity ratio
 - 9.2.4 Times-interest-earned ratio
 - 9.2.5 Quick ratio or acid-test ratio
 - 9.2.6 Inventory-turnover ratio
 - 9.2.7 Return on assets
 - 9.2.8 Net-income-to-sales ratio
 - 9.2.9 Cost-of-sales-to-payables ratio
 - 9.2.10 Debt-to-net-worth ratio
- 9.3 How Creditors Use Ratio Analysis

10. THE FINANCING PROPOSAL PACKAGE

REFERENCES

(Text continued on page 3)

1. INTRODUCTION

In many situations, accountants are asked to advise clients or businesses in need of funds. Often, the inflow of new funds can mean the survival of the entity. In addition, accountants may be requested to prepare data for presentation to potential lenders and investors. The importance of proper assistance in these tasks must not be underestimated.

Financing sources change constantly as the needs of borrowers change. Services provided by creditors are also changing. Many current financing tools evolved to meet borrowers' special needs. As a result, particular financing needs may require creativity in dealing with creditors. This chapter explores many of the financing avenues currently available and provides information that will enable accountants to better assist clients and businesses in obtaining funds from both internal and external sources. It should be viewed as an overview and preliminary guidance source discussing general considerations.

This chapter is limited to initial considerations of needs and sources and to preparation of a financing package to present to lenders. Since rates and costs are subject to constant change, the generalizations herein should be used only to provide comparisons between the rates and costs of alternative sources.

2. PRELIMINARY CONSIDERATIONS

Before recommending a financing source and compiling a financial presentation, the accountant should take several fundamental steps, including

- Analyzing the borrower's needs.
- Discussing the effects of borrowing with management.
- Examining alternative financial sources and providing cost-benefit analysis for each source.

2.1 Analysis of Needs

When examining financing sources, it is necessary to determine the purpose of the loan. For example, a loan may be used to increase working capital, in which case it may be harder to provide the lender a security interest in fixed assets than would be the case if the funds were necessary for plant or machinery purchases. Normally the type of financing is selected according to the use of funds.

Another example is the underleveraged borrower who has investment opportunities at high rates of return. In that case corporate bonds may be an attractive alternative, providing funds upon which a higher rate of return might be expected.

A borrower may need funds to accommodate seasonal pressures. In this circumstance, the funding required may be less and the ability to pay may arise at the end of the season, so short-term borrowing may be appropriate.

Several other questions should be addressed for a thorough analysis. The accountant will want to know

- The amount needed.
- How long the funds will be needed.
- When and how funds will be available for repayment.
- Whether or not sufficient collateral exists to secure the debt.
- Whether equity funding would meet the client's need satisfactorily, or whether debt financing would be more appropriate.
- How soon the funds will be needed.
- The intended use of the fund proceeds.

At this point, the accountant would understand the funding sources that are likely to be available and the cost of obtaining funds from alternative sources.

Common financing needs include business start-up capital, long-term working capital, seasonal working capital, equipment financing, business expansion, and debt restructuring in the case of a financially distressed business. Each of these needs might lead to different funding alternatives. For example, long-term working capital needs would be funded differently than seasonal working capital needs, since seasonal needs can be met with short-term financing. Similarly, the financing alternatives available and the interest rate paid may be significantly different for expanding a successful business as opposed to restructuring a financially distressed business.

In assessing the business needs and the financing alternatives available, the needs mentioned may require drastically different financing approaches. For example, a start-up business may consider venture capital or a similar alternative. For long-term working capital needs, real estate loans and unsecured term loans may be appropriate. For seasonal working capital needs, trade credit and a line of credit may be the best approach. For equipment and facilities acquisition, loans or leases tied to the equipment or real estate may be most appropriate. To finance business growth, certain term loans, or alternatively, equipment and real estate loans, may again be appropriate.

2.2 The Effects of Borrowing

Management should be advised of the risks of borrowing. If funds have been obtained through a personal guarantee and personal statements, the client may need to have independent counsel explain the extent of liability in the event of default. This discussion should also explain why risk increases as leveraging increases.

2.3 Preparing Financial Projections and Client Information

The accountant must remember that cash-flow projections and sales forecasts are vital in material lending decisions. Such projections require consideration of the capital sources to best match the client's needs.

In addition to cash-flow projections and sales forecasts, other information related to the client's goals and objectives, as well as to the client's business and industry, should be gathered. The objectives behind the fund request might influence the accountant's determination of the type of lender to approach. For example, certain funding sources specialize in providing venture capital for new businesses, while other financing sources provide funds for expansion and facilities acquisition.

The accountant should gather data on the business ownership, finances, operations, and personnel and might also want to seek information regarding the client's attorney, banker, and credit reporting agencies.

The owners' financial strength should be analyzed. An assessment should be completed as to whether the owners could provide additional sources of funds. Prior financial statements should be analyzed to complete sales forecasts and projections, and if such information is not available, the accountant should help the client develop the forecasts and projections.

The accountant should also consider the type of product being sold, the industry position of the client along with the potential market for the products, and other factors, such as competition, company facilities, and inventory-turnover ratios. An analysis of gross profit ratios and other trends for the past few years should also be completed.

The accountant should also complete a summary of the education, experience, and other capabilities of the client's key personnel. This will help the lender evaluate the enterprise's ability to meet debt obligations plus the potential for growth and business success. In the case of a start-up business, the information related to personnel is particularly important since historical financial data are not available. Once again,

the accountant can assist the client in preparing personnel data when resumés of key management personnel are not available.

The accountant should also study industry data related to the client and compare key ratios to those of the industry in general. Many financial institutions subscribe to annual statement studies by independent organizations to analyze the industry averages. The following ratios are commonly used by financial institutions:

- Current assets to current liabilities
- Net profits to tangible net worth
- Average collection period of receivables
- Net sales to inventory
- Net fixed assets to tangible net worth
- Total debt to tangible net worth
- Net profit and net sales

A financial projection assists the client in determining the precise funding requirements and the repayment schedule. Additionally, a financial projection shows lenders how the company expects to grow and fund its projected debt retirement.

The accountant should help the client project cash flow of receipts and disbursements over the loan amortization period. If an operating budget already exists, the needed information may be readily available. If an operating budget does not exist, the accountant should assist the client in projecting cash receipt and disbursement amounts. To effectively estimate sales, the accountant needs to gain a thorough understanding of the client's business and industry and also of the general business and economic conditions. The accountant might want to categorize the client's products into various groups to establish sales patterns and then interview management and other key personnel to establish the assumptions on which the sales estimates can be based. Additionally, prior-period statements can be analyzed, and various financial models may also be used.

To complete the projection, the accountant should establish assumptions for cost of sales, expenses, and other factors affecting net income. The sales estimate can be established based on volume projections and unit sale prices. Cost of sales can be estimated based on historical information or on projected future cost factors.

A projected income statement on the accrual accounting method should be converted to cash receipts and disbursements by adjusting for various uncollected and unpaid items. Accounts receivable and accounts payable factors can be considered, along with other income

and expense items not generating or requiring cash. For a further discussion, see the chapter on Business Plans.

3. SHORT-TERM FINANCING

3.1 Trade Credit

Trade credit exists when businesses make sales or purchases on terms resulting in future, rather than immediate, payment. For example, a purchase on the twentieth of March might not require payment until the tenth of April. If payment were then made on April 10, the buyer would have received twenty-one days of “interest-free” credit.

Trade credit is a “spontaneous” financing source because it becomes available from ordinary business transactions. It is a very flexible credit source because it may be repaid at the purchasing company’s option and does not affect control of the company. As a result of the flexibility and relative ease of obtaining trade credit, many firms choose to utilize all credit that is available to them in the normal course of their business. From the standpoint of the seller, however, trade credit may be a costly (but necessary) sales promotion device.

3.1.1 Trade credit terms

Trade credit terms can fluctuate widely between various industries and companies and may also vary according to the seller’s perception of the risk each buyer represents. Accordingly, it may be important for the buyers to show as much objective data as possible that provide a basis for obtaining favorable terms.

In some industries, more standardized credit terms are based on various factors, including

- The nature of the product (higher-turnover items usually have shorter-term credit, reflecting increased ability to pay and lack of security after assets are sold).
- The buyer’s financial soundness (sound buyers are usually accorded more favorable terms, since providing them credit involves less risk).
- The seller’s financial soundness (sound sellers are better able to use credit terms as a sales promotion device because of their resources).
- The competitive conditions the seller faces (most often in highly competitive businesses, trade credit extension becomes necessary).

Trade credit terms may be stated in such terms as “2/10, net 30.” This means that if payment is made within ten days, a 2 percent cash discount will be allowed, but full payment will be due within thirty days, regardless.

The early-payment discount should be taken when the buyer can borrow at a rate of interest that is less than the cost of not taking advantage of the cash discount. In the example above the cost of not taking the discount may be computed using the following formula:

$$\begin{array}{r}
 \text{Cost of not} \\
 \text{taking discount}
 \end{array}
 = \frac{2 \text{ (discount percent)}}{(100 - \text{discount percent})}$$

$$\begin{array}{r}
 \text{TIMES} \\
 360 \\
 \hline
 20 \text{ (due date less discount period)}
 \end{array}$$

$$\begin{array}{r}
 \text{EQUALS} \\
 \frac{2}{98} \times \frac{360}{20}
 \end{array}$$

$$\begin{array}{r}
 \text{EQUALS} \\
 \text{approximately } 36.7\%
 \end{array}$$

The cost of using trade credit for twenty days instead of paying early is at an effective interest rate of 36.7 percent.

3.1.2 Sight drafts and time drafts

Sight drafts and time drafts are used when a seller demands payment from a buyer and title to goods is not transferred until the payment is made. A sight draft requires a buyer to pay at the time of receipt of goods or services (i.e., “at sight” of the goods or services). A time draft allows the buyer to defer payment for a specified time after receipt. Examples of time drafts might be 30, 60, or 90 days. Drafts involve the extension of credit from the seller to the buyer. The seller must wait for money until payment is made.

3.1.3 Letters of credit

A letter of credit is used when the buyer’s bank, upon the request of the buyer, promises to pay the seller an agreed sum of money provided required documents are properly prepared and delivered to the bank within a specified time period. By using letters of credit, the credit risk of the buyer is replaced with the credit risk of the bank of the buyer. Almost all letters of credit are irrevocable, such that the credit cannot be altered or canceled by the buyer without the permission of the seller. Using letters of credit may be expensive for the buyer because funds

may need to be committed before merchandise or documents giving title have been received. However, letters of credit do protect both the buyer and seller from loss.

3.1.4 Advantages and disadvantages

There are several advantages to using trade credit. It allows firms more flexibility in their financing sources without affecting the control of the business. Trade credit is often less formal and more available than other credit sources, since the seller is often in a good position to judge the buyer's ability to resell the product. Furthermore, since trade credit is sometimes used as a sales promotion device, the terms may be extremely favorable in order to further the seller's goal of extending its markets.

On the other hand, utilizing trade credit is not always a sound financing policy. Often, if the early-payment discount is not taken, the cost of this credit becomes very high and the buyer would find better financing elsewhere. Trade credit is dependent on goods purchased and services offered by specific trade creditors.

3.2 Short-Term Financing Through Commercial Banks

Short-term bank credit is an extremely popular source of financing for all types of businesses. Often a business relationship is established with

(Text continued on page 9)

a local commercial bank through which the bank may become a participant in the business's financial planning. The types of loans offered by commercial banks vary greatly and using a commercial bank for short-term financing provides many options.

Short-term financing emphasizes the borrower's financial capacity in the near future. Therefore, emphasis on cash flow lending as opposed to net worth lending increases. Banks are increasingly looking for projections and other assurances that indebtedness can be repaid through cash generated, and are placing a lower emphasis on the borrower's net worth. Certain lending based solely on net worth as opposed to cash flow factors has historically given rise to problems. For example, as more lending occurred in the agricultural sector based on the value of farmland, a significant decline in farmland values, and accordingly in net worth, occurred, resulting in lenders' finding themselves under-collateralized.

Many banks use the prime rate and other indexes as bases of interest rates. This allows the interest rates of many loans to vary, minimizing the lending institution's interest rate risk. Thus, when the prime rate and other specified amounts increase, the interest rates on many loans also increase automatically.

In determining the cost of bank credit, the real borrowing cost of such credit must also be analyzed. Some arrangements require compensating balances to be maintained. A compensating balance is a required minimum noninterest-bearing checking account balance that a borrower must maintain with the lender bank. The balance is generally equal to 15 to 20 percent of the amount of the loan outstanding, but it varies by bank. Compensating balances raise the effective interest rate on bank loans.

3.2.1 Characteristics

Short-term commercial loans have several unique characteristics. For example, a short-term commercial loan is usually for a period of ninety days or less. It may be secured or unsecured, depending on the amount of risk the bank faces in evaluating the prospects for timely repayment. This type of financing is generally used to take advantage of suppliers' trade discounts, to expand inventory levels, or to finance seasonal liquidity shortages.

3.2.1.1 Security agreements

When a bank loan is secured, the lender normally executes a security agreement. Under a security agreement, the borrower pledges certain business assets as collateral. For example, when the lender takes a security interest in accounts receivable and inventory, the business

pledges those assets as collateral under the terms of the lending agreement. Security interests are often publicly recorded to protect the lender's interest.

The lending institution might alternatively obtain the borrower's personal guarantee. While such a loan is not collateralized by business or other assets, a guarantee for loan repayment exists with the borrower's full faith and credit. Normally, borrowers with higher incomes and significant net worths are able to obtain loans offering no more than personal guarantees (also see section 3.2.4).

3.2.1.2 Cosigners

On certain loan types, another individual is required to cosign the debt instrument on the borrower's behalf. In the event the borrower defaults on payments under the loan terms, the lending institution is then able to pursue collection attempts with the cosigner, who essentially offers a personal guarantee for loan repayment.

Agreements with a cosigner are common in new business relationships. In these agreements, a friend or relative, often the new businessperson's parent, cosigns and guarantees the note, thus allowing financing to occur.

3.2.2 Bank credit cards

Bank credit cards issued by commercial banks are another type of short-term credit. The credit card eliminates virtually all the risk of accounts receivable to the retailer and allows the bank to extend receivables-based credit to the bank's customers. The accountant must carefully weigh the benefit of this immediate cash flow against the normally higher cost the bank will charge for this service.

3.2.3 Line of credit

Another type of short-term credit offered by commercial banks is a line of credit. Typically, when a bank grants a line of credit to a business it provides that, so long as certain conditions and terms are met, the bank is willing to provide the business an agreed amount of funds. Interest is charged only on the amount actually owed to the bank during the period of credit. The bank may, however, ask for a fee to keep the line of credit open or may cancel at its own option. Normally, the borrower is an established business with known profitability.

3.2.4 Character loans

Short-term commercial bank credit may also take the form of character loans, which are generally unsecured and made available because of

the outstanding credit rating of the business or individual applying for the funds. Even though not secured by specific business assets, these loans often require the personal guarantee of the borrower, an officer, or a related party.

In general, these short-term commercial bank loans are self-liquidating, meaning repayment will follow the normal liquidation of inventory and receivables. Much bank lending is for a short period under the above-mentioned loan arrangements, which leaves the bank in a position to meet the needs of other commercial borrowers entering seasonal periods in which additional borrowing is necessary.

3.2.5 Choosing a lender

The accountant should point out the differences among banks when considering them as a source of financing. A larger bank will be able to spread its risk out over a broader range of investments and therefore may be able to provide financing to a business that might be considered too risky for a small bank. A smaller bank, on the other hand, may offer more personal service.

Many times, the business relationship with a specific bank's management or loan officer may be much more important than with the bank as a whole. This is particularly true with small businesses and smaller banks.

Another factor to consider in choosing a commercial bank is the amount of financial and business counseling it may be able to provide. For example, some bank loan officers specialize in working with growth companies or companies in the developmental stage.

Another characteristic in which banks differ is the degree of loyalty that will be evidenced in bad economic times. This is most important to companies in high-risk and seasonal businesses for which a forced loan liquidation at the wrong time could be disastrous.

The accountant should examine the degree of loan specialization when choosing a commercial lender. The bank chosen should be the one with the greatest amount of experience in the borrower's industry. By choosing an experienced lender, the borrower may receive more active support and creative cooperation in the particular line of business in which it is engaged.

Finally, the accountant should consider such commonsense factors as whether or not the bank is large enough to handle the borrower's financing needs or whether the borrower has had previous dealings with an area bank in another capacity and has thereby developed a good credit record with that bank.

Bankers are normally concerned with the following factors:

- *Character*: Will the borrower do everything in his or her power to repay the indebtedness?
- *Capital*: Has the borrower invested a sufficient amount of his or her own capital in the business?
- *Capacity*: Does the borrower have the managerial skill to use the funds wisely and profitably?
- *Collateral*: Does the borrower have such a high personal credit standing that he or she can borrow unsecured, or do sufficient assets exist to pledge as collateral?
- *Circumstances*: If the business is of a seasonal nature, what is the competitive position of the company, the nature of the product, and so forth?
- *Coverage*: Is there insurance to protect against the death of an owner, the stoppage of operations due to business interruption, and so forth?

A banker studying a borrower's financial statements will look for indications such as: the inventory level in relation to sales; excessive salaries paid to the owners; substantial officer loans; a high percentage of past-due receivables; extremely high investments in property, plant, and equipment; an overextended credit position; or an unstable company structure.

On a more detailed level, the banker will want information regarding the following:

- *Inventory*: This may include detail reflecting the amount in raw materials, work-in-process, and finished goods by type of product, in addition to any obsolete or consigned inventory.
- *Receivables*: Any receivables that are pledged, a listing of aged receivables, the largest receivable customers, and the percentage these receivables represent.
- *Equipment*: Type, age, and condition of equipment, along with an appraisal.

In almost all cases of closely held business borrowing, the officers or stockholders of the company will be required to give a personal guarantee and might also be required to maintain a compensating balance with the bank. As described in section 3.2.1.2 on cosigners, if the position of the company is extremely weak, the bank may request another guarantee on the loan.

The loan interest rate will vary with the loan's size and terms, and with the risk associated with granting the funds.

3.2.6 Advantages and disadvantages

The advantages of using a commercial bank for this type of financing include a close working relationship between lender and borrower. A borrower who might be considered a high credit risk elsewhere might be an acceptable candidate for a commercial bank loan. Clients should be advised to seek financing from banks large enough to have a sophisticated profitability analysis, thereby evaluating profitability from all sources of business the client provides to the bank. In addition, by using commercial bank loans, the company establishes a working financial relationship that may be essential in times of business emergency as well as a foundation for supporting the client's growth, acquisitions, or expansion needs.

Disadvantages of commercial banks as a source of short-term funds include the fact that they have a limited lending capacity. Title 12 of the United States Code (Section 84) provides that the limit of the obligation to any national bank "shall at no time exceed 10 percent of the amount of capital stock." Most state banking laws are similar to or more restrictive than the federal law on this point.

Another disadvantage of commercial banks as sources of short-term lending is the possibility that they may provide only limited management counsel. Because of the loan volume banks ordinarily handle, it is impractical for them to provide detailed counsel to more than a few of their many customers.

3.3 Commercial Paper

Corporations with a national reputation and a good-to-excellent credit rating may turn to a commercial paper house, which resells the promissory notes of reputable corporations and businesses. Commercial paper financing is normally only available to extremely large corporations and is not available to small, closely held corporations. There are two types of commercial paper—industrial paper (issued by major industrial firms) and finance paper (sold directly by finance companies).

Generally, commercial paper yields are slightly higher than Treasury bills of the same maturity. Although maturity generally ranges from two to six months, average maturity is about five months. Commercial paper is generally bought in round dollar amounts and as a series of notes. Dealers prefer handling the paper of businesses with high net worths because of the high expense of handling these notes.

There are several advantages in using the commercial paper market to obtain financing:

- It allows the broadest and most advantageous distribution of paper.
- It provides more funds at lower rates than most other financing methods.
- The borrower can avoid the expense and inconvenience of having to obtain financing from other institutions, which may each require a compensating balance.
- As the borrower's paper (and therefore product) becomes more widely known, some goodwill may accrue.
- The commercial paper dealer is often available to offer expert financial advice to clients.

The main disadvantage of commercial paper is its high cost. The company must have enough liquidity to cover this cost. Also, a company that faces temporary financial difficulty may receive better consideration from a commercial bank than from a commercial paper house.

3.4 Commercial Finance Companies

Finance companies generally participate in financing other companies' credit sales as well as providing funds for short-term purposes. These finance companies borrow funds from investors and bankers in large denominations and then lend them directly to businesses and other customers. As a result, commercial finance companies are often less desirable as a financing source than banks because the interest cost of funds is higher. Commercial finance companies also provide several services.

3.4.1 Financing accounts receivable

Accounts receivable financing involves the pledging or sale of the company's receivables. Since accounts receivable can be reasonably and accurately valued and are usually liquid, they make a suitable asset for pledging to obtain funding. Then, as the accounts receivable are collected, the indebtedness is reduced. When the full value of the receivables is not pledged, the excess collections are returned to the debtor.

The procedure for financing accounts receivable between the seller and the financial institution begins with creating a legally binding contract between the parties. This contract generally includes:

- The percentage to be advanced on accounts sold or pledged (often approximately 80 percent).
- The procedures to be followed for account collections.
- The parties' legal obligations.
- The schedule of the accounts assigned.
- The procedure for dealing with overpayments to the lender.
- The interest amount the lender will charge.

The more specific the contract, the less likely it is that problems will arise.

3.4.2 Factoring accounts receivable

When receivables are actually sold to a financial institution, the sale may be made with or without recourse. The financial institution would normally prefer that the sale be made with recourse, so that the risk of the account not being fully collected lies with the business selling the receivables. If the accounts receivable are purchased without recourse, the process is called *factoring*.

When the lending company factors the accounts receivable, it is in fact assuming the credit risk and therefore the service will be more expensive. Usually, a factor will charge a percentage commission on net invoice amounts factored and will also charge interest at a rate between 3 and 4 percent over the prime rate.

3.4.3 Collection

Once the contract has been drawn, collection may be made directly or indirectly. If the collection is made indirectly, the account customers will send their remittances directly to the debtor, who immediately forwards them to the lender. Account customers are not notified of the assignment.

When collection is direct, account customers are notified to remit directly to the lender. This can present a problem because the account customers are informed of the financing type used and some adverse effects on the company's goodwill may result.

3.4.4 Security interest

The security interest taken by the debtor will be in the form of a floating lien under the Uniform Commercial Code. The creditor will normally require a fully perfected lien.

3.4.5 Advantages and disadvantages

Some advantages of using accounts receivable financing include, first, the availability of funds and the greater cash flow provided. A second advantage is that as the firm expands and requires more funds, the amount of accounts receivable available should also expand. Also, if the accounts are factored, the company does not have to rely completely on its own credit department.

Disadvantages of accounts receivable financing begin with high administrative expense. Second, as mentioned earlier, some stigma may become apparent, and other creditors may be hesitant to extend financing when the receivables are removed as a possible source of repayment.

3.5 Inventory Financing

Inventory financing may be obtained with a secured or an unsecured loan. A company that is a good credit risk may obtain an unsecured loan; companies considered poorer risks often have to grant a security interest in their inventory. Security interest includes field warehouse receipts, trust receipts, and chattel mortgage securities, as defined below. Bankers will carefully review collateral and frequently monitor inventory levels to ensure the value is not diminished.

3.5.1 Field warehouse financing

Warehouse lending uses inventory as security. Field warehousing represents an economical method of financing inventory in which the warehouse is established at the place of the borrower. Two elements are necessary in the establishment of a field warehouse: First, public notification of the field warehouse arrangement must be made; second, the field warehouse must be supervised by a custodian. The custodian, a field warehouse company, should be a third party employed by the lending institution. In a relatively small field warehousing operation, an employee of the borrower may be hired as the custodian; however, lending institutions usually consider this practice undesirable due to the lack of an independent supervisor.

The lending institution establishes a loan on which the borrower can draw based on the warehoused inventory. As the borrower receives purchase orders, it transmits them to the bank. The bank directs the custodian to release the inventories. Per the agreement, as remittances are received by the borrower, they will be turned over to the bank. These remittances by the borrower are applied against the loan made by the bank.

3.5.2 Trust receipts financing

A trust receipt is an instrument acknowledging that the borrower holds the inventory in trust for the lender. Upon receiving funds from the lender, the borrower conveys a trust receipt for the inventory. The inventory may be stored at a warehouse or held on the premises of the borrower. The trust receipt indicates that the inventory is held in trust for the lender or is segregated in the borrower's premises on behalf of the lender. Sale proceeds are remitted to the lender per the trust receipt instrument.

Trust receipts financing requires that a trust receipt be issued for specific inventory items, normally serially numbered. Automobile dealer financing is a good example of trust receipts financing.

3.5.3 Chattel mortgage security financing

A chattel mortgage security gives the lender a secured interest in the inventory. As the inventory is sold, the receipts are paid to the lender as stated in the mortgage terms. In many jurisdictions, a chattel mortgage must be recorded and must include a complete description of the goods.

3.5.4 Advantages and disadvantages

The advantages of inventory financing are quite similar to those applicable to accounts receivable financing, as discussed in section 3.4.5. Financing is easy to obtain, while providing the ability to generate greater cash flow. An expanding firm will likely have an expanding inventory base from which to draw cash funds.

Disadvantages include a high administrative expense associated with the financing. Since the inventory is now security on an inventory-financed loan, a business may have difficulty borrowing money for other needs.

4. INTERMEDIATE-TERM FINANCING

Intermediate-term financing is the term generally used to describe debt that is repaid in less than ten years but after more than one year. In this chapter, the intermediate financing types discussed include only financing where the principal is repaid in periodic installments.

The installment repayment method makes refinancing with the same source difficult, so the maturity date of intermediate-term financing is extremely important. Typically, the company will have few intermediate-term needs; this type of financing is used to finance permanent

assets, and the liquidation or sale of the asset financed will not be used as a source of repayment. In such instances, companies are required to commit future earnings toward the loan repayment and, therefore, these funds are not available for other requirements.

4.1 Term Loans

Term loans are business loans that extend more than one year. These loans may be secured or unsecured (depending upon the debtor's financial condition). Repayment, or amortization, of term loans is made by periodic repayments over the loan life. By retiring the loan slowly, the borrower will be able to make adequate provision for debt retirement during the life of the loan. To protect the lender against default, most term-loan contracts include an acceleration clause providing that all installments will become due upon default of any payment.

The interest rate depends on many factors, including the loan amount, the borrowing company's credit rating, the maturity date, and the bank's relationship to the borrower. Generally, this rate is slightly higher than the rate that would be charged for a short-term loan. The interest rate may also be tied to the bank's prime rate.

An alternative to term loans is lease financing (see section 4.3 of this chapter). Advantages and disadvantages exist with each, and in certain situations, a sale-leaseback transaction may be appropriate. Under such a transaction, an asset is sold to a third party and then leased back to the original owner at a stated amount. Such transactions often allow a future buyback of the asset at a fixed price or fair market value at a certain point in time.

4.2 Installment Equipment Financing

New equipment manufacturers often provide financing arrangements for their customers. This is another type of intermediate-term financing because the loan terms often allow several years for repayment. This financing is used solely for purchasing equipment and may be available through several sources, such as the equipment manufacturer, commercial credit corporations, and commercial banks.

Generally, this financing method requires a large down payment on the equipment to assure continued payments. The equipment is usually pledged as collateral so the loan's outstanding balance always is expected to be less than the asset's value. The lender normally retains the option to repossess in case of default.

When considering this type of financing the accountant should determine that the cash flow is likely to be sufficient to make the periodic payments required.

4.3 Lease Financing

Lease financing has become increasingly popular in recent years. It allows a company to acquire equipment or plant assets without a large required down payment. Banks, insurance companies, and specialized leasing companies all provide this type of financing.

Leasing can be used to acquire equipment temporarily or permanently. A true lease (or operating lease) typically has a shorter term with ownership of the equipment remaining with the lessor at the end of the lease. A finance (or capital) lease is generally characterized by a longer term and a bargain purchase option that may vest the ownership in the lessee.

There are many reasons why an equipment user might decide to lease rather than buy:

- A lease arrangement eliminates a large down payment, thereby maximizing the amount of funds available to the company in the short term.
- A lease is often more easily obtained than other credit sources, since the leasing companies have the security of actually owning the equipment.
- Lessors are often responsible for servicing any equipment leased, thereby eliminating concerns about technical and administrative services.
- Leasing eases concerns about obsolescence.
- Leasing may allow a company to take advantage of the tax benefit of faster writeoff of the lease payment compared to the current tax depreciation allowances.

As a financial adviser, one should also weigh the disadvantages of leasing:

- The firm loses the opportunity to take advantage of any increases in the resale market price that might exist at the end of the lease unless it also has an option to purchase at a fixed price.
- For companies that can obtain other financing easily, leasing equipment is generally more costly than borrowing to pay for it.
- Since the lessee does not actually own the equipment, problems with replacement equipment at the end of the lease or lessor interference with the equipment's use during the lease may arise.

4.3.1 Lease accounting rules: FASB 13

Before counseling a client as to the effects of a leasehold, the accountant must be familiar with Financial Accounting Standards Board (FASB) Statement 13. This statement provides that a lease may be treated as either a capital lease or an operating lease, depending on the terms of the lease. Where the risks and benefits of ownership are passed on to the lessee (a capital lease), the lessor must treat the lease as a sale or a financing transaction. The lessee must treat the lease as an acquisition of an asset with a corresponding liability.

To ensure that the lease will qualify for tax treatment as a lease, it must follow the guidelines set forth in Revenue Procedure 75-21 (1975-1 C. B. 715). An awareness of the IRS requirements will help the accountant structure the lease agreement so that potential IRS problems will be minimized.

4.3.2 Analysis of leasing costs

In analyzing the lease costs, a discounted cash flow analysis should be used to compare the after-tax cash flows of leasing with other financing alternatives, with a present value approach applied to each alternative. This method allows the accountant to determine the present value of the net after-tax cost of each alternative. (Software is available to assist in lease-versus-buy calculations and FASB 13 calculations.)

The true lease cost must include any front- or back-end charges, any nonrefundable fees, applicable sales tax, and any commitment fees that must be paid. Some leases may allow a purchase at the end of the lease at a fixed amount or at fair market value.

4.4 Government Lending Programs

Several governmental agencies provide financial assistance to businesses. The accountant must be aware of the financial opportunities made available by the state and local governments. Similarly, minority-enterprise small business investment companies can provide a financing source if the company qualifies.

4.4.1 The Small Business Administration (SBA)

The Small Business Administration (SBA), an agency of the federal government, provides business loans to small businesses. In order to be considered by the agency, a small business must be independently owned and operated. The company's net worth must be substantially less than \$6 million and the net profits for the previous two fiscal years

must be less than \$2 million. Criteria used in determining whether a business qualifies as a *small business concern* include the following:

- Number of employees
- Dollar volume of business
- Type of industry in which the business is competing (Some industries, such as newspaper publishing, are not eligible.)
- Liquidity levels (If either the company or its guarantors have excess liquidity, the company would be ineligible.)

The SBA does not generally provide direct loans to small businesses. The SBA will guarantee loans to small businesses if other financing is not available. The SBA loan program, the “7A Program” is one of the most common SBA financing packages. These guarantees are limited to 90 percent of the loan amount. All loans are subject to an aggregate ceiling of \$750,000 per company. In general, loans under \$100,000 may not justify the paperwork involved. Additionally, banks may be unwilling to issue individual loans exceeding \$550,000.

Credit terms for SBA loans are similar to those for any good bank customer. Interest rates normally fluctuate, based upon the prevailing prime rate. Common maturities are as follows:

- Working capital 3 to 5 years
- Equipment 5 to 7 years
- Real estate up to 25 years

Loans with combined purposes generally are set up with a melded term. Loan proceeds cannot be used to finance changes in ownership among family members.

The SBA requires a *new company* requesting SBA financing to have adequate capital to invest in its own business. For example, a borrower is often expected to contribute one-third to one-half of the total funds needed to start a new business. A *minimum* of a 10-percent capital investment is required of the borrower. One common SBA loan type, called a 504 loan, is based upon a 10-percent contribution by the borrower, 40-percent funding from SBA, and 50-percent conventional bank funding.

For an *existing business* applicant, the SBA places more emphasis on the company’s credit factors. In all cases, loan repayment is expected to be made from business profits. A projected cash flow statement is, therefore, a necessary component of the SBA application.

The SBA loan application process can require a significant investment of time. In most cases, banks recommend having an accountant assist in preparing the application. Inaccuracies in the application, or

incomplete data, could disqualify the applicant from obtaining SBA funds.

4.4.2 SBICs and MESBICs

The SBA also licenses, regulates, and provides financial assistance to small business investment companies (SBICs) and minority-enterprise small business investment companies (MESBICs). These investment companies provide advisory services and venture capital in the form of long-term loan funds and equity financing to small business concerns and small companies owned by minority owners who are economically disadvantaged.

These companies provide loans either directly or on a participation basis. The maximum interest rate charged is determined by the SBA. The maturity date cannot exceed twenty years, subject to an extension or renewal limitation of an additional ten years.

General requirements for obtaining SBA financing include

- Adequate collateral to protect the government interest.
- Earnings projections sufficient to make loan repayments.
- A demonstration that the company will not be able to receive funds from conventional sources at reasonable terms and rates.
- A showing that adequate collateral will be available to cover the loan.
- A brief company history including products and services provided.
- Management personnel's and principal shareholders' backgrounds.

With these requirements in mind, local offices also provide the necessary forms for loan applications and detailed information about the current status of these programs.

4.4.3 VA and FmHA

Financial assistance is also available through programs administered by the Veterans Administration (VA) Office of Small and Disadvantaged Business Utilization and the Farmers Home Administration (FmHA). Certain borrowers may qualify for assistance through the VA and FmHA programs, depending upon financing needs, income levels, and other factors.

4.4.4 Industrial revenue bonds

Industrial revenue bonds are issued by state or local economic development authorities. Such states and localities are able to issue tax-free

bonds to support projects that create or retain jobs. The borrower in such a case arranges for a lender (usually a bank) to accept the mortgage on the equipment or building to be acquired. The state or locality then sells tax-exempt bonds to the lender to be used only for acquiring the building or equipment. Only the underlying assets and rentals charged for the asset use are applied to retire the bonds, and as such, the bonds are not the responsibility of the state or locality.

The primary advantage to the lender is that the interest on these bonds may be exempt from federal taxes. The advantage to the borrower is that the interest rate is normally around 65 percent to 75 percent of the prime rate, rather than one or more points over the prime. States and municipalities use this program to add employment or maintain jobs that might be lost, thus enhancing their tax bases.

4.4.5 State and local programs

Various financial programs are available through state and local governmental units. These financing sources realize that granting funds will

(Text continued on page 23)

normally create employment opportunities in their area and an attendant increased tax base. The local Chamber of Commerce or economic development organization is a good source to locate financing programs in a particular area.

4.5 Business Development Corporations

Business development corporations (BDCs) are private organizations that lend to companies that do not qualify for standard types of financing. BDCs are attractive because they are more flexible than other financing sources. For instance, a loan can be unsecured or secured. Also, a BDC can provide purchase and sale leasebacks in addition to granting loans that are guaranteed by the SBA. Generally, the interest rate is 2 to 4 percent above the prime rate with an average term of four to ten years. Not all states have BDCs.

4.6 Community Development Companies

Community development companies (CDCs) share the same objectives as BDCs, except that CDCs are nonprofit organizations. Financing is generally developed through SBA-guaranteed loans; therefore, this financing source is not as flexible, since the SBA criteria apply. CDCs' focus is to promote economic development in communities.

5. LONG-TERM DEBT FINANCING

Long-term debt has many forms and may be an advantageous financing method for long-term needs for several reasons:

- Interest payments are tax-deductible.
- In inflationary periods, it will benefit the firm to pay interest and principal with inflated dollars.
- By obtaining debt rather than equity financing, the control of the business is not diluted.
- In periods when extraordinary profits are earned, the creditors do not participate.

In certain circumstances, long-term debt may have some disadvantages. For instance, long-term debt requires a repayment schedule that must be honored regardless of cash flow. In times of economic hardship, the borrower must make the loan payments or face potential default. If

other financing alternatives might later become more attractive, a call provision should probably be included in the debt agreement.

5.1 Instruments of Long-Term Debt Financing

Although there are many types of instruments that may be used for long-term debt financing, this section discusses the two main types: bonds and mortgages.

Long-term financing can also occur through an installment purchase of property, the seller acting as the lender in the transaction. Negotiation of an installment contract may result in a lower interest rate than is available through other financing sources.

In all cases of long-term borrowing, the lender will consider the following:

- The borrower's net earning power
- Management's capability
- Both the company's and the industry's long-range prospects

5.1.1 Bonds

A bond is an interest-bearing debt certificate with agreed maturities. It is a promise to pay a certain amount of money with payments of principal and interest at agreed dates. Most bond certificates also include an *indenture*, which is a rather elaborate legal instrument representing the collective security of all bondholders holding bonds of a single issue. The indenture describes and restricts the general bondholder's rights and must comply with the terms of the Bond Indenture Act of 1959. Most indentures contain two parts. The first part covers agreements between the borrower and the bondholders as to how the business will be conducted. The second part specifies how the bondholders will be protected if the borrower defaults.

Although bonds may provide the corporation with a significant capital source, their use increases the amount of risk. Because their payment provisions are not flexible, bonds increase the pressure on management to realize current operating profits to provide funds for bond payments.

Certain bonds are also convertible (i.e., a privilege exists to convert the bonds to common stock at a future point). Other bonds are redeemable, allowing the company issuing the bonds to redeem them at specified points. The bond interest rate will reflect these various features. A lower interest rate may be required if a convertible feature exists,

whereas a higher interest rate may be required with a redeemable feature.

5.1.2 Mortgages

A mortgage is a security device allowing one to borrow money by pledging property as security. A mortgage has three characteristics:

1. The lender's interest in the property ends when the obligation is fully paid.
2. The lender has a right to foreclose on the mortgage should the debtor default.
3. The debtor has a right to redeem or regain the property.

Any form of property with marketable value can generally be mortgaged. The debtor need not have complete ownership, since any owned interest may be mortgaged. As a rule, mortgages should be recorded to prevent questions at a later date regarding the parties' intentions.

5.1.2.1 Points

With certain mortgages, a borrower must pay points when arranging the mortgage. Points are an additional cost to the borrower, and basically represent a fee paid for the privilege of obtaining the mortgage.

Points are normally represented as a percentage of the mortgage amount. For example, one point on a \$50,000 loan would require the borrower to pay \$500 at the time of executing the mortgage. Four points on a \$100,000 loan would require the borrower to pay \$4,000 at the time of executing the mortgage. Since points represent an additional cost to the borrower, they should be considered in calculating the effective interest rate of the mortgage.

5.1.2.2 Adjustable rate mortgages (ARMs)

Many mortgages offered today allow the interest rate to be adjusted over the mortgage term. These are known as *adjustable rate mortgages* (ARMs). Under an ARM, the mortgage is executed for a certain time period—for example, fifteen years. However, the interest rate can change at certain terms throughout the mortgage, such as annually, every five years, or even in relation to various targeted interest rates, such as the prime rate.

The disadvantage of an ARM to the borrower is that the interest rate over the mortgage life is unknown, and certain risks are assumed in that the interest rate could rise significantly over the loan term. However, ARMs exist in several varieties, many of which have ceilings above which the rate cannot go or points beyond which the rates cannot rise within a given time period.

5.1.3 Common and preferred stock

Even though a stock sale is not generally a financing tool but rather an equity investment to raise funds, a brief mention is necessary. Generally, a common or preferred stock sale is a method of raising capital for a start-up business, thereby forming a basis for future borrowings. Rather than periodic interest charges, investors expect a dividend return or capital appreciation in the stock. The biggest disadvantage to obtaining funds through equity offerings is that interest payments are tax deductible whereas dividends are not. For further information on public offerings, refer to the chapter on Securities Regulation.

5.1.3.1 Initial public offerings (IPOs)

Initial Public Offerings (IPOs) are issues from companies that first go public. When new shares are offered to the public, there is a spread between what the underwriters buy the stock from the issuing corporation for and the price at which the shares are offered to the public. This spread between the underwriting proceeds (the amount paid to the issuing corporation) and the price at which the shares are offered to the public covers various costs, including management costs for negotiating and managing the offering, underwriting fees for assuming the risk of buying the securities from the issuing corporation, and selling commissions.

Investing in IPOs tends to be a risky investment. Some issues appreciate materially very quickly, while other companies fail and the value of the stock decreases significantly. Shares of IPOs are often hard to purchase, as the managing underwriter reserves these shares for the best customers.

IPOs represent a method for a corporation to obtain capital, although significant costs are normally associated with bringing the stock to market. In addition to the management and underwriting costs previously discussed, significant professional fees, including legal and accounting fees, are normally associated with bringing an issue to market. Stringent SEC rules apply to new stock issues. See also the chapter on Securities Regulation, herein.

6. EMPLOYEE STOCK OWNERSHIP PLANS (ESOPs)

Another financing alternative available is employee stock ownership plans. This financing source may also serve to improve labor relations and reduce employee turnover. Since many plans allow favorable tax

treatment under Section 4975 of the Internal Revenue Code, many businesses now provide these programs. This discussion deals with each of the basic forms of ESOPs separately.

6.1 Stock Bonus Plans (SBPs)

Under a stock bonus plan (SBP), a corporation must contribute shares of its own stock or cash to purchase outstanding shares. The contribution is then held in trust with the employees becoming the beneficiaries. For tax purposes, the contribution limit is 15 percent of annual employee compensation. The corporation is allowed a tax deduction equal to the fair market value of the shares contributed.

The trust must hold the contributed stock in individual accounts and may not distribute the stock until vesting requirements are met and there is a separation from employment. The employee is not taxed until the distribution is received.

The firm receives a tax deduction without decreasing its working capital. In addition, the company benefits from greater worker incentive, resulting in better productivity and loyalty, since the employees receive an interest in the company. The negative aspects of this arrangement include dilution of stock ownership as well as the initial expenditure of purchasing stock for the trust.

(Text continued on page 27)

If stock rather than cash is contributed to the plan, the cash flow benefits can be substantial. For example, a contribution of stock produces the same tax deduction as does a cash contribution, but without the cash outflow.

Shareholders of privately held companies operating as C corporations may achieve nonrecognition of their gain through deferral upon sale of their shares to an ESOP. Immediately after the sale, the ESOP must own at least 30 percent of the outstanding securities, and the selling shareholder must purchase “qualified replacement property” within twelve months. For further information see the reference section at the end of this chapter and the section on ESOPs in the chapter of this manual titled Employee Retirement and Deferred Compensation Plans.

6.2 Leveraged ESOPs

The primary difference between a leveraged ESOP and an SBP is that the ESOP may borrow from the sponsoring corporation. The trust may purchase shares in the corporation and have the corporation guarantee loans for the purchase. Also, the trust may make installment purchases from other shareholders.

Leveraged ESOPs have become a popular financing device for leveraged buyouts (LBOs). LBOs typically involve three levels of financing. A bank (or other financial institution) provides to the buyer a major portion of the acquisition price. The bank’s position constitutes the top tier of the financing and is secured by the assets and, particularly, by the corporation’s cash flow and earning power. Equity investors, looking for high annual returns, provide the bottom tier of the financing. In a predictable income and cash flow situation, equity investment will ordinarily be about 20 percent of the firm’s value. The middle tier may be provided by notes taken back by the seller, by third parties willing to invest or lend on a subordinated basis, or by an ESOP.

Leveraged ESOPs must be invested in common stock. If there is more than one class of common stock, then the common stock owned by the ESOP must have the highest dividend and voting rights of all other classes of common stock. Leveraged ESOPs usually acquire a large block of stock at their inception, financed with an “exempt” loan. The stock is held as collateral while the company makes loan installment repayments. Shares are released in proportional allocations to employees’ accounts as the loan is repaid. Appreciation on the collateralized shares, in effect, belongs to the employee-shareholders and not to the company. Thus, the possibility of using the appreciation as a tax deduction has been lost. Therefore, a strongly growing company might prefer

to fund a nonleveraged ESOP each year by contributing its increasingly valuable shares and, consequently, earning larger tax deductions (up to the statutory limit).

Interest on the ESOP debt repayment is tax deductible and, in certain cases, principal payments up to 25 percent of covered payroll are tax deductible under IRC Sec. 404(a)(9).

The company could also pay dividends to the ESOP. Dividends used to make loan payments on an exempt loan are tax deductible. Also, cash dividends paid to a participant are deductible by the employer and taxable to the employee, not as wages subject to payroll taxes, but as a dividend distribution. The ten percent early distribution penalty does not apply to the dividend distributions to an employee.

The company's assets and earning power are at risk for the ESOP debt repayment. Thus, default could place the company in bankruptcy. Privately held companies must give their employees (and their heirs) a *put*, which is the right to sell their stock to the company at its current value. (The Tax Reform Act of 1986 mandates an annual appraisal of the fair market value of closely held securities.) Growth of the company together with the aging of its labor force can create a "repurchase liability" for the puts that must be carefully monitored.

Leveraged ESOPs provide the same benefits as stock bonus plans and increase net assets and cash flow by any loan amount used to purchase stock. However, the American Institute of Certified Public Accountants and the Securities and Exchange Commission recommend that the loan amount be recorded as a liability, noting that the negative effects attributable to SBPs apply here as well.

7. VENTURE CAPITALISTS

Although equity agreements are discussed in another chapter of this manual, venture capitalists merit mention here since they often provide funding where it may not otherwise be available. Most frequently, venture capitalists will look at small, high-growth-potential firms. Unfortunately, the cost of this type of financing, in terms of loss of control, is usually very high (to compensate for the risk involved). As a result, the option of involving venture capitalists should be considered only in circumstances where alternative sources are not preferable or possible. The company should also understand that venture capitalists are looking for a significant return on their investments within a relatively short time period (five to seven years), and this type of return can usually

only be realized if the business is taken public. This financing type is advantageous because the company may grow rapidly rather than gradually with the additional investment.

Since venture capital is risky, investors will examine closely the company's attributes. In technically complex situations, a consultant may be hired to sort out the products and services marketed. The commonly reviewed attributes are

- The company's market size.
- The product's competitive condition.
- Production expense.
- Financial statements.
- The company's legal documents.
- Management's capability.

With regard to venture capital, corporate venture capital subsidiaries are another financing source. Typically, a large corporation sprouts a subsidiary company, thus cultivating future purchases and potentially becoming a new division of the corporation. This allows companies to gain openings into new technologies and markets and then to be assimilated into the corporation. Corporations may turn to this as a method to use excess space and surplus cash.

8. THE ECONOMICS OF REFINANCING

Once a financing decision has been made, the borrower should be advised that the decision is not necessarily final. For instance, if funds are necessary when interest rates are high, the borrower should be aware that a rate decrease may make refinancing less expensive than repayment according to the original agreement terms. This is why it is important, especially in times of high interest rates, to incorporate into the financing arrangement provisions that will keep the costs of refinancing down.

For example, assume a company obtains financing through a bond issue at a high interest rate and, subsequently, bond market interest rates decline. If the original bond issue includes a call provision, even with a redemption premium, refunding by issuing a second series of bonds at a lower interest rate to replace the earlier issue may significantly decrease the total expense of financing.

The interest rate is not the only factor to be considered in refinancing. Other issues to consider involve the costs of repaying the first

financing source and of securing a second source, which includes the following:

- Are there any penalties for prepayment?
- Is prepayment possible under the agreement terms?
- What are the costs of securing a new financing source?
- Are there other hidden costs, including loss of the client's management time?

All the "extra" costs may make refinancing more expensive than it might appear at first. Therefore, when obtaining financing in times of high interest rates, the borrower should try to negotiate terms that will reduce the termination cost if interest rates decrease.

9. THE IMPORTANCE OF FINANCIAL STATEMENTS

Creditors often decide to provide financing based on the debtor's financial statements. In the case of a personal guarantee, the guarantor's financial statements will be examined. The accountant, as adviser, must understand fully the nature and use of financial statements that may need to be furnished to the creditors.

9.1 Procedure of Creditor Analysis

Creditors typically follow a procedure in business analysis that includes the following:

- An examination of the income tax returns, balance sheets, and income statements for the past three to five years
- A credit check, often done by a professional agency, on the business as well as any guarantors
- An examination of the collateral to serve as protection for the amount of funds loaned and, possibly, an outside appraisal
- A cash flow analysis for prior and, possibly, future years
- An analysis of the financial ratios of the business
- A check that the company is properly incorporated
- An indication of the company's management capabilities

The tax returns and financial statements are examined not only to get an overall picture of the business but also to uncover any recent

developing trends. A credit check, on the other hand, determines the borrower's solvency. Similarly, a cash flow projection for future years helps assure the lender that the borrower will have enough cash on hand to repay the obligation. (Financial ratio analysis is discussed in the following subsection.) An assurance of proper incorporation safeguards the lender against fraudulent loans and is evidence of a proper business purpose. Because of their direct relationship and profitability, an understanding of management's capabilities is very useful.

9.2 Creditor Analysis of Financial Ratios

Financial ratio analysis allows a comparison of the company's financial strength with other comparable companies. Several software programs have been developed to facilitate the full analysis of various financial ratios.

The ratios most commonly examined by creditors are liquidity ratios and financial position ratios.

9.2.1 The current ratio

The current ratio is the ratio of current assets to current liabilities. For example, if current assets amount to \$500,000 and current liabilities are \$100,000, the current ratio would be 5-to-1.

Examination of the current ratio helps to determine whether a company will be able to pay its current liabilities. This ratio shows the firm's short-term liquidity by disclosing the extent to which short-term creditors' claims can be matched to assets that may easily be converted to cash.

The "acceptable" current ratio to creditors varies according to the company, industry, and the season of the year, among other factors. For instance, in the industrial field, a 2-to-1 ratio is often thought of as being appropriate, while a 3-to-1 ratio may be necessary for a trade firm since there is a greater need for inventory and receivables. A company with a more rapid asset turnover will generally require a lower current ratio than one with a slow turnover.

9.2.2 Debt-to-total-assets ratio

The debt-to-assets ratio is determined by comparing all the debt to all the company's assets. This ratio represents the amount of total assets claimed by the owners over and above the amount necessary to totally repay the creditors. This ratio is used to help measure the soundness of the company.

9.2.3 Debt-to-equity ratio

Another ratio used to calculate the firm's soundness is the debt-to-equity ratio, which may be arrived at by dividing total liabilities by total equity. The industry norm will vary directly in relation to the expected stability of the firm's earnings. For example, since many public utilities are safe companies with steady earnings, a debt-to-equity ratio of 60 to 70 percent may be considered acceptable. In industries in which earnings are less stable, a much lower debt-to-equity ratio will be necessary for creditor approval.

To calculate the debt-to-equity ratio, various adjustments for determining the total business debt may be required. For example, debt may include items such as deferred taxes and subordinated debt to the business owners, which may need to be removed from total indebtedness to allow proper calculation of the ratio.

9.2.4 Times-interest-earned ratio

Yet another measure of long-term solvency is the times-interest-earned ratio. This ratio is calculated by dividing net income before interest and income tax expense by the amount of interest expense. The ratio is used to assess the probability that the firm may default on the loan for failure to meet the required interest payments. This ratio is especially important to those seeking long-term credit, because interest payments must be made to these creditors from operations over a long period of time.

9.2.5 Quick ratio or acid-test ratio

The quick ratio is determined by taking the cash and equivalents plus net trade receivables and dividing by the amount of current liabilities. Often, this ratio should equal at least 1.0 or better. If there is a very high inventory-turnover rate, a lower quick ratio may be acceptable.

9.2.6 Inventory-turnover ratio

The inventory-turnover ratio is considered an important ratio because it shows how well the company uses the resources at its command. The inventory-turnover ratio equals total cost of sales divided by total inventory. A high inventory-turnover ratio will be evidence that the company does not hold excess inventory stock, and thus that it has better (higher) liquidity. On the other hand, the ratio can indicate an inventory shortage when demand is high. A low ratio implies poor liquidity, overstocking, inventory buildup, or obsolete inventory. Regardless of inventory level, the computation does not account for seasonal fluctuations that can affect the ratio analysis.

9.2.7 Return on assets

Net income divided by total assets yields the company's return on assets. This formula reflects the earning power and effective use of all the company's resources. A heavily depreciated company or a large intangible asset amount can distort this ratio. Consequently, these points need to be considered during the analysis.

9.2.8 Net-income-to-sales ratio

Also called the profit margin ratio, the net-income-to-sales ratio helps measure the company's profitability prospects. Profitability ratios show how effectively management is running the company, and this particular ratio measures the level of protection against losses that might result from increased expenses or falling prices.

9.2.9 Cost-of-sales-to-payables ratio

The cost-of-sales-to-payables ratio indicates the number of times trade payables turn over during the year. If the ratio is high, the time between purchase and payment is shorter. If the ratio indicates a slow payable turnover compared to that of other industries, this may signify that the company has potential cash shortages and possible invoice disputes with suppliers having extended terms or deliberately increased trade credit. Therefore, if a company purchases on thirty-day terms, typical payable turnover will be thirty days.

9.2.10 Debt-to-net-worth ratio

Debt-to-net-worth ratio represents the amount of capital contributed by the owner set against that contributed by creditors. If the ratio is high, the creditor is acquiring the burden of risk. A low ratio gives the company the advantage to borrow in the future.

9.3 How Creditors Use Ratio Analysis

In a normal loan situation, a creditor may adopt the following credit analysis procedure: the current ratio to determine short-term solvency, the profit-margin ratio to determine the company's future prospects, and the debt-to-assets ratio to ensure that any credit extended is likely to be covered by assets. Accordingly, when applying for financing, a company should provide any information that might explain an unacceptable ratio and give the lender confidence that the ratio is not a matter of great concern.

Various sources of standard industry ratios exist, such as the *Robert Morris Annual Report* or Dun & Bradstreet's *Key Business Ratios*. With

these sources, the ratio of a particular business can be compared to industry averages. In this manner, ratios can be determined to be unacceptable or out of line and, in such cases, the additional note of clarification should be added.

10. THE FINANCING PROPOSAL PACKAGE

Once a proposed funding plan has been decided, the formal funding proposal package should be completed. This package will be submitted to the selected funding source.

Since the funding proposal package will contain information enabling the potential lender to make a decision, the information should be very specific and thorough. The information submitted should include

- Budgets and projections, including possible budgets from past periods and comparison of actual to budget.
- Repayment schedule, along with cash flow projections and other repayment provisions.
- Past earnings history and historical financial data, with a thorough explanation of any losses or unusual events in past years.
- Information about key management personnel, including, for example, age, experience, and education.

The financing proposal package should also include information on accounts receivable aging, documentation regarding receivable amounts of major customers, evidence of high-risk collection amounts, and any notes receivable. Also included should be inventory-related information, such as inventory aging, inventory turnover, price stability, and so forth. Market and appraised value of investments and fixed assets should be included, along with explanations of all liabilities.

Additionally, there should be clear specification of the collateral being offered, along with personal financial statements of all key personnel, if personal guarantee agreements are to be used.

It is important to provide the lender with as much useful information as possible, including information about any unfavorable items, so that the client can address such unfavorable items.

A sample funding case study can be found in appendix B of the MAS Small Business Consulting Practice Aid 1, *Assisting Small Business Clients in Obtaining Funds*, published by the American Institute of Certified Public Accountants.

If a lending institution grants a loan, typically the lending policies will be somewhat formal. The loan agreement may specify the following items:

- Working capital must be maintained at a specified minimum amount.
- Audited or reviewed financial statements must be furnished at periodic intervals.
- Restrictions on items such as dividend payments, merger or consolidation agreements, prevention of any additional indebtedness, prevention of capital expenditures in excess of a specified amount, and prevention of officer loans.

It is extremely important to accurately determine financing requirements. The cash flow projections and net income projections that are completed for the proposal package should clearly indicate the maximum financing amount required. Extreme caution should be exercised against underestimating the amount of financing required. Businesses with insufficient financing may experience significant problems in cash flow and growth.

If stockholder or similar loans currently exist in the company, the bank may require such loans to be subordinated to the bank indebtedness. Similarly, the bank may restrict loans from a company to an officer, and may subordinate loans from the officer to the company.

REFERENCES

- AICPA Staff. *Assisting a Financially Troubled Business*. (Small Business Consulting Services Practice Aid 92-8.) New York: American Institute of Certified Public Accountants, Inc., 1992.
- . “Financial Forecasts and Projections,” AT§200, and “Compilation and Review of Financial Statements,” AR§100. In *Professional Standards*, vols. 1 and 2. New York: American Institute of Certified Public Accountants, Inc., 1997.
- Alarid, William M. *Free Help from Uncle Sam to Start Your Own Business, Or Expand the One You Have*, 4th rev. ed. Santa Monica, Calif.: Puma Publishing Company, 1997.
- Bokser, Daniel. *Pratt’s Guide to Venture Capital Sources*. New York: SDC Publishing, 1997.
- Brealy, Richard, et al. *Fundamentals of Corporate Finance*. New York: The McGraw-Hill Companies, 1995.

- Brigham, Eugene F., and Louis C. Gapenski. *Financial Management: Theory and Practice*, 8th ed. Fort Worth, Tex.: Dryden Press, 1996.
- Fallek, Max. *Finding Money for Your Small Business: The One-Stop Guide to Raising All the Money You Will Need*. Chicago: Dearborn Financial Publishing, Inc., 1994.
- Finnerty, John D. *Project Financing: Asset Based Financial Engineering*. New York: John Wiley & Sons, Inc., 1996.
- Garner, Daniel R., Robert R. Owen, and Robert P. Conway. *Ernst & Young Guide to Financing for Growth*. New York: John Wiley & Sons, Inc., 1994.
- Green, Charles H. *The Comprehensive Handbook for SBA Loans: An Easy Guide to Financing & Loan Guarantees from the U.S. Small Business Administration*. Atlanta, Ga.: Advisory Press, 1996.
- Harrington, Diana R., and Brent D. Wilson. *Corporate Financial Analysis: Decisions in a Global Environment*, 4th ed. Burr Ridge, Ill.: Irwin Professional Publishing, 1993.
- Heath, Gibson. *Getting the Money You Need: Practical Solutions for Financing Your Small Business*. Burr Ridge, Ill.: Irwin Professional Publishing, 1995.
- Hicks, Tyler G. *101 Ways to Get 100 Plus Percent Financing for Real Estate & Business*, 9th ed. Rockville Centre, N.Y.: International Wealth Success, Inc., 1998.
- Hughes, A. and D. J. Storey, eds. *Finance and the Small Firm*. New York: Routledge, 1994.
- Lister, Kate, and Tom Harnish. *Finding Money: The Small Business Guide to Financing*. New York: John Wiley & Sons, Inc., 1995.
- Logue, Dennis E., ed. *The WG&L Handbook of Financial Markets*. Cincinnati: South-Western Publishing Co., 1994.
- . *The WG&L Handbook of Short-Term and Long-Term Financial Management*. Cincinnati: South-Western Publishing Co., 1994.
- . *Handbook of Modern Finance: 1998 Edition*. Boston: Warren, Gorham & Lamont, 1998.
- Low, Robert J. *Bottom Line Basics: Understand and Control Business Finances*. Grants Pass, Ore.: PSI Research, 1995.
- Mancuso, Joseph. *How to Get a Business Loan*. New York: Simon & Schuster Trade, 1990.
- National Association of State Development Agencies. *Directory of Incentives for Business Investment and Development in the United States*, 3d ed. Washington, D.C.: Urban Institute Press, 1991.

- National Register Publishing Co. Staff. *The Corporate Finance Sourcebook 1999*. New Providence, N.J.: National Register Publishing, 1998.
- Ruda, Howard. *Asset-Based Financing: A Transactional Guide*. 4 vols. New York: Matthew Bender & Company, Inc., 1985. Loose-leaf.
- Thomsett, Michael C. *Ultimate Guide to Raising Money for Growing Companies*. Burr Ridge, Ill.: Irwin Professional Publishing, 1990.
- Tuller, Lawrence W. *Entrepreneurial Growth Strategies*. Holbrook, Mass.: Adams Media Corporation, 1994.
- . *Finance for Non-Financial Managers and Small Business Owners*. Holbrook, Mass.: Adams Media Corporation, 1996.

BUSINESS VALUATION

1. INTRODUCTION

- 1.1 Scope
- 1.2 Duty to Be Independent

2. DEFINITIONS

3. VALUATION PURPOSES

- 3.1 Sales and Purchases
- 3.2 Gift and Estate Taxes
- 3.3 Divorce
- 3.4 Valuing Minority Interests
- 3.5 Litigation
 - 3.5.1 Federal rules for expert witnesses

4. IMPORTANT VALUATION CONCEPTS

- 4.1 Corporate Life Cycle
- 4.2 Management
- 4.3 Liquidation Value v. Going Concern Value
- 4.4 Book Value v. Market Value
- 4.5 Discount Rate v. Capitalization Rate
 - 4.5.1 Discount rate
 - 4.5.2 Capitalization rate

5. COMMON METHODS OF VALUATION

- 5.1 Guideline Company Valuation Method
 - 5.1.1 Selecting guideline companies
 - 5.1.2 Using the guideline company method
- 5.2 Capitalization of Earnings Method
- 5.3 Capitalization of Excess Earnings Method
- 5.4 Dividend Capacity Method
- 5.5 Adjusted Net Assets Method
 - 5.5.1 Tax effect
- 5.6 Discounted Future Earnings Method
 - 5.6.1 Earnings forecast

6. APPLYING DISCOUNTS

- 6.1 Discounts for Size of Interest, Key Person
 - 6.1.1 Discount for minority interest
 - 6.1.2 Discount for lack of marketability
 - 6.1.3 Key person discount

- 6.1.4 Successive discounts
- 6.2 Case Study: Valuation of a Closely Held Corporation

7. REACHING CONCLUSIONS

- 7.1 Examining Valuation Results
- 7.2 Weighting Valuation Results
- 7.3 Matching Valuation Methods to the Business

8. THE INTERNAL REVENUE SERVICE APPROACH

- 8.1 Revenue Ruling 59-60—IRS Business Valuation Principles/
Valuing Closely Held Stock
 - 8.1.1 Purpose
 - 8.1.2 Background
 - 8.1.3 Approach
 - 8.1.4 Key provisions
 - 8.1.5 Summary
- 8.2 Revenue Procedure 66-49 and Revenue Procedure 96-15—
Donated Property
- 8.3 Revenue Ruling 65-192—Intangible Assets
- 8.4 Revenue Ruling 68-609—The “Formula” Method

9. VALUATION OF SELECTED ITEMS

- 9.1 Cash
- 9.2 Accounts Receivable
- 9.3 Inventory
- 9.4 Investment Securities
- 9.5 Insurance
- 9.6 Life Insurance Policies
- 9.7 Prepaid Expenses
- 9.8 Equipment
- 9.9 Real Estate
- 9.10 Intangibles
- 9.11 Leases
- 9.12 Liabilities
- 9.13 Liens

10. SPECIAL VALUATION CONSIDERATIONS

- 10.1 Valuing Employee Stock Ownership Plans
- 10.2 Valuing Professional Practices

11. AICPA GUIDANCE

- 11.1 Statement on Standards for Accountants’ Services on
Prospective Financial Information, *Financial Forecasts and
Projections*

BUSINESS VALUATION

- 11.2 *Guide for Prospective Financial Statements*
- 11.3 Statements on Standards for Management Consulting Services (SSMCSs)
- 11.4 MAS Small Business Consulting Practice Aid No. 8, *Valuation of a Closely Held Business*

12. OTHER PROFESSIONAL GUIDANCE

- 12.1 Uniform Standards of Professional Appraisal Practice
- 12.2 Principles of Appraisal Practice and Code of Ethics of the American Society of Appraisers
- 12.3 Business Valuation Standards of the American Society of Appraisers
- 12.4 Publications of the Institute of Business Appraisers
- 12.5 Publications of the Canadian Institute of Chartered Business Valuators

13. RESEARCH SOURCES

- 13.1 Data Sources
- 13.2 Researching the Economy (National and Local)
- 13.3 Researching the Industry
 - 13.3.1 Identifying the SIC code
 - 13.3.2 Surveying the industry
 - 13.3.3 Collecting industry financial data
 - 13.3.4 Companies in the industry
 - 13.3.5 Merger and acquisition data
- 13.4 Researching Guideline Companies

14. REPORT WRITING

- 14.1 Are Written Reports Always Required?
- 14.2 Components of a Written Report
 - 14.2.1 The nature and scope of the assignment
 - 14.2.2 Assumptions and limiting conditions
 - 14.2.3 Definition of value
 - 14.2.4 Sources of information
 - 14.2.5 Economy
 - 14.2.6 Industry
 - 14.2.7 Company
 - 14.2.8 Financial analysis
 - 14.2.9 Major considerations
 - 14.2.10 Valuation methods and calculations
 - 14.2.11 Conclusion
 - 14.2.12 Signature and inclusion of dissenting opinion(s)
 - 14.2.13 Exhibits and appendixes

14.3 Presentation

14.3.1 Quality of the writing

14.4 Who Gets Copies?

14.5 Examples of Valuation Reports

REFERENCES

APPENDIX 1: Illustrative Letters

APPENDIX 2: Valuation Checklist

APPENDIX 3: Research Checklist and Sources

Exhibit A: Research Checklist

Exhibit B: Sample Research Sources

1. INTRODUCTION

Business valuations are conducted for many purposes. A number of the purposes are discussed in section 3 of this chapter, including the sales and purchases of business enterprises, gift and estate taxes, divorce, valuing minority interests, and litigation. The accountant performing a business valuation must keep the following factors in mind:

- The *exact date* of the valuation
- The *purpose* of the valuation
- *What is being valued* (meaning, 100 percent of the stock of the company, a minority interest in the company, or a majority interest in the company)
- The *standard of value* (for example, fair market value, or fair value)
- The *methods* that are most appropriate, given the above

Business valuation is subjective and therefore by no means an exact science. Outside factors, such as market forces or limited salability, may affect a valuation to the extent that several different valuation methods will each yield different, yet entirely appropriate, results. Internal factors, such as the company's products and how the firm's future prospects fit into its industry, also affect the valuation. (For example, consider how differently a company would be perceived if it produced slide rules rather than electronic calculators.)

Unique facts and circumstances of each valuation determine the most appropriate, objective valuation methods to be used. Actual transactions in the company's stock are important, as are actual transactions in comparable companies (referred to as guideline companies). Conclusions need to be based on an unbiased, objective review of the facts and circumstances.

1.1 Scope

This chapter provides a basic understanding of the factors pertinent to performing an accurate business valuation and can serve as background on and a guide to valuation methods and techniques. This chapter describes—

- The purposes for which valuations are performed.
- The fundamental concepts of valuation.
- An overview of some methods and techniques of valuation and the subjective factors that affect the validity of each method.

— The standards and guidelines for valuing businesses as established by professional organizations.

CAUTION: Computer programs are available that perform valuations and/or prepare a valuation report. Great care should be exercised that the method(s) used and the result of such programs are appropriate to the circumstances of the assignment and in keeping with business valuation standards.

Also, one must understand exactly how the computer program calculates values and must agree with each and every facet of such calculations in order for the computer program conclusion to be used as the appraiser's conclusion. In general, the appraiser should do the calculations and not rely on a "canned" approach.

1.2 Duty to Be Independent

It is important for the accountant to understand his or her role in performing a business valuation. The client may want the appraiser to advocate a position favorable to the client—in a divorce, for example. Nevertheless, the appraiser has a duty like that of an accountant in an audit—to be independent. The appraiser should look at the valuation questions from the point of view of a willing buyer and from the point of view of a willing seller, and then use judgment to reach an independent opinion. Once he or she has reached an opinion, it is his or her duty to advocate that opinion and to support it.

2. DEFINITIONS

The following definitions are used throughout this chapter and are listed here for easy reference. However, the reader is encouraged to consider the definitions within the context of the applicable discussions. The terms marked with an asterisk (*) are as defined by the American Society of Appraisers' (ASA's) Business Valuation Standard I, which provides uniform definitions of terminology used by professional business appraisers who are members of the ASA and is fast becoming the industry standard. (For more information on this organization, see section 12 of this chapter.)

***Appraisal.** The act or process of determining value. It is synonymous with valuation.

***Appraisal approach.** A general way of determining value using one or more specific appraisal methods (for example, asset-based approach, market approach, income approach).

***Appraisal method.** Within approaches, a specific way to determine value.

***Business appraiser.** A person who, by education, training, and experience, is qualified to perform an appraisal of a business enterprise and/or its intangible assets.

***Capitalization rate.** Any divisor (usually expressed as a percentage) that is used to convert income into value.

Closely held corporations. Corporations owned by a relatively small number of shareholders. The limited number of shareholders implies that the stock is not publicly traded in a free and active market (Rev. Rul. 59-60).

***Discount rate.** A rate of return used to convert a monetary sum, payable or receivable in the future, into present value.

Fair market value. Price for which property would change hands between a willing buyer and a willing seller if the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts (Rev. Rul. 59-60).

Going concern value. Value that takes into account the fact that a collection of assets in an operating business is worth more than the sum of the replacement value of each asset. Intangible elements of value in a business enterprise result from factors such as having a trained work force and an operational plant, as well as the licenses, systems, and procedures necessary to operate as a business enterprise.

***Goodwill.** That intangible asset that arises as a result of name, reputation, customer patronage, location, products, and similar factors that have not been separately identified and/or valued but which generate economic benefits.

Liquidation value. Value that would be obtained for an asset or group of assets if they are sold separately.

***Marketability discount.** An amount or percentage deducted from an equity interest to reflect lack of marketability.

***Minority discount.** The reduction, from the pro rata share of the value of the entire business, which reflects the absence of the power of control.

Opportunity cost. Return that would be realized on the next best alternative whose rate of return is known.

3. VALUATION PURPOSES

Business valuations (or appraisals) may be performed for many reasons. Business valuations add credibility to a negotiating position in a sale

or purchase, divorce, or litigation. They are also used for various other purposes, such as gift and estate tax matters, financing, and government actions.

The business appraiser may sometimes be required to testify in a court of law and to prepare various exhibits for submission to the courts. The appraiser should be sufficiently familiar with business valuation techniques and the specific reason for the particular valuation to provide the courts with accurate professional testimony. Exhibits summarizing valuation calculations may be submitted as evidentiary material in legal proceedings. The appraiser should closely coordinate all efforts with the attorney representing their mutual client, yet maintain the independence and integrity of the appraisal. A written valuation report covering all pertinent information and detailing the underlying assumptions, analysis, rationale, and conclusions of the valuation procedures is an especially important communication and may be required under professional standards.

3.1 Sales and Purchases

A valuation for the sale or purchase of a business can help avoid misunderstandings of how the sale or purchase price was determined. A written report enables the parties to understand the specific factors that contributed to the price. In addition, a clearly written, well-documented valuation report may preclude claims of an unfair price.

The valuation report may serve as a valuable negotiating tool. The proponent of the report will be able to provide objective data urging the other party to reconsider the price and substitute another that is more “appropriate and reasonable.”

The valuation report may also be a guide to how appropriate the proposed sale or purchase will be by providing the buyer or seller with more concrete information about the business being appraised, including its future prospects.

3.2 Gift and Estate Taxes

A professional valuation may be required in determining gift or estate taxes, particularly where the deceased was key to the operations of the business. In this situation, the business value may properly be discounted to take into account the owner dependency of the business. For instance, a professional manager may be needed to continue the business, lest the entity be valued as if it is to be liquidated. The compensation paid to such a manager may be different than that of the owner. Life insurance proceeds must also be considered.

Valuations for gift purposes may differ because the owner is still present. However, consideration must be given to minority interests as well as to future prospects for obtaining a controlling interest through stock options or other means.

In disputes involving the Internal Revenue Service (IRS), the valuation issue may become moot because the tax differential may not exceed valuation and legal fees. If a contest is anticipated, it is often advisable to prepare a written valuation report and submit it to the IRS with the return. Courts tend to rely more heavily on properly prepared valuation reports prepared prior to filing the tax return than on reports prepared years later after the IRS has contested the return. Refer to section 8 for additional information on rules provided by the IRS through Revenue Rulings addressing valuations for gift or estate tax purposes.

3.3 Divorce

In valuations involving divorce, the effect of the divorce on the business must be considered. Depending upon state law, the valuation may be adversely affected if a number of the business assets must be sold or if one spouse no longer contributes to the operation of the business.

If one of the spouses has left the operation of the business, the effect on goodwill may be even more difficult to determine than in the case of valuation for estate tax. The contention that the departing spouse provided substantial value to the business may be challenged by the other spouse. An independent valuation requires the appraiser to be especially careful not to compromise professional standards of objectivity and professional judgment.

If the business remains intact, standard valuation methods and procedures are sufficient. If, however, some of the assets must be sold, the appraiser will have to evaluate not only the effects of the decrease in assets but also the decrease in earnings and the effect on goodwill as a result of the contraction of operations.

3.4 Valuing Minority Interests

In several circumstances, it may be necessary to obtain an independent value of minority interests. Examples include buyout of dissenting minority shareholders, valuation of such interest at divorce or death, and valuation related to estate or gift taxes.

Minority interests in closely held corporations are often difficult to sell because they lack the ability to control corporate policy and dividends, and thus may lack marketability. The courts have long recognized that such a discount exists, making minority stock interests in a

closely held corporation less valuable than the proportionate share of the whole enterprise. Courts have allowed minority discounts even though an individual's shares combined with those of family members constitute majority control (Rev. Rul. 93-12).

In addition, Rev. Rul. 59-60 acknowledges that a discount for blocks of shares may properly be applied as follows:

The size of the block itself is a relevant factor to be considered. Although it is true that a minority interest in a nonpublic corporation's stock is more difficult to sell than a similar block of publicly traded stock, the amount of the minority interest discount is a factual question. It is a consideration which involves a sound evaluation of all the factors applicable to the particular case.

A review of court cases indicates that discounts for minority interests from 15 percent to 25 percent are common, although discounts often reach 50 percent and more. In addition, other types of discounts may be available. See section 6 for further discussion of such discounts.

3.5 Litigation

Expert valuations of closely held businesses are becoming increasingly important in various kinds of litigation. Common situations in which a valuation may be required in litigation include divorce, insurance claims, lost profits, and compensatory damage cases. Support can be provided to an attorney who is deciding whether to proceed with a case. A valuation may also be necessary if the appraiser is to testify as an expert witness.

In circumstances that include litigation, it is important to know the purpose of the valuation, to work closely with the attorney, and to be prepared with a complete report. Remember that the laws differ by jurisdiction. Thus, it is critical to know the definition of value in the particular jurisdiction and the key case law interpreting the standards of value. It may also be helpful to investigate prior court cases that are similar to the situation at hand. Additional guidance in this area is available in the American Institute of Certified Public Accountants' (AICPA's) Management Consulting Services Technical Consulting Practice Aid No. 7, *Litigation Services*.

3.5.1 Federal rules for expert witnesses

The Federal Rules of Civil Procedure apply in federal court unless the local jurisdiction opts out of certain provisions. The rule amendments effective December 1, 1993, are the most sweeping changes since the

Rules were first adopted in 1938. Business appraisers who may be called to testify as expert witnesses are required by these Rules to provide a written report under most circumstances. In addition to the report, expert witnesses must furnish the following supplemental information:

- A list of the cases in which the expert witness testified either by deposition or testimony in the prior four years
- Disclosure of the compensation being paid to the expert witness for study and testimony
- A list of all publications authored by the expert witness in the preceding ten years without regard to relevancy

An appraiser who will provide expert testimony should meet these requirements unless the attorney involved explicitly directs the expert witness that those Rules do not apply in the particular jurisdiction where the matter is pending.

4. IMPORTANT VALUATION CONCEPTS

Valuation is based on the highest and best use of an asset. The same business can have different values for different purposes. For example, a business may be valued at one level for divorce purposes and at another for dissenting shareholder cases. The following subsections provide a basis to determine if certain values are more appropriate and therefore more applicable to the valuation process.

4.1 Corporate Life Cycle

Businesses are much like people. They have an inception. They have a nurturing stage during which they cannot support themselves. They may have a period of rapid development similar to adolescence. They experience maturity, decline, and, perhaps, even death. The business life cycle, though, can be changed by bringing in new management, new products, or new financing.

An important consideration in valuing a business is to identify as closely as possible where the company is in the corporate life cycle. In adolescence, for example, the company is growing so quickly that it runs out of working capital. The inventory is not enough, the receivables are not enough, the company struggles, and growth is not always smooth. Earnings tend to be good, but cash flow is a problem. By comparison, a company in decline is not growing. Rather, its sales are decreasing, and earnings may be dropping. The cash flow is very good, however,

because inventories are being liquidated and receivables are being liquidated. Because the company is mature, the assets are generally paid for and there is little leverage.

As a buyer, which would you prefer to invest in—a company that is growing and, in so doing, struggling to meet its cash flow requirements, or a company that is declining, losing market share, and has a limited future? Keep in mind that, by buying a company past its peak and in a declining stage, it is possible to downsize—that is, to liquidate a number of the assets—and generate almost as much total profit with a fraction of the total assets.

4.2 Management

Inherent in any business appraisal is an assessment of the quality of management. Experienced, competent, imaginative management will recognize and address problems. Inexperienced, unimaginative management can turn a good company into a poor investment quickly. The quality of top management is important in the long run. The quality of second-line management is also important in the long run. Is there a clear management succession scheme? Is there a key person in the company, the loss of whom would be significant? Is that key person the owner or an inventor-type who develops the new products—and what happens to the company in the absence of new product development?

If the appraiser determines that the company relies on one person or a very few key people, there are at least two ways to incorporate that circumstance into a business valuation calculation. The appraiser can adjust upward the discount rate or capitalization rate used in the calculations of value under certain valuation methods to recognize the risk to the company of the loss of a key person. How to determine an appropriate discount rate and capitalization rate is reviewed in subsection 4.5. Another option is to calculate the value of the company ignoring the key person risk and then apply a separate, special discount for that risk. The key person discount is discussed in subsection 6.1.3.

4.3 Liquidation Value v. Going Concern Value

Liquidation value is the amount that could be realized if the company's assets were sold separately. For example, if the owner of a restaurant were to sell the inventory and equipment, the proceeds from such a sale would be the liquidation value of the business. Orderly liquidation is the sale of assets over a reasonable period with an attempt to get the

best price for each asset. Forced liquidation is the sale of assets as quickly as possible, frequently all at one time, at auction.

In contrast, going concern value is the amount that could be realized if the business entity, as a viable operating entity, were sold as a whole. In the preceding example, this would be the amount realized for the sale of the entire restaurant. If this amount exceeds that which could be obtained from the assets separately, the difference is the amount attributable to the going concern separate from its tangible assets—that is, intangible value.

The willing seller/willing buyer concept suggests that no seller would accept a liquidation value if the business has been highly profitable and, thus, the value under an earnings approach is higher. Conversely, no seller would accept an earnings approach value if the liquidation value is substantially higher. A buyer may be willing to pay almost liquidation value if the buyer believes he or she can sell off a number of assets and maintain a profitable business with the assets that remain.

4.4 Book Value v. Market Value

Use of the book value of assets as a basis for valuation can be very misleading. Because book value is determined on the basis of historical accounting cost and certain assets are depreciated, depleted, or amortized according to generally accepted accounting principles (GAAP) or current tax legislation, there is often a wide variation between the current book value of an asset and its market value. Accountants, therefore, make no representation that the current book value of an asset is equal to the current market value of an asset. Nevertheless, book value is important to determine the seller's income tax ramifications. Book value is also important as a starting point if the approach to valuation is weighted heavily toward asset values.

4.5 Discount Rate v. Capitalization Rate

An often confusing issue in business valuation is the discount rate and the capitalization rate used in various calculations of value. The discount rate is a rate of return used to convert future expectations of either earnings or cash flows to a present value. The discount rate is similar to the opportunity cost in that it measures the return required to induce a potential investor to invest in a company.

A capitalization rate converts a particular stream of earnings or cash flows into value. Mathematically, the capitalization rate is equal to the discount rate minus growth. Using a capitalization rate is appropriate only if the subject company's growth is expected to be at a constant rate. If growth is not expected to be constant, the appraiser should use a valuation method that utilizes a discount rate.

4.5.1 Discount rate

The calculation of the appropriate discount rate requires consistency and judgment. Under appropriate circumstances, an appraiser might discount the earnings either pretax or after tax. Under other circumstances, discounting the earnings before interest and taxes may be appropriate. Under still others, earnings before interest, depreciation, and taxes may be discounted. At least in theory, one should discount the net cash flow—that is, the after-tax earnings, plus noncash expenses, depreciation and amortization, less capital expenditures, less principal payments, plus new principal borrowing.

It is possible to calculate a discount rate in a step-by-step process. A company's discount rate is composed of a number of identifiable risk (or return) factors that, when added together, result in the total return that a prudent buyer would demand from an investment in the company. The discount rate can be built up in this process, as follows:

1. A risk-free rate of return (the return an investor could obtain from a low-risk, safe investment) is determined for the valuation date. This risk-free rate is assumed to be approximately equal to the yield to maturity of long-term bonds (U.S. Treasury bonds or tax-free bonds, in some cases).
2. To this risk-free rate is added a risk premium that the average equity investor will demand above this risk-free rate. Ibbotson Associates has published information in the *Stocks, Bonds, Bills and Inflation* yearbooks regarding actual premiums since 1926.
3. Depending on the circumstances, a small stock risk premium, which the average investor will demand above the rate required on larger companies, may also be added to this rate. Ibbotson Associates' yearbooks include information on actual small stock premiums paid. Ibbotson determines this risk premium based on the weighted average return earned by the smallest 20 percent of all companies listed on the New York Stock Exchange, plus American Stock Exchange companies and Over the Counter Exchange companies of similar size.

4. Finally, an additional increment is added for risk associated with the particular company being valued. Some of the risk may be offset by the company's strengths.

How to arrive at the discount rate through the build-up process is summarized in the following example:

| | |
|---|----------------------|
| Risk-free rate | 6.34% |
| (a composite long-term U.S. Treasury bond rate, as of the valuation date) | |
| Equity risk premium | 7.30% |
| Small stock premium | 5.20% |
| Company specific risk premium | <u>3.00%</u> |
| Discount rate | <u>21.84%</u> |
| Rounded | <u><u>22.00%</u></u> |

4.5.2 Capitalization rate

Once a discount rate has been determined, calculating the capitalization rate seems a simple subtraction problem. However, complex considerations affect the determination of a capitalization rate.

When the expected growth rate of an earnings stream is constant, the capitalization rate will be the reciprocal of the price-to-earnings (P/E) ratio. For example, if the P/E ratio is 5, then the capitalization rate is 20 percent.

However, in most instances, the expected growth rate of an earnings stream will not be constant but will instead be affected by factors such as interest-rate changes, expected changes in the business, and other economic conditions. If growth is not expected to be constant, conversion of the estimate of future earnings to a present value by using a discount rate is a more appropriate valuation method.

If an earnings history is the basis for calculating value (see subsection 5.2), a capitalization rate can be used to convert the historical earnings to present value. As noted earlier, the capitalization rate is the discount rate minus growth. Subtracting a growth factor is appropriate because the discount rate is normally applied to estimates that include future growth, but actual historical earnings do not include future growth. If comparable companies are used in the valuation process, the price-to-weighted-average-earnings ratio of the similar companies over

the historical period (usually five years), may be used to arrive at an appropriate capitalization rate. The capitalization rate is the reciprocal of this ratio.

Section 6 of Rev. Rul. 59-60 discusses capitalization rates and admits that “a determination of the proper capitalization rate presents one of the most difficult problems in valuation.” Although Rev. Rul. 59-60 does not present a standard formula for capitalization rates, it does list some of the more important factors to be considered in deciding the capitalization rate in a particular case, the same factors considered in determining the discount rate, as follows:

- The risk
- The nature of the business
- The stability or instability of earnings

In addition to these factors, the riskless rate of return (such as that of U.S. government securities) should be considered, along with the rate the company pays to borrow money. Shareholders take a greater risk than the bank and are entitled to a greater return.

Business risk considers the relative importance of management as well as several other factors such as the condition of the economy, and the uncertainty of the sources of supply, product quality, skilled labor.

Managerial skills may be measured by comparing a company's past performance with that of similar businesses. In older businesses with strong historical earnings and less risk, the P/E ratio generally will be higher and the capitalization rate, therefore, lower.

In contrast, businesses that are established but that require a great deal of managerial ability because of the instability of the market in which they compete would have a lower P/E ratio than those businesses requiring fewer managerial skills and, therefore, a higher capitalization rate.

In small businesses that truly rely on one key manager as the key component of earnings, the capitalization rate may equal 100 percent. Therefore, the value will be approximately equal to the earnings of a single year because the earnings are almost entirely dependent upon the skill of the manager and are subject to the company's ability to retain this person.

(Text continued on page 17)

5. COMMON METHODS OF VALUATION

Several important valuation methods are discussed below; however, space does not permit a comprehensive list of all possible valuation methods.

In circumstances where a binding, contractual agreement specifying a particular valuation method exists, the agreement would dictate the valuation method to be used, for example, a buy-sell agreement may indicate a fixed price, a formula price, or a specific capitalization factor. In addition, a valuation method based on recent arm's-length sales may take precedence over other valuation methods if the sales were made under appropriate circumstances.

Otherwise, a combination of the methods discussed below may be the best way to reach a valuation conclusion. In the absence of a binding contractual agreement and/or recent prior sale, the guideline company valuation method may provide the most appropriate valuation. Other methods become appropriate, should the guideline company valuation method not be applicable.

5.1 Guideline Company Valuation Method

In valuing the stock of closely held companies, the market values of stocks of comparable publicly held companies (and privately held companies if enough information is available) are relevant factors for providing guidance on the value of the subject company. Such comparable companies are called guideline companies. Conclusions about the financial condition of a company can also be drawn by comparing its operating results with those of guideline companies.

To be truly comparable to the subject company, a guideline company should be engaged in the same or a similar line of business. Its size, capital structure, and trend of sales and earnings should be similar. To reflect the public market attitude, a guideline company's stock should be actively traded in a free and active market, whether on an exchange or over the counter.

The guideline company valuation method is perhaps most appropriate for larger companies that compete with publicly traded companies. The first step in this method is the selection of a group of publicly traded companies similar to the subject company. The accuracy of the results of this valuation method depends on finding truly comparable companies.

5.1.1 Selecting guideline companies

An appraiser will rarely find a company that is exactly the same as the subject company in all respects. The best the appraiser can usually hope

for is to find a number of public companies that are similar to the subject company in many respects. The appraiser must exercise a great deal of judgment in determining which companies are similar enough to be used as guideline companies. Reasonable, informed appraisers exercising their professional judgment may reach different conclusions about which specific companies should be used as guideline companies.

Industry similarity should always be a primary criterion in selecting guideline companies, but appraisers differ in their judgments as to how this criterion should be applied. For example, a number of appraisers include the company's customers; customers may be in a different industry, but they and the subject company face the same economic and industry influences. Degree of diversification, similarity of products and markets, degree of vertical integration, economic and regional influences, and the maturity of the business are all factors to consider in judging whether the companies are actually in the same industry.

Among the other criteria used in determining comparability are size, historical trend and growth prospects, financial risk, operating risk, management depth, and dividend paying capacity.

If no guideline companies can be found, the other valuation methods discussed in this chapter should be considered.

5.1.2 Using the guideline company method

If an acceptable group of comparable, publicly held companies has been found, the various P/E ratios, dividend payout ratios, and market value-to-book value ratios should be calculated; other ratios may also be used, but these three are usual. Consider the results of these calculations. Is a simple average appropriate? Perhaps the median (the middle value ranking the ratios high to low) should be the main consideration. Perhaps a particular company's ratios are so out of line that the company should be ignored. Are some of the guideline companies very comparable and others less so? Excellent judgment is needed at this point.

Next, each ratio should be applied to the subject company to arrive at an implied market price derived in the context of each ratio. What adjustments then need to be made?

After arriving at the implied market price derived by the relevant ratios as adjusted, the relative importance of each ratio or factor must be considered and the results of applying each ratio weighted accordingly. In *Central Trust v. U.S.*, (305 F. 2d 393(1962), 62-2 USTC 12,092), it was determined that earnings should be weighted at 50 percent because the company was a manufacturer with a consistent dividends and earnings record. The court divided the remaining 50 percent between the dividend yield and book value factors.

Examples of the guideline company valuation method are presented in *Guide to Business Valuations* by Jay E. Fishman, Shannon P. Pratt, J. Clifford Griffith, and D. Keith Wilson, and in *Valuing A Business: The Analysis and Appraisal of Closely Held Companies* (2nd Ed.), by Shannon P. Pratt. (See References at the end of this chapter.)

5.2 Capitalization of Earnings Method

In the capitalization of earnings valuation method, company earnings, adjusted for unusual or nonrecurring items, are converted to value by applying an appropriate capitalization rate. Asset values are not considered under this method.

In some cases, projected future earnings may be used; however, often a three-to-five-year earnings history is used, with more weight apportioned to the most current earnings. For example, the most current year may receive a weight of 5 if a five-year history is used, a weight of 4 for the preceding year, and so on. This weighting stresses the importance of current trends in reaching a realistic valuation.

The capitalization of earnings method can be illustrated as follows:

| <i>Year</i> | <i>19X5</i> | <i>19X4</i> | <i>19X3</i> | <i>19X2</i> | <i>19X1</i> | |
|---|-----------------|-----------------|------------------|-----------------|-----------------|------------------|
| Weight adjusted after-tax earnings | 5 | 4 | 3 | 2 | 1 | |
| | <u>\$70,000</u> | <u>\$40,000</u> | <u>\$ 45,000</u> | <u>\$30,000</u> | <u>\$90,000</u> | |
| × | <u>5/15</u> | <u>4/15</u> | <u>3/15</u> | <u>2/15</u> | <u>1/15</u> | |
| | \$23,333 | \$10,667 | \$ 9,000 | \$ 4,000 | \$ 6,000 | |
| Five-year weighted average earnings | | | | | | \$ 53,000 |
| Capitalization rate | | | | | | +15% |
| Value of business before discounts and premiums | | | | | | <u>\$353,333</u> |

5.3 Capitalization of Excess Earnings Method

Capitalization of excess earnings is similar to the capitalization of earnings method in that earnings, adjusted for unusual or nonrecurring items, are capitalized on the basis of a five-year earnings history. Normal expected earnings are composed of two parts. The first part is the fair return the company should earn on the tangible assets. The second part is any earnings in *excess* of a fair return on tangible assets, which

must be a return on *intangible* assets. Therefore, the *excess* earnings are capitalized at an appropriate rate (higher than the rate of return for tangible assets because intangible assets are at greater risk of loss in the future). The value of the intangible assets plus the value of the tangible assets (net of liabilities) is the value of the equity.

The capitalization of excess earnings method can be illustrated as follows.

| | | |
|---|--------------------|-------------------------|
| Net tangible assets at valuation date (equals tangibles and identifiable intangibles minus liabilities, all at fair market value) | | \$100,000 |
| Weighted average of five-year earnings (after deducting extraordinary items and discontinued operations) | \$ 15,000 | |
| Less: average industry rate on net tangible assets for the size of the company involved | - \$ <u>10,000</u> | |
| Excess earnings | \$ 5,000 | |
| Capitalization rate (determined from industry data) | + <u>20%</u> | |
| Value assigned to unidentifiable intangibles (goodwill) | | <u>\$ 25,000</u> |
| Value of the business before discounts or premiums | | <u><u>\$125,000</u></u> |

The capitalization of excess earnings method should be followed only if no other methods apply.

5.4 Dividend Capacity Method

The dividend capacity valuation method is of questionable usefulness for the closely held business since dividends and salaries are both controlled by the owner. In fact, the minimization of dividends is typical for smaller businesses. However, as the method's name implies, it is the dividend capacity (the amount of earnings that could be distributed) that is important—not the actual dividends that have been paid. Because it is difficult to gather objective information of this nature for a closely held business, this method is seldom used.

5.5 Adjusted Net Assets Method

The adjusted net assets valuation method is frequently used for valuing real estate and other investment companies or businesses to be liquidated by utilizing itemized appraisals of the company's assets. This method of determining the business value is arrived at by subtracting the fair market value of the liabilities from the fair market value of the assets. An adjustment is also made for unrecorded intangible assets such as goodwill, if they can be sold. This method produces a static valuation and is difficult to use because of the substantial actual time and cost that may be needed to carry out an asset-by-asset evaluation.

This method may be valuable as a check on other methods because it attempts to find the cost of reproducing the business enterprises. It also may identify those items that do not contribute to current earnings or profitability. A discussion of procedures for valuing selected items is found in section 9 of this chapter. The adjusted net assets method is frequently used as part of an analysis of the value of a business in a partial liquidation, whereby some of the assets are sold to reduce the size of the company to a level that is justified by the remaining earnings.

5.5.1 Tax effect

When using a net asset method, business appraisers (and courts) may disagree on the appropriate considerations to be given to tax consequences. For example, if the appraiser determines that the fair market value of a plant exceeds its book value by a substantial amount, he or she would substitute the fair market value of the plant for its book value in preparing an adjusted balance sheet. What about the tax consequences of selling the plant for the new, adjusted fair market value price? In a number of states, in the instance of divorce, for example, if the plant is not going to be sold in the near future, the courts may ignore the income tax effect as being speculative as to 1) whether or not there ever would be a tax, and 2) the amount of tax that would be incurred at the future disposition date.

Some appraisers believe that assets are valued "as if" put up for sale, without assuming that a sale will occur. Since there is no sale, no taxes will be incurred on any gains on asset sales (or benefits from losses on those sales), and no tax adjustments are needed because gains and losses on asset sales and the related tax expense are recognized in the ongoing net income amounts used in other going-concern valuation methods. Thus, they believe that it would be inconsistent to provide for tax effects on the appraisal adjustments.

Other appraisers believe that taxes generally should be provided for the difference between the market values of net assets and their tax

basis. Since enactment of the Tax Reform Act of 1986, many sales involving C corporations have been structured as sales of stock, with the buyer retaining the seller's old basis. That means the buyer does not receive the additional tax deductions associated with stepping up the basis in appreciated assets acquired in the purchase. Since the buyer's tax deductions are reduced, the total benefits from purchasing the company are reduced. Likewise, if the corporation sells assets rather than the owner selling stock, the corporation will have to pay taxes, thus reducing the net proceeds. Calculating tax effects of the net asset value adjustments recognizes these costs.

The IRS's position on this issue appears in Technical Advice Memorandum (TAM) 9150001. This TAM considered the issue of whether or not an estate is entitled to discount the net asset value of a Subchapter C real estate holding corporation for estate tax purposes in order to reflect the capital gains taxes that would be incurred if the corporation were liquidated. The effect of the conclusion expressed in the TAM is that an individual would pay the same price to purchase the real estate directly as to purchase 100 percent of the stock of a corporation that owned the real estate (the corporation having a very low basis in the real estate).

The question for the appraiser to consider, then, is this: If there is no way for the company to avoid paying income tax at the corporate level under the appropriate appraisal method being used, then should that deferred tax be considered in determining the net asset value? If the taxes could be avoided by appropriate planning, then the appraiser would not consider taxes that would not have to be paid.

CAUTION: A minority shareholder may not be able to force the company to take actions. Thus, the appraiser needs to consider whether a method that assumes some actions at the corporation level, such as the sale of assets, is appropriately used in appraising a minority interest in a closely held business.

5.6 Discounted Future Earnings Method

The discounted future earnings valuation method is used to determine whether a business's price can be recovered through future earnings. In discussing future amounts, the appraiser must be able to calculate not only the amount of the expected future earnings but also the appropriate discount rate.

Theoretically, the most reliable method for determining the fair market value of a business is to determine the future benefits and discount those benefits to a present value. The experienced practitioner realizes that it is difficult under the best of circumstances to predict one or two years accurately, let alone five years, ten years, or even into

perpetuity. Further, the calculation of the appropriate discount rate requires a clear assessment of the risks of the accuracy of the projections, as well as market influences and alternative investments available to a buyer. Thus, while the theory is clear, its application is quite difficult and is subject to differences of opinion. Factors that influence the reliability of the projections include the following: How the projections are prepared, how successful the company has been historically in meeting its projections (meaning, how accurate were past projections), how volatile the business is, and the effect of relatively small errors in the projections relative to the value.

5.6.1 Earnings forecast

The preparation of an earnings forecast usually involves preparation of a five-to-ten-year forecast of operations. Although these earnings forecasts are not exact, they provide some insight into expected future earnings. Although business people regularly consider optimistic, pessimistic, and most likely scenarios, an accountant who does so may be in violation of certain AICPA pronouncements. (See subsection 11.2.)

It has been suggested that the element of risk inherent in using such projections may be reduced by providing for a weighted estimated earnings figure. For example,

$$\text{Weighted estimated earning} = \frac{a + 3m + b}{5}$$

Where:

a = the most optimistic estimate

m = the most likely estimate

b = the most pessimistic estimate

There are two basic ways to address a higher degree of risk. One is to reduce the earnings forecast to indicate that a greater risk factor is present. The preferred treatment, however, is to increase the discount rate to reflect the greater risk.

6. APPLYING DISCOUNTS

6.1 Discounts for Size of Interest, Key Person

As noted earlier in this chapter, various discounts may be pertinent that affect the final conclusion of value.

6.1.1 Discount for minority interest

A minority interest in a closely held business is worth much less than its proportionate share of the whole company because of the absence of control. The holder of a minority interest cannot elect a majority of

the board of directors and, therefore, cannot compel the payment of dividends, force the sale of the company or its assets, dictate management policies, or choose top management. A minority shareholder cannot ensure his or her own position as an officer or even as an employee.

Empirical evidence quantifying the discount for minority interest is provided by extensive studies of control premiums in public companies and the implied minority discount. Merrill Lynch Business Brokerage & Valuation, Inc. studies transactions involving the purchase of controlling interests in public companies (before 1988, W. T. Grimm and Company conducted similar studies). Statistics on these acquisitions are published annually in *Mergerstat Review*. These statistics indicate that average implied minority interest discounts ranged from 26 percent to 34 percent during the period 1980 through 1992. These statistics are based on market prices during the five business days prior to the merger announcement. Studies have shown that stocks have some tendency to rise in anticipation of such announcements, starting considerably more than five days prior to the announcement. Therefore, the *Mergerstat Review* statistics may understate the discount for minority interest.

Houlihan, Lokey, Howard and Zukin, Inc. (HLHZ) also publishes studies of control premiums and implied minority discounts in public companies in the *Control Premium Study*. HLHZ analyzes the prices of a target company's stock before the acquisition date and attempts to select a price that is unaffected by preannouncement speculation about the proposed transaction. HLHZ's analyses covering 1989, 1990, 1991, and 1992 indicate an average implied minority discount ranging from 30 percent to 35 percent.

Thus, these empirical studies indicate a range for average implied minority discounts of 26 percent to 35 percent.

To determine the appropriate minority discount to apply in a valuation, the appraiser looks at the degree of control or lack of it in the particular company. Based on experience and knowledge and grounded in the results of empirical studies, the appraiser arrives at an appropriate discount for minority interest from the pro rata value per share of the entire enterprise.

NOTE: If the value per share is derived from public market guideline companies, that data already reflects minority interests, thus no additional discount is appropriate.

6.1.2 Discount for lack of marketability

A discount for lack of marketability may also be appropriate because a minority interest in a closely held business does not enjoy the ready market of an actively traded, publicly held security. Marketability

addresses the liquidity of the investment or how quickly the investment can be converted to cash.

Empirical evidence quantifying the discount for lack of marketability is provided by numerous studies. Shannon P. Pratt summarizes these studies in his book, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies* (2nd ed., 1989, Chapter 10). One approach to quantifying the discount for lack of marketability is to compare prices of restricted stock of publicly traded companies with prices of unrestricted stock of the same company at the same time. The only difference between the restricted stock and unrestricted stock in these studies is the lack of a public market for the restricted stock. Therefore, the difference in price between restricted and unrestricted stock is one way to measure the discount for lack of marketability. Pratt summarizes seven independent studies of several hundred transactions from the late 1960s to 1984. Average discounts observed in these studies ranged from 26 percent to 45 percent.

Another approach to quantifying the discount for lack of marketability is to study the stock sales of closely held companies, which then become publicly held companies. Stock prices immediately before the announcement of the intent to offer stock on public markets are compared with subsequent prices on public markets (with certain adjustments for market conditions at the different times). A series of studies by John D. Emory (covering an 18-month period from 1980 to 1981 and four 18-month periods from 1985 to 1992) and a series of studies by Willamette Management Associates (1975–1985) utilized this approach. Evidence from these studies covered hundreds of transactions. The average discounts observed in these studies ranged from 42 percent to 74 percent. Current restrictions on the sale of securities are somewhat less stringent than the restrictions in force at the time of the earliest of these studies. This is reflected in Emory's findings of average discounts of 60 percent in his 1980–1981 study versus 42 percent in his 1990–1992 study.

To determine the appropriate marketability discount to apply in a valuation, the appraiser looks at factors that affect the marketability of the stock such as buy–sell agreements, dividend paying history, and anticipated cash flow needs. Based on experience and knowledge and grounded in empirical evidence, the appraiser arrives at an appropriate discount for lack of marketability.

6.1.3 Key person discount

The degree to which the company's success depends on the efforts of a single individual (often the majority owner) dictates the magnitude of the key person discount. Having safeguards in place that protect the company reduces the magnitude of the key person discount.

Key person risk may be considered within a discount rate or capitalization rate (as noted in subsection 4.5) or as a separate discount applied to the value of the company. Generally, this risk of loss can be attributed to one of three possibilities: 1) death, 2) disability, or 3) leaving the company (which may further include competing against the company). Life insurance can be purchased that reduces the risk of loss due to death. Employment contracts that include noncompete agreements may be used to reduce the risk of voluntary leaving. Additional management support may be a way to reduce all three levels of risk.

A company that carries sufficient life insurance on a key person and has a noncompete agreement with the key person has less risk of loss of the key person and, therefore, a lower discount than would be applied to the value of a company without those contractual advantages. By considering a separate discount for the risk of loss of a key person, the appraiser can be more analytical and reach more objective conclusions.

6.1.4 Successive discounts

The order in which discounts are taken is important because it affects the results. Key person discounts and other discounts that reflect the whole company should be taken first. This is consistent with either taking a discount or adjusting the discount rate for the whole company. The conclusion arrived at for the value of the entire company after the key person discount or other similar discounts is called the enterprise value. That is the value for 100 percent of the enterprise.

Next, when appropriate, a minority discount should be taken. This discount reduces the pro rata value per share of the enterprise value to get to a value per share on a block of stock constituting a minority interest. This is consistent with the conclusion reached using a guideline company market approach as the public market is made up of many minority blocks of stock, generally without any one individual or group owning absolute control. Sometimes, for identification purposes, appraisers refer to the total number of shares outstanding times the value per share for minority blocks of stock as the aggregate minority value. Note that when valuing a control position in a closely held company, if the appraiser has used guideline companies to reach a value per share, that share value is typically considered to reflect a minority interest. To move from the minority interest value per share to a control position, the appraiser often adds a control premium to the aggregate minority value per share to describe the control position.

After determining the minority value per share, it may also be necessary to take a discount due to lack of free marketability. Such a discount is particularly appropriate if the conclusions reached about the company were based on alternative investments that provide liquid-

ity. These might include guideline company methods which value on the basis of publicly held company stocks, or discount rates that consider U.S. Treasury bills or a diversified portfolio of common stocks as a part of a calculation of the discount rate.

It is not appropriate to merely add the discounts and then apply the sum to the pro rata enterprise value per share. Taking the appropriate discounts consecutively leads to a different conclusion than adding them together and applying them. For example, consecutively applying a 25-percent discount for minority interest and a 25-percent discount for lack of marketability yields a different result than that achieved by applying a 50-percent total.

6.2 Case Study: Valuation of a Closely Held Corporation

| | <i>May 31,</i> | | | | | |
|--|-----------------|-----------------|------------------|------------------|------------------|----------------------|
| | <i>19X4</i> | <i>19X5</i> | <i>19X6</i> | <i>19X7</i> | <i>19X8</i> | <i>Total Average</i> |
| Average net worth | \$59,000 | \$95,000 | \$125,000 | \$147,000 | \$187,000 | <u>\$122,600</u> |
| Weighting factor | <u>1/15</u> | <u>2/15</u> | <u>3/15</u> | <u>4/15</u> | <u>5/15</u> | <u>15/15</u> |
| Weighted net worth | <u>\$ 3,933</u> | <u>\$12,667</u> | <u>\$ 25,000</u> | <u>*\$39,200</u> | <u>\$ 62,333</u> | \$143,133 |
| Rate of return on investments | | | | | | 15% |
| Return on investments | | | | | | <u>\$ 21,470</u> |
| Net income after taxes | \$45,000 | \$36,000 | \$30,000 | \$22,000 | \$40,000 | <u>\$34,600</u> |
| Weighting factor | <u>1/15</u> | <u>2/15</u> | <u>3/15</u> | <u>4/15</u> | <u>5/15</u> | <u>15/15</u> |
| Weighted net income | <u>\$ 3,000</u> | <u>\$ 4,800</u> | <u>\$ 6,000</u> | <u>\$ 5,867</u> | <u>\$13,333</u> | <u>\$33,000</u> |
| Earnings attributable to goodwill (\$33,000 adjusted net income less \$21,470 return on investments per above) | | | | | | \$ 11,530 |
| Capitalization rate | | | | | | + 20% |
| Value of goodwill | | | | | | \$ 57,650 |
| Fair market value of identifiable assets less liabilities | | | | | | 120,000 |
| Total value of corporation, May 31, 19X8 | | | | | | \$ 177,650 |
| Total number of shares outstanding | | | | | | 500 |
| Pro rata value per share | | | | | | \$ 355.30 |
| Less minority discount of 20 percent | | | | | | 71.06 |
| | | | | | | <u>\$ 284.24</u> |
| Less lack of marketability discount of 15 percent | | | | | | 42.64 |
| Value per share | | | | | | \$ 241.60 |
| Total shares in block being valued | | | | | | 150 |
| Value of shares | | | | | | <u>\$36,240.00</u> |

7. REACHING CONCLUSIONS

Each of the various valuation methods calculates a conclusion. How does the appraiser reach an opinion of the fair market value given these various indications of value?

7.1 Examining Valuation Results

One helpful step is to organize the various methods used and the results of each method in a summary chart. The three major headings of asset approaches, earnings or cash flow approaches, and market approaches give an array of value conclusions that shows immediately whether or not the valuation methods produced similar results. If the value conclusions fall in a relatively tight range within an approach and among approaches, the appraiser can be confident that the final conclusion is within the range. If, however, there is a wide disparity within each of the approaches, the appraiser should decide which methods are a better representation of the value of the subject company, considering the influences that may have skewed the result of each method. Was there an error in the calculations? Were there inconsistent assumptions? Are the differences caused by the nature of the business or some economic event?

Also consider the following questions. What value would a willing seller demand? What value would a willing buyer accept? Which methods best achieve the purpose of the appraisal?

7.2 Weighting Valuation Results

Sometimes the approaches and/or methods are weighted to arrive at a final conclusion of value. For example,

| | | |
|-----------------------|---|-----|
| Earnings approach | = | 50% |
| Market approach | = | 25% |
| Adjusted asset method | = | 25% |

If the range of value is minimal, the appraiser can be confident of the conclusion reached by weighting (even though different appraisers may reach slightly different conclusions). If the range of values is wide, however, a mere averaging or weighting may be less reliable than choosing one or a few methods that make the most sense and relying on their results to indicate a final conclusion.

7.3 Matching Valuation Methods to the Business

The nature of the business may dictate which valuation approaches will produce the most reliable results. Generally, service businesses are best valued on the basis of earnings or cash flow. For businesses with a heavy asset base, such as grocery stores or manufacturers, asset approaches and, particularly, adjusted assets methods may lend themselves better. Large-sized businesses that compete with and are similar to publicly held companies are best valued by market approaches and, particularly, guideline company methods.

8. THE INTERNAL REVENUE SERVICE APPROACH

Treasury Regulation 25.2512-1 defines “fair market value”: “The value of property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts.” Although this definition has been generally accepted, it may not be appropriate in all situations. A number of factors and methods must be weighed in performing a valuation that may ultimately involve the IRS. It is important to tailor the valuation report to the standards the IRS has set forth. A brief summary of selected IRS standards follows. Additional Revenue Rulings pertinent to business valuation include Rev. Rul. 77-287, Valuation of Restricted Securities; Rev. Rul. 81-253, Family Attribution (re: Minority interest discounts); and Rev. Rul. 83-120, Valuation of Preferred Stock.

8.1 Revenue Ruling 59-60—IRS Business Valuation Principles/Valuing Closely Held Stock

In this ruling, the IRS provided a detailed consideration of many factors it feels are relevant to the valuation of closely held stock. The reader is advised to read and review Rev. Rul. 59-60. This ruling has also been relied on as a source of authority in numerous valuation cases not involving the IRS. For informational purposes, the key points of Rev. Rul. 59-60 are summarized below.

8.1.1 Purpose

The purpose of this ruling was to outline the factors the IRS believes should be considered in valuing shares of closely held corporations specifically for gift and estate tax purposes. Then, in 1965, through Rev. Rul. 65-192 and 65-193, the Treasury Department announced that these same factors would be extended to all types of business interests for income tax purposes. The IRS went on to list certain fundamental factors that should be examined.

8.1.2 Background

The second section of Rev. Rul. 59-60 discusses the definitions of fair market value and closely held corporations. This section also explains that the valuations (for gift and estate tax purposes) must be made subject to the applicable sections of the Internal Revenue Code (IRC) and the estate and gift tax regulations.

8.1.3 Approach

The IRS contends that a determination of fair market value is a question of fact and that no single formula is applicable to all valuation cases. This ruling section also discusses the fact that the fair market value of stocks will fluctuate with general economic conditions, so the appraiser must exercise judgment as to the risks the corporation will face. Finally, the section states that, in many instances, the price at which publicly held companies in the same or a similar line of business are trading will be the best measure of value.

8.1.4 Key provisions

Rev. Rul. 59-60 contains a list of some of the factors the IRS considers fundamental to valuations:

- The nature of the business and the history of the enterprise from its inception
- The economic outlook in general and the condition and outlook of the specific industry in particular
- The book value of the stock and the financial condition of the business
- The earning capacity of the company
- The dividend-paying capacity of the company
- Whether or not the enterprise has goodwill or other intangible value

- Sales of stock and the size of blocks of stock to be valued
- The stock market price of corporations engaged in the same or a similar line of business having their stocks actively traded on a free and open market

Each of these factors is discussed by the ruling in some detail. The analysis of each of these factors involved a method that in effect combined several of the other tests. The practitioner must be knowledgeable about each of these factors since they have been stressed by the IRS in this ruling.

Rev. Rul. 59-60 specifically discourages averaging factors. “No useful purpose is derived by taking an average of several factors (for example, book value, capitalized earnings, and capitalized dividends) and basing the valuation on the results.”

The courts, however, have moved away from this IRS position and seem to support weighting the various factors. When weighting is used, the weight to be accorded to each factor depends upon the nature of the company’s business. For example, earnings should be a primary consideration when valuing companies that sell products or services, but asset values will be given the greatest weight when valuing investment or holding companies. (A brief discussion of the treatment of capitalization rates under this ruling appears in subsection 4.5.2.)

Rev. Rul. 59-60(8) also states that in the case of a restrictive agreement, an option price, for example—although a factor to be considered—will not determine fair market value for gift tax purposes. The IRS recognizes that these agreements have often been used to avoid gift and estate taxes by trying to pass the decedent’s shares for less than adequate value.

8.1.5 Summary

Rev. Rul. 59-60 does not provide a specific formula by which the IRS will measure valuations. It does, however, provide guidelines as to what factors should be assessed in a valuation report and provides some guidance about when those factors may be applicable.

8.2 Revenue Procedure 66-49 and Revenue Procedure 96-15—Donated Property

The IRS states that Rev. Proc. 66-49 is used as a guideline for all persons making “appraisals of donated property for federal income tax purposes, under Sec. 170 of the Internal Revenue Code.” This procedure also states that, although the cost or actual selling price of an item within a time period surrounding the valuation date may be the best

evidence of its fair market value, the sale must have been an arm's-length transaction.

This revenue procedure stresses the importance of expert opinion and the appraisal report. According to the requirements of this procedure, the appraisal report should contain

- A summary of the appraiser's qualifications.
- A statement of the value and the appraiser's definition of the value obtained.
- The basis on which the appraisal was made.
- The date of the appraisal and the signature of the appraiser.
- The date the property was valued.

This revenue procedure also outlines the method for reviewing appraisals. The burden is on the taxpayer for supporting the fair market value listed on the tax return. The IRS will not issue advance rulings on valuations and, if the taxpayer's appraisal is not accepted, the IRS may make its own determination of fair market value (made through an independent appraiser employed by the IRS).

In 1996, the IRS released Rev. Proc. 96-15, informing taxpayers how to complete an application for a statement of value from the IRS to substantiate the value of donated art for income, estate, or gift tax purposes. The revenue procedure generally applies to items that have been appraised at \$50,000 or more, with an effective date of requests submitted after January 15, 1996. Statements may also be issued for items appraised at less than \$50,000, if the statement request includes a request for appraisal review for at least one item appraised at \$50,000 or more (subject to IRS determination that such a request is in the best interest of tax policy).

8.3 Revenue Ruling 65-192—Intangible Assets

The stated purpose of this ruling is to furnish information and guidance concerning the usage of methods for valuing intangible assets. Basically, it states that the formula method (meaning, the capitalization of excess earnings) of valuing intangibles, as delineated in Appeals and Revenue Memorandum (ARM) 34, is not "conclusive of the existence and value of goodwill" if better evidence is available.

This ruling goes on to state that the methods and procedures outlined in Rev. Rul. 59-60 are also applicable to intangible asset valuations for income and other tax purposes and that the formula method

set forth in ARM 34 may be used only if other alternatives are not available.

8.4 Revenue Ruling 68-609—The “Formula” Method

Rev. Rul. 68-609 comprehensively sets forth the IRS position regarding the valuation of goodwill.

An example of the formula follows:

(Text continued on page 33)

| | | |
|---|-------------|--------------------|
| 1. Value of tangible assets | | \$1,000,000 |
| Value of goodwill | | |
| a. Fair return on tangible assets | | |
| Value of tangible assets | \$1,000,000 | |
| Reasonable return (for example, 8 percent in low-risk or 10 percent or more in high-risk businesses or the industry average) | | 8% |
| Computed return on assets | \$ 80,000 | |
| b. Compute "excess" earnings | | |
| Average earnings per year | \$ 100,000 | |
| Computed return per above | 80,000 | |
| Excess earnings attributable to intangible assets | \$ 20,000 | |
| c. Capitalize excess earnings | | |
| Excess earnings | \$ 20,000 | |
| Capitalization rate for intangibles (for example, 15 percent on low-risk to 30 percent on high-risk businesses; use industry average) | | + 15% |
| Value of goodwill | | \$ 133,333 |
| Total value of business | | <u>\$1,133,333</u> |

There is significant weakness and limited use of the excess earnings/formula method as applied to valuations of closely held businesses. Any appraisal relying heavily on this valuation method should be cognizant of the number of criticisms that can be raised to discredit it. The most obvious flaws relate to arbitrary rates of return and the unclear industry standard for rate of return.

The formula method will not be used in determining the fair market value of intangibles if a better basis is available for making the determination, such as testimony of the presence or absence of goodwill.

9. VALUATION OF SELECTED ITEMS

The following procedures are recommended in valuing selected items.

9.1 Cash

A common technique for the valuation of cash assets is to reconcile the bank statements and confirm the amount and account.

9.2 Accounts Receivable

Methods vary from using a five-year weighted average of bad debts in determining a percentage to reduce current receivables, to performing individual analyses of each receivable to determine collections.

9.3 Inventory

Inventory is normally valued at its replacement cost, according to the entity's records. Generally, the LIFO (last-in first-out) method should be used. Entities using FIFO (first-in first-out) should adjust to the LIFO method. However, circumstances may warrant that if inventory turns more than once a month, use of FIFO may be acceptable without any adjustment.

In valuing inventory, supplies must be included if they are a material item rather than considered an expense. Hidden reserves should also be accounted for. Obsolete and slow-moving inventory items should be identified and valued at their net realizable value.

9.4 Investment Securities

The current value of investment securities may be obtained from a broker or by checking *The Wall Street Journal* or *The New York Times*, among other sources.

9.5 Insurance

If existing insurance policies will not be continued, the short cancellation rate often provides the best value. The remaining prepaid portion of the last premium paid should otherwise be used.

9.6 Life Insurance Policies

This valuation amount will be the cash surrender value of the policy itself, less any policy loans. Interest on policy loans is often paid in advance, a fact that also should be considered.

9.7 Prepaid Expenses

The components of the prepaid expenses should be valued. The most common examples are rent, office supplies, taxes, and insurance. There

may be valuable prepaid expenses that do not show up on a balance sheet because they were charged directly to expenses.

9.8 Equipment

Usually the suppliers of the business entity deal with both new and used equipment and are able to provide figures that represent what the company could obtain in a fair market transaction for the asset, less any moving and reinstallation costs. Our technology is growing very fast, so a written estimate provides the best objective evidence.

9.9 Real Estate

A real estate appraisal by an appraisal specialist should be used. An appropriate appraisal may be obtained by combining and then averaging the appraisals of several local realtors.

When appraising real estate, the following three approaches are normally acceptable:

- *The cost approach.* The appraiser estimates the current cost to reproduce or replace the existing structure, deducts accumulated depreciation, and adds the value of the land.
- *Sales comparison approach.* The appraiser compares similar properties that have been sold recently, while making price adjustments based on elements of comparison.
- *Income approach.* Where there is income-producing property, the appraiser capitalizes a single year's income expectancy or an average of several years income expectancy that reflects a return on investment.

9.10 Intangibles

Intangibles considered for valuation should include covenants not to compete, employment agreements, patents, customer lists, trademarks, copyrights, franchise values, trade secrets, business plans, employee training programs, research and development, and developed computer software.

Patents and copyrights may be valued by taking the discounted value of future royalties, using an appropriate rate as of the valuation date.

These intangibles as well as all the other factors mentioned in this section may be considered part of goodwill. It is important to keep

these factors in mind when performing a valuation and to determine whether they will be valued separately or included in goodwill.

9.11 Leases

A lease is considered to have value when the lessee can retain the lease for an amount less than the lessor could obtain from a new tenant.

9.12 Liabilities

Long-term debt may be present-valued, using the current prime rate or actual borrowing rate. Current debt may be valued at face value. Pension liabilities may be valued by finding the present value of the accrued benefits. This is based on the assumption that the plan will be terminated at the valuation date.

Contingencies should generally be included only if they meet the conditions of Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies*, paragraph 1, under which an estimated loss from a contingency should be considered if certain considerations are met.

Although contingencies may not be measured if they don't meet the criteria of FASB Statement No. 5, buyers may still reduce the value by increasing the required rate of return due to the increased risk.

Deferred tax should be treated in a manner similar to long-term debt if the buyer will ultimately be responsible for this tax. Any future payments that will be due as a result of present operations should be present-valued using the company's borrowing rate. Consideration should also be given to any potential taxes upon liquidation of a corporation.

9.13 Liens

If the company has any of its assets pledged, such facts should be noted.

10. SPECIAL VALUATION CONSIDERATIONS

10.1 Valuing Employee Stock Ownership Plans

The Tax Reform Act of 1986 included provisions dealing specifically with Employee Stock Ownership Plans (ESOPs). On May 17, 1988,

the Department of Labor issued proposed regulations defining the “adequate consideration” limitation on the amount an ESOP can pay for securities. The “Proposed Regulation Relating to the Definition of Adequate Consideration,” published in the *Federal Register* of May 17, 1988, also specifically addresses the valuation of securities held by ESOPs. Basically, the provisions and regulations guide ESOP fiduciaries in fulfilling their statutory duties even though the regulations have not been formally adopted.

The Department of Labor requires fiduciaries to purchase ESOP assets for not more than adequate consideration, defined as fair market value determined in good faith. Good faith is defined as applying sound business principles of evaluation and conducting a prudent investigation of the circumstances prevailing at the time of the valuation. IRS provisions are included by reference as well.

A key point of the regulations is that the appraiser must be *independent*. An independent appraiser is defined as a qualified appraiser, that is, one who holds himself or herself out to the public as an appraiser qualified to make appraisals of the type of property being valued. The appraiser is not considered qualified as to the specific property if the donor of the assets had knowledge of facts which would cause a reasonable person to expect the appraiser to overstate the value of the property being appraised. Any person employed by the company being valued is *not* independent, and any person whose relationship to the company being valued “. . . would cause a reasonable person to question the independence of such appraiser . . .” is *not* independent (IRS Temporary Regulation 1.170A-13T).

In most respects, valuing the assets held by an ESOP is no different from other valuation assignments. One facet that is more typical of the ESOP, however, is the *put* option. This is the legal requirement that an ESOP participant who receives a distribution of stock in a closely held company be given an option to sell the stock to the ESOP and alternatively to the employer company. The put option ultimately creates a company liability to repurchase the stock that must be considered when analyzing the financial condition of the company.

Leveraged ESOPs are much more complex and are beyond the scope of this chapter.

10.2 Valuing Professional Practices

A large portion of the value of a professional practice, such as a medical, dental, legal, engineering, architectural, or accounting practice, may lie in the goodwill associated with the practice. Goodwill includes professional goodwill that is transferable and personal goodwill that is not

transferable. Goodwill encompasses professional qualifications, personal reputation, the practitioner's skill, retention of clients, and anticipated future earnings, and can be affected by the practitioner's age, work habits, and health.

The courts have recognized a variety of methods for valuing professional goodwill, including the capitalization of earnings method and the capitalization of excess earnings method, both of which have been reviewed in this chapter. As with other valuation assignments, the existence of a contractual agreement, such as a buy-sell agreement, specifying a value or valuation method would take precedence in determining value for certain purposes. Outside of such circumstances, the best valuation method is a recent offer to purchase the practice.

Particular complications in valuing professional practices arise when the valuation is performed in connection with a divorce. Viewing goodwill as marital property focuses attention on how to "divide and distribute" this intangible asset. Several potential valuation methods take into consideration future earnings, which can be viewed as proposing that postdivorce income be distributed as part of the marital assets. Several courts have looked unfavorably on that concept.

11. AICPA GUIDANCE

The practitioner should have a thorough understanding of the valuation methods discussed and referenced in this chapter while keeping abreast of changing alternatives and methods.

In addition to understanding the valuation process, it is important to follow related AICPA guidelines applicable from the initial engagement through reporting on the valuation and obtaining representation letters (see Appendix 1 for illustrative letters).

These guidelines have grown in recent years. Sufficient time should be devoted to becoming familiar with these guidelines. The following is a summary of some of the AICPA guidelines.

11.1 Statement on Standards for Accountants' Services on Prospective Financial Information, *Financial Forecasts and Projections*

This Statement on Standards for Attestation Engagements (SSAE) No. 1 (AICPA, *Professional Standards*, vol. 1, AT sec. 200), was issued in October 1985 for statements dated September 30, 1986, or later, and

provides standards and guidance concerning performance and reporting on engagements that examine, compile, or apply agreed-upon procedures to prospective financial statements. The standards also set forth minimum presentation guidelines in submitting prospective financial statements. Since a business valuation can involve forecasts or projections, accountants need to follow these guidelines whenever they are associated with prospective financial information.

Although these standards may serve as a guide, they are not intended to provide standards or procedures for engagements involving prospective financial statements used solely in connection with litigation support services. For additional resource material, the practitioner may want to consult the AICPA Management Advisory Services Technical Consulting Practice Aid No. 7, *Litigation Services*.

11.2 Guide for Prospective Financial Statements

This guide, published by the AICPA in 1986, presents recommended procedures to be followed when an accountant is associated with prospective financial information prepared on or after September 30, 1986.

The purpose of this guide is to provide guidelines for the preparation, presentation, and performance of professional services on prospective financial statements.

Prospective financial statements are defined as statements that present financial position, results of operations, and changes in financial position. Statements that cover periods that have expired are not prospective financial statements; therefore, pro forma statements that demonstrate the effect on historical financial statements based on hypothetical future transactions are not considered prospective financial statements. Any statement that meets the definition of a prospective financial statement will be considered one even if the statement is referred to as a forecast, projection, feasibility study, break-even analysis, or budget.

Among other items, the guide covers the following:

- Types of prospective financial statements and their uses
- Responsibility for prospective financial statements
- Preparation guidelines
- Presentation guidelines
- Illustrative statements
- Guidelines for accountants who provide services on prospective financial statements

- Compilation procedures
- Examination procedures
- Illustrative engagement and representation letters for compilations and examinations
- Accountants' reports
- Various other topics such as agreed-upon procedures, internal-use-only statements, partial presentations, SEC policy on projections, and IRS regulations regarding tax shelter opinions.

11.3 Statements on Standards for Management Consulting Services (SSMCSs)

In 1992, the AICPA issued guidelines for the conduct of a practitioner providing consulting services. The preparation of business valuations falls under these standards.

SSMCS No. 1, *Consulting Services: Definitions and Standards* (AICPA, *Professional Standards*, vol. 2, CS sec. 100) discusses, among other topics, professional competence, due professional care, planning and supervision, having sufficient relevant data, objectivity, understanding with client, and communication of results.

SSMCS No. 1, also references the standards established under Rule 202 of the AICPA *Code of Professional Conduct* (AICPA, *Professional Standards*, vol. 2, ET sec. 50).

The practitioner should be familiar with these standards before accepting an engagement involving business valuations.

11.4 MAS Small Business Consulting Practice Aid No. 8, *Valuation of a Closely Held Business*

Another source available to practitioners is MAS Small Business Consulting Practice Aid No. 8.

Published by the AICPA in 1987, it provides information on several different methods that may be used in valuing a business, as well as examples of the application of these methods.

The practice aid provides a list of additional publications that may be useful in preparing business valuations. It also recommends the use of engagement and management representation letters (see Appendix 1 for sample letters).

12. OTHER PROFESSIONAL GUIDANCE

Several professional organizations have published standards which govern the ethics, nature, and process of business valuations. These standards are essential reading for anyone performing, reviewing, or using business valuations. As the appraisal profession advances, the standards have been modified to reflect the “state of the art.” Following are the primary documents produced by professional business valuation-related organizations.

12.1 Uniform Standards of Professional Appraisal Practice

The Appraisal Standards Board of The Appraisal Foundation develops, publishes, interprets, and amends the *Uniform Standards of Professional Appraisal Practice (USPAP)* on behalf of appraisers and users of appraisal services. The original Standards were jointly developed by representatives of nine professional appraisal organizations, eight of which were real estate appraisal related. Although the bulk of *USPAP* focuses on real estate and personal property appraisals, Standard 9 and Standard 10 speak directly to business valuation.

A copy of *USPAP* is available for a \$25.00 charge from (please call to obtain an order form):

The Appraisal Foundation
1029 Vermont Avenue, NW
Suite 900
Washington, D.C. 20005-3517
(202) 347-7722
FAX: (202) 347-7727

12.2 Principles of Appraisal Practice and Code of Ethics of the American Society of Appraisers

The American Society of Appraisers, a multidisciplinary organization of real estate, machinery and equipment, personal property, business valuation, and technical valuation specialists, offers education and professional accreditation. The *Principles of Appraisal Practice and Code of Ethics* provide authoritative guidelines covering all classes of property and setting forth accepted appraisal procedures and appropriate, professional conduct.

12.3 Business Valuation Standards of the American Society of Appraisers

The Business Valuation Committee of the American Society of Appraisers has adopted *Business Valuation Standards*, which provides minimum criteria to be followed by business appraisers in the valuation of businesses, business ownership interests, or securities. As of this writing, nine Standards have been approved by the American Society of Appraisers, Board of Governors. The Standards address proper terminology, performance requirements, and specific approaches to and procedures for performing valuations. Both the *Principles of Appraisal Practice and Code of Ethics*, as well as the *Business Valuation Standards* are available free of charge from:

American Society of Appraisers
International Headquarters
P.O. Box 17265
Washington, D.C. 20041
(703) 478-2228

Upon adoption, the Standards are also published in *Business Valuation Review*, P.O. Box 101923, Denver, Colorado 80250, (303) 758-8818.

12.4 Publications of the Institute of Business Appraisers

This professional organization also publishes a code of ethics, its *Standards of Business Appraisal Practice*, and standards related to report writing. The Institute of Business Appraisers also awards a professional designation. Information is available from:

The Institute of Business Appraisers, Inc.
P.O. Box 1447
Boynton Beach, Florida 33435

12.5 Publications of the Canadian Institute of Chartered Business Valuators

This professional organization also offers professional accreditation and publishes a code of ethics which designates the general content of a valuation report and other professional requirements. Information is available from:

Canadian Institute of Chartered Business Valuators
277 Wellington Street West,
Fifth Floor
Toronto, Ontario M5V 3H2
(416) 204-3396
FAX: (416) 977-8585

13. RESEARCH SOURCES

Research is vital to any appraisal assignment because it provides an understanding of a company's business environment. Research helps the appraiser understand the effect of the economy on the industry and the company as well as the investment community's attitude toward the industry. This understanding allows the appraiser to make an informed judgment about the risks a company faces and the kind of return an informed investor would require based on these risks.

13.1 Data Sources

There are innumerable sources of information pertinent to business valuation research. The ones you use will most likely be those most readily available to you, either in your own library or a public or college library near you, or via a computer link. Preparing a checklist of those sources for your own use with each appraisal is an effective means of keeping track of the research sources that should be and have been used.

As computer technology has advanced, the methods for storing and retrieving data have advanced. The business appraiser can take advantage of on-line access to information from periodicals, stock data, company annual reports, and much more—although there is a cost to doing so. You must have the proper computer equipment and pay the charges associated with being on-line. You will have to investigate and decide for yourself if this kind of access would be cost-effective.

Appendix 3, exhibit A provides a checklist of sources of information to use in conducting your independent company, industry, and economic research. Information about specific publications that have proved useful to business appraisers as of this writing appears in appendix 3, exhibit B.

13.2 Researching the Economy (National and Local)

Information about the general economy should include the status of key indicators of economic health—for example, consumer spending,

strength of manufacturing, productivity, retail sales, unemployment rates, residential and commercial construction, loan demand, the trade deficit, and agricultural conditions. An examination of interest rates is important; you should know, as of the valuation date, the prime rate, treasury bill rates, and municipal bond rates. Such general information is available from a variety of periodicals and government publications.

Regional and local economy information may also be available from government agencies and from periodicals. Local chambers of commerce or economic development groups often publish literature detailing the economy of their area.

The industry information you gather will likely also have references to the economy's effect on the industry.

13.3 Researching the Industry

13.3.1 Identifying the SIC code

A key to finding information in a wide variety of sources is the company's Standard Industrial Classification (SIC) code, defined in the United States Office of Management and Budget (OMB) publication *Standard Industrial Classification Manual*. The company's tax return shows its SIC code (though you should verify that this is the correct one according to the latest version of the coding system), or you can determine what code is appropriate by knowing the company's business description and finding a matching code description in the manual or in other sources set up by SIC codes (for example, Robert Morris Associates' *RMA Annual Statement Studies* and *F&S Predicasts Index*). A number of companies may have more than one line of business; therefore, you will identify more than one SIC code and research, accordingly.

13.3.2 Surveying the industry

There are a number of types of industry information that could be acquired. Foremost is to determine how an industry is affected by changes in the economy and whether the industry has any control over those changes (for example, by using alternative sources of raw materials or by undertaking lobbying efforts).

You should also determine where the industry is in its life cycle. This influences the competitive environment. In an emerging high-growth industry, for example, companies are able to maintain high profit margins. In a mature or declining industry, profit margins come under pressure as companies compete on the basis of price. Competition is also affected by the number of companies in the industry and the degree of market dominance enjoyed by the largest companies.

Emerging products are another area to research because they may indicate the future direction of an industry.

The annual reports and especially Securities and Exchange Commission (SEC) Forms 10-K of publicly held companies are helpful, not only for their financial information but also for their comments on trends in, and the state of, the industry. To identify public companies, use *Moody's Company Data on CD-ROM*, the blue pages from Volume T-Z of *Standard & Poor's Standard Corporation Descriptions*, which list public companies by SIC code, or a similar source. Call the public companies directly to have several years of annual reports and 10-Ks mailed to you at no cost, or use a computer database information service for this.

The aforementioned *United States Industrial Outlook and Industry Surveys* present good overviews of a number of industries. *Value Line Investment Survey* includes both company reports and industry overviews. A variety of indexes to periodicals exist which can be used to locate articles in magazines and newspapers on the industry and companies in the industry.

13.3.3 Collecting industry financial data

Industry financial ratios are another useful tool for assessing a company's financial position relative to other companies in its industry. Although there are several sources presenting such industry norms, you must be careful to note the date of the information. The publication date typically lags by six months to three years. Get as close to your valuation date as you can. These sources include *RMA Annual Statement Studies*, *Financial Studies of the Small Business*, *Dun and Bradstreet's Industry Norms and Key Business Ratios*, and *The Almanac of Business and Industry Ratios*. Remember that trade associations may also make such data available.

13.3.4 Companies in the industry

In addition to the aforementioned *Moody's Company Data on CD-ROM* and *Standard & Poor's Standard Corporations Descriptions* list of public companies by SIC code, other sources can yield lists of public and private companies in the industry. *Standard & Poor's Register of Corporations*, Volume 3, is a list by SIC code of public and private companies. *Market Share Reporter*, *Ward's Business Directory of U.S. Private and Public Companies*, *Manufacturing USA*, and *Service Industries USA* all show the leading companies in a specific SIC code. Information on the companies, once they are identified, is also fairly easy to find, often in the same sources which provided the list of companies by SIC code or by industry name.

13.3.5 Merger and acquisition data

Information on mergers and acquisitions may be detailed enough to use a recent acquisition as a proxy for valuing your subject company if the acquired company is a close match. You may be able to obtain a proxy statement or purchase agreement from the acquisition to get the details. It is more likely, however, that you will find only sketchy coverage in the public literature, and your primary interest will be to see the degree of merger and acquisition activity in the industry. Use indexes to find articles in newspapers and magazines, check the periodical *Mergers & Acquisitions*, or use computer databases to find merger and acquisition information.

Some detailed information appears in the Transaction Roster in *Merrill Lynch's Mergerstat Review*. This annual publication is also a source of compiled and averaged price/earnings ratios and premiums paid in actual transactions by industry and by year, though the number of transactions on which the data is based may be few.

13.4 Researching Guideline Companies

Information on guideline companies may be used in several valuation methods to arrive at an indication of value for your subject company. Conclusions about the financial condition of a company can also be drawn by comparing its operating results with those of guideline companies.

Your research into companies in the industry will lead you to identifying a list of possible guideline companies. Also consider the companies named by management as your subject company's competitors.

Although the research you do on companies in the industry may be rather general and summarizing, your research on guideline companies must be specific and detailed. You will need to gather these kinds of information for each possible guideline company:

- The business description, as of the valuation date; this can come from any of a number of sources—for example, *Standard & Poor's Register of Corporations*, *Standard & Poor's Standard Corporation Descriptions* company report, *Moody's Manuals* company report, *Value Line Investment Survey* company report.
- Stock price as of the valuation date; this is available from the *Wall Street Journal* or other periodicals, the *Daily Stock Price Record*, *Standard & Poor's Security Owner's Stock Guide*, among other sources; you may also find additional, useful data in such sources—for example, the *Stock Guide* also shows institutional holdings, trading volume, the high, low, and last sale or bid, price/earnings ratio, and other financial information.

- Details of the company's financial condition; the best source is the company's annual report and Form 10-K, plus its Forms 10-Q, which provide quarterly updates; financial details are also available in such sources as *Moody's Company Data on CD-ROM*, *Moody's Manuals* company reports, *Standard & Poor's Standard Corporation Descriptions* company reports, *Standard & Poor's Stock Reports*, *Value Line Investment Survey* company reports, and reports from brokerage houses; company information filed with the SEC is also available from various databases such as Disclosure, Inc., who will send a printed company report (even on short notice) for a fee.

14. REPORT WRITING

All readers of this chapter may not be members of the American Society of Appraisers (ASA) and all appraisals may not be subject to the Standards of the Appraisal Foundation. Nevertheless, these two organizations have gained enough stature in the appraisal profession that the failure to follow their standards may subject the appraiser to the significant criticism that he or she has departed from professional standards. We recommend that all appraisers and all appraisals meet the standards of these two organizations.

14.1 Are Written Reports Always Required?

As a general rule, a written appraisal report is preferred. The formal report is a comprehensive written document that allows the appraiser to explain in detail the analysis, the methods, and other considerations used in reaching conclusions. (See section 14.2 for details on the content of a report.) Other formats include a summarization of data in a letter of conclusion, or an oral presentation. Such appraisal formats are permitted if requested by your client.

14.2 Components of a Written Report

There are a number of standard components that generally should be included in a full written report. A number of these are required; others are recommended. The components are derived from the standards set by various professional appraisal organizations, the Uniform Standards of Professional Appraisal Practice, and the requirements of Internal Revenue Ruling 59-60. The format of the report, however, is for

the most part a matter of style. A summary of the necessary components and their purpose follows.

14.2.1 The nature and scope of the assignment

The nature and scope of the assignment are typically identified in either a cover letter, or in the opening section of the report. Information pertaining to the assignment such as the identity of the client, a description of the stock being appraised, the company name, the effective date of valuation, and the extent of the appraisal assignment should be included. Also, perhaps in a following paragraph, give a brief description of the company, including its incorporation status and industry. You can also include a summary of the valuations methods used and indicate the final estimate of value in a cover letter (required). The format for the report is flexible and can be tailored to your individual style.

14.2.2 Assumptions and limiting conditions

A statement regarding the assumptions and limiting conditions that affected the analyses, opinions, and conclusions contained in the report is required. The Uniform Standards of Professional Appraisal Practice (USPAP) specifies the contents of these statements. You can include the assumptions and limiting conditions in the body of the report or as an exhibit referenced within the body of the report. You may use USPAP's suggested wording or your own.

14.2.3 Definition of value

The applicable standard of value should be identified and defined in the report. There are various kinds of standard value, the most frequently used and accepted standard of value is *fair market value*. The fair market value definition is commonly used by courts, valuation consultants, and the Internal Revenue Service. The definition of fair market value as it appears in this author's reports follows:

The standard of value to be determined is fair market value. Fair market value is defined as "... the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts." (Internal Revenue Service Revenue Ruling 59-60, 1959-1, CB 237)

Other standards of value include fair value, orderly liquidation value, forced liquidation value, and book value.

14.2.4 Sources of information

This section should highlight the primary sources of information used and reference an exhibit detailing sources. Identify the individuals interviewed and any facilities visited, including the dates of such interviews and field trips. You may also want to disclose the primary sources used in gathering data for the economy and industry and to specify the source of the financial information (for example, audited financial statements, internal financial statements, tax returns).

14.2.5 Economy

Revenue Ruling 59-60 requires that consideration be given to general economic conditions. A concise but sufficiently in-depth summary of economic conditions as of the valuation date on national, regional, and local level may be important. You should identify any significant economic factors that may have an impact on the company and explain how they affect the valuation being performed.

You might begin the summary with a paragraph discussing the importance of considering the economic outlook in connection with the valuation, followed by the economic analysis. The national economy should include a discussion of economic indicators such as real gross national product (GNP) or gross domestic product (GDP), interest rates, housing and construction, employment, income, and consumer spending. The summary should also contain information relating to important economic issues at or around the date of the valuation. Also, discuss how these economic considerations influence the valuation.

In addition to discussing the national economy, it is typically important to provide economic information concerning the region or regions in which a company operates. The regional economic outlook can sometimes be as or more important than the national outlook. A specific city or county can be more important than a region. The economic climate in a city or county can differ substantially from other areas of the state or the state as whole.

14.2.6 Industry

It is important to obtain a general understanding of the industry or industries in which the company operates and to understand the company's position in relation to the rest of the industry. You may want to include information concerning the life cycle of the industry, trends as of the date of valuation and prospects for the future. You may want to include information on the industries' products and services and what might affect its growth, and any information concerning supply and demand. You should discuss how the company fits into the industry,

its size relative to its competitors, its strengths and weaknesses, and any special niches it may fill. You should also explore the industry of the customers of your client, particularly if a few customers make up the majority of sales or operate primarily in one market segment.

14.2.7 Company

Your written report should discuss in some detail the company and its operations. In order to obtain knowledge of the company's operations, you should submit a request for documents with your proposal letter. The information requested should include but not be limited to financial information such as annual financial statements, tax returns, depreciation schedules, sales and profits by product line, inventory, and order backlogs. Other information requested should include information regarding product and market information, information on management and personnel, and corporate documents and information such as articles of incorporation, bylaws, and corporate minutes.

After you have received and reviewed the requested documents and information, it may be necessary to conduct a field interview. An on-site visit and interview at the company may not always be necessary depending on the circumstances of the appraisal and your knowledge of the company and its operations. However, a field interview can give you insight beyond that obtained from the documents and information provided to you. A field interview allows you to see firsthand the company's operations and the condition of its facilities. In addition, face-to-face discussions with management personnel can bring new information to light. If you plan to conduct a field trip, you should review all documents and information previously sent and then prepare a list of questions. The questions should be designed to help obtain specific information that was either unclear, not included in the information already received, or came about after having reviewed such information.

Following is a list of information that may be obtained from the company and included in your written report:

History of the business

- Legal status and ownership of the business
- Date the business was founded and its founders
- Changes in legal status or ownership
- Significant changes in product lines
- Changes in geographical locations
- Any acquisitions or divestitures

Operations

- Products and services offered
- Proprietary products
- Market areas served
- Suppliers
- Customers
- Competition
- Sales organization and planning
- Advertising and promotion
- Research and development
- Labor, benefits, and employee relations
- Regulatory climate

Plant and equipment

- Brief descriptions of land and buildings
- Location, dates purchased or built
- Manufacturing processes and capacity
- Condition of the facilities and equipment
- Terms of any major leases

Management

- Directors and officers, and their responsibilities
- Employment contracts
- Management compensation
- Key employee insurance
- Union membership and contract status
- Stock options or bonus arrangements
- Pension or profit-sharing programs

Stock ownership

- Classes of stock
- Stock ownership
- Prior transactions in stock
- Stock restrictions
- Buy–sell agreements

14.2.8 Financial analysis

The financial analysis section should include discussions of the company's financial condition, its profitability and earning capacity, dividend-paying capacity, tangible assets, and goodwill or any other intangible asset values. Consideration should be given to the company's historical financial information, its current position, and prospects for the future as indicated by the financial information. Include a discussion on historical trends and what you expect the future financial results will be.

Explain any adjustments that you made to the financial statements. Examples of cases in which adjustments to the company's earnings may be appropriate include excessive salaries, discontinued operations, cash method of accounting, and the expensing of certain repairs and improvements.

The company's historical financial data may be presented in the financial analysis section or included as an exhibit or addendum to the report. Typically, balance sheets and income statements for the current year and prior four years are analyzed. Common size statements, trend and ratio analysis, and comparative industry data may also be included. Focus on historical growth profit rates compared to other companies within the industry. Also, make a comparison of the financial information to the guideline companies you selected (if any).

14.2.9 Major considerations

List the key factors that influenced you in reaching your conclusions. Focus on the factors that tended to increase the value and other factors that tended to decrease the value. Discuss their relative importance as well.

14.2.10 Valuation methods and calculations

Discuss in general terms the various valuation methods that you considered most relevant and the general conclusions reached by each of these valuation methods. It may also be appropriate to discuss why certain methods were not used. Explain your final conclusion of value and the major factors that influenced that conclusion.

14.2.11 Conclusion

Restate the final conclusion to clearly summarize your opinion. This final statement should include a statement of a specific opinion of value or a range of values and should parallel the appraisal assignment statement with which you opened the report.

14.2.12 Signature and inclusion of dissenting opinion(s)

The user of the appraisal report is entitled to assume that you and/or others signing the report are responsible for the findings contained therein. Therefore, you, as the appraiser, are responsible for the appraisal report, whether prepared by you or by others under your supervision. The completed report must be signed either by you individually or by you as an officer of your corporation. If you are preparing the appraisal jointly with other appraisers, all involved must sign the report. Should one of the parties disagree with all or part of the conclusion, the dissenting opinion must be included as part of the report.

14.2.13 Exhibits and appendixes

Exhibits supporting a point being made may appear in the body of the report or as an attachment to the report. In addition to the exhibits mentioned previously, include exhibits summarizing the company's financial statements and the various financial ratios. Exhibits may also illustrate valuation calculations.

Appendixes contain pertinent information that supports the appraisal but is not vital to understanding the appraisal conclusion. You will want to include your resume and qualifications as an appraiser, and the resume and qualifications of any other appraiser involved, as an appendix.

14.3 Presentation

It is a good idea to number pages consecutively and to bind the report. This prevents the danger that a few pages may be copied and used without the whole report. Use graphs that help explain a point but do not overuse them.

14.3.1 Quality of the writing

The report may be the only way a reader has to judge the quality of your work. Spend the time to correct spelling errors, grammatical errors, and incomplete sentences. Reread and revise the report to make it concise.

14.4 Who Gets Copies?

Limit the number of copies given to the client to a number appropriate for the intended purpose, generally six or less. A client who wants thirty-five copies for a gift tax valuation probably intends to use the report for some other purposes as well.

14.5 Examples of Valuation Reports

Examples of valuation reports are presented in *Guide to Business Valuations* by Jay E. Fishman, Shannon P. Pratt, J. Clifford Griffith, and D. Keith Wilson, and in *Valuing A Business. The Analysis and Appraisal of Closely Held Companies*, third edition, by Shannon P. Pratt (see References).

REFERENCES

- AICPA. *Conducting a Valuation of a Closely Held Business*. Small Business Consulting Services Practice Aid 93-3. New York: American Institute of Certified Public Accountants, Inc., 1993.
- Bishop, John A., and Idelle A. Howitt. *Federal Tax Valuation Digest Annual*. Boston: Warren, Gorham & Lamont, 1998.
- Blackman, Irving L. *Valuing the Privately-Held Business: The Art and Science of Establishing a Company's Worth*, rev. ed. Burr Ridge, Ill.: Irwin Professional Publishing, 1992.
- Brown, Ronald L., ed. *Valuing Professional Practices and Licenses: A Guide for the Matrimonial Practitioner*, 2d ed. New York: Aspen Law & Business, 1993.
- Copeland, Thomas, Tim Koller, and Jack Murrin. *Valuation: Measuring and Managing the Value of Companies*, 2d ed. New York: John Wiley & Sons, Inc., 1994.
- Crouch, Holmes F. *Selling Your Business: Tax Guide 405*, 2nd ed., rev. Saratoga, Calif.: Allyear Tax Guides, 1998.
- Desmond, Glenn M. *Unrisky Business*. Culver City, Calif., Camden Harbor Publishing, 1994.
- Fishman, Jay E., Shannon P. Pratt, J. Clifford Griffith, and D. Keith Wilson. *Guide to Business Valuations*, 3 vols. Fort Worth, Tex.: Practitioners Publishing Company, 1996. Loose-leaf.
- Guatri, Luigi. *The Valuation of Firms*. Malden, Mass.: Blackwell Publishers, 1994.
- Horn, Thomas W. *Business Valuation Manual: An Understandable Step-by-Step Guide to Finding the Value of a Business*. Fort Collins, Co.: Charter Oak Press, 1990.
- Pratt, Shannon P., et. al. *Valuing A Business. The Analysis and Appraisal of Closely Held Companies*, 3rd ed. Burr Ridge, IL: Irwin Professional Publishing. 1995.

Tuller, Lawrence W. *Small Business Valuation Book*. Holbrook, Mass.: Adams Media Corporation, 1998.

West, Thomas L. and Jeffrey D. Jones, eds. *Handbook of Business Valuation*. New York: John Wiley & Sons, Inc., 1992.

Zukin, James H., ed. *Financial Valuation: Businesses and Business Interests*. Boston: Warren, Gorham & Lamont, 1990.

The following resources provide composite industry information for use in a business valuation. The directory noted below lists information on professional business valuation specialists.

American Society of Appraisers. *Directory of Certified Business Appraisers, 1995*. Washington, D.C.: 1995.

Financial Research Associates. *Financial Studies of the Small Business*. Winter Haven, Fla.: Financial Research Associates. Annual.

Ibbotson Associates, Inc. *Stocks, Bonds, Bills, and Inflation Yearbooks*. Chicago: Ibbotson Associates, Inc. Annual.

Robert Morris Associates. *RMA Annual Statement Studies*. Philadelphia: Robert Morris Associates. Annual.

Troy, Leo. *Almanac of Business and Industrial Financial Ratios*. Upper Saddle River, N.J.: Prentice Hall. Annual.

(Text continued on page 57)

APPENDIX 1: Illustrative Letters

Sample Valuation Engagement Letter

Date

Ms. Irma Prescott, President
Enterprises, Ltd.
1503 Poplar Street
Anytown, USA 00000

RE: Valuation of common stock

Dear Ms. Prescott:

At your request, Smith Corporation will perform an appraisal of the fair market value of 100 percent of the common stock of Enterprises, Ltd., for the purpose of assisting you in pending litigation matters. We will also provide such other financial and accounting assistance as you may direct.

The appraisal will include the review of the information requested in Exhibit A to this letter, other necessary research and investigation, interviews with key personnel, analyses of the financial and tax records, and a review of both the tangible and intangible assets owned by the business. The appraisal will be conducted under the limiting conditions set forth in Exhibit B to this letter. An opinion of value will be determined after consideration of all the pertinent facts available. We will provide a report presenting our findings of fact and conclusions of value.

We generally perform appraisals in four phases. Phase one consists of a review of the information requested and our own independent research. Phase two consists of visiting company facilities and interviewing management. Phase three consists of additional analysis and reaching our conclusions. Phase four consists of the preparation of a letter of conclusion. Approximately three weeks after the receipt of the information requested in Exhibit A, we would be in a position to visit company facilities and interview management. Approximately three weeks thereafter, we would be in a position to communicate our conclusions to you.

The fee for the appraisal is estimated to be between \$_____ and \$_____, based on charges for appraiser and staff time and efforts ranging from \$____ to \$____ per hour, plus direct out-of-pocket expenses. We do require a \$_____ retainer to begin our work. Deposition and/

or court testimony, should they be required, would involve additional time and, therefore, additional expense.

We will invoice monthly for professional fees, based on our standard rates and expenses, with payment due in thirty (30) days from the invoice date. We will require payment of all professional fees and expenses incurred to date prior to offering deposition testimony or any written opinions. Further, we will require payment of incurred and estimated professional fees and expenses through completion of our assistance before offering testimony at trial. (Law firm) will be responsible for payment of professional fees and expenses. Payment of our professional fees and expenses is not contingent on our findings or on the outcome of the action.

Documents, records, papers, transcripts, and information provided will be maintained on a confidential basis. Documents, records, papers, and transcripts will be returned or destroyed upon completion of our assistance at your direction and in accordance with professional business valuation standards.

If you wish to engage our services, please sign the enclosed copy of this letter acknowledging our understanding and return with the information requested in the attached exhibit. I look forward to hearing from you at your earliest convenience.

Sincerely,

SMITH CORPORATION

John D. Smith
President

Accepted:

EXHIBIT A

Please furnish the following information as of _____, the valuation date.

1. Financial information
 - a. Annual financial statements for the last ten years
 - b. Monthly financial statements for the last two years plus the current year to date
 - c. Tax returns for the last five years
 - d. Detailed depreciation schedules
 - e. Any financial budgets and/or projections
 - f. List of affiliated companies, partnerships, or proprietorships and their financial statements for the last five years
 - g. Sales and profits by product line
 - h. Other management reports
 - i. Plans for capital expenditures
 - j. An accounts receivable aging schedule
 - k. A breakdown of inventory
 - l. List of order backlog
 - m. List of contingent liabilities
2. Product and market information
 - a. Sales forecasts by product line and division
 - b. Sales brochures, price lists, and advertising copy
 - c. List of major competitors and their locations
 - d. List of major customers including sales to each for prior five years
 - e. List of major suppliers including amount of purchases in each of the last five years
 - f. Samples of trade publications regularly received by the company
 - g. Names of trade associations to which the company or officers belong
 - h. Newspaper or magazine articles regarding the company, its products, services, or key employees
3. Personnel information
 - a. List of current officers and directors, including background, experience, age, and compensation including all company paid benefits
 - b. List of other key management personnel, including job title, background, experience, responsibilities, compensation, and age of each
 - c. Schedule of all insurance policies owned by the company including the name of the insurance company, the property insured,

policy number, effective date, annual premium, and a copy of the face page of all major insurance policies

- d. Organization chart
 - e. Summary of pension and profit-sharing plans
 - f. Employee handbook
4. Other corporation information
- a. Articles of Incorporation and Bylaws
 - b. Minutes of shareholders' and board of directors' meetings for the last ten years
 - c. Major contracts and other agreements, including loan agreements, buy-sell or other shareholder agreements, employment agreements, franchise agreements, leases, and so on
 - d. Current stockholder list and list of any transactions in company stock since inception
 - e. Description of physical facilities
 - f. Previous appraisals of real estate, personal property, or the business
 - g. Previous offers to purchase company assets or stock
 - h. List of matters currently pending before any government agency
 - i. Any CPA or other consultant's reports regarding the company

EXHIBIT B**Limiting Conditions**

The appraisal will be conducted under the following limiting conditions:

- 1) The appraisal will consider all elements pertaining to the valuation of closely held businesses per Internal Revenue Service Revenue Ruling 59-60.
- 2) The appraisal will be conducted in accordance with the *Uniform Standards of Professional Appraisal Practice* of The Appraisal Foundation.
- 3) All estimates of value will be based upon the facts and data obtained during the investigation, some of which may be representations of management.
- 4) The appraiser has no past, present, or anticipated financial interest in the entity to be appraised or in any affiliate thereof. The appraiser has no personal interest in or bias toward any parties involved. The appraiser's compensation for the appraisal is not contingent upon the values or the conclusions reported, nor upon an action or event resulting from the analyses, opinions, or conclusions in, or the use of, the appraisal report.
- 5) The conclusions to be reported are for the purpose and use established between the client and Smith Corporation. No further use of these conclusions is authorized.
- 6) At the client's direction and in the interest of saving both time and expense, we may furnish a summary letter of conclusion rather than a fully detailed report.

Sample Valuation Report Cover Letter

Appraisers may differ on what constitutes an appropriate report format. Some advocate the use of a cover letter, called a "transmittal letter," to accompany the report. Others set up the report so that a transmittal letter is unnecessary. Regardless of the format of the report, it must be a clear communication, not misleading, and meet the guidelines established by professional organizations.

John Smith, CPA
12 Third Avenue
Anytown, USA 00000

Date

Ms. Irma Prescott, President
Enterprises, Ltd.
1503 Poplar Street
Anytown, USA 00000

Dear Ms. Prescott:

I have prepared a valuation report of Enterprises, Ltd. as of December 31, 19X6. I have made my valuation in accordance with the combination method. I performed review procedures on certain data necessary for the preparation of the valuation, namely, earnings-per-share data, normal industry earnings-per-share data, and net tangible asset data at the date of valuation.

I have based the valuation of Enterprises, Ltd. on the most probable quantitative valuation. The range presented for the valuation considers certain general factors normally used in the process. I take no responsibility for updating this report to reflect events and circumstances occurring after the date of the valuation. During the valuation process, the management of Enterprises, Ltd. compiled data on earnings per share and net tangible assets at the date of valuation. After performing limited analytical review procedures on the data, I used it in preparing the valuation report.

Had I performed additional procedures or performed an examination of the underlying financial statements of Enterprises, Ltd. in accordance with generally accepted auditing standards, significant matters that would alter the amounts used in the preparation of the valuation might have come to my attention.

The cash flow forecast, designated as an appendix to this report, is not an integral part of this valuation. Its inclusion and my report on it provide information that may be useful to your management in deciding whether to acquire the business under consideration.

Sincerely,

John Smith, CPA

Sample Representation Letter for a Business Valuation Engagement

Company Letterhead
Enterprises, Ltd.
10 Fourth Avenue
Anytown, USA 00000

Date

John Smith, CPA
12 Third Avenue
Anytown, USA 00000

Dear Mr. Smith:

In connection with your valuation of Enterprises, Ltd. as of December 31, 19XX, we confirm the following representations made to you during your valuation:

1. All information that we believe is relevant to your valuation and all information requested has been made available to you.
2. The five years of income tax returns are exact and complete copies of returns submitted to the IRS.
3. The financial statements submitted to you for the year ended December 31, 19XX, present the financial position, results of operations, and changes in financial position of Enterprises, Ltd. in conformity with generally accepted accounting principles as promulgated by the authoritative literature.
4. The financial statements noted in paragraph #3 disclose all commitments or contingent liabilities, including those arising from litigation, claims, and assessments.
5. We have advised you of all actions taken at meetings of the stockholders, directors, and directors' committees that might affect the valuation.
6. The acquisition of a new business interest or the disposition of existing segments or product lines is not currently being negotiated.
7. There would be no guarantees of profitability by either the corporation or the shareholders if the corporation were sold.
8. The valuation report will serve as a basis for arriving at a valuation for the sale of Enterprises, Ltd. Furthermore, the distribution of the report is restricted to the internal use of Enterprises, Ltd., and accordingly, will not be distributed to outside parties.

App.

BUSINESS VALUATION

9. We represent that the information about the company presented in the preliminary draft of your valuation report, a copy of which is attached, is accurate and complete.

Sincerely,

Name, Title
Enterprises, Ltd.

Date: _____

APPENDIX 2: Valuation Checklist

The following is a sample checklist to aid in preparing a business valuation.

| | <u>Done By</u> | <u>Date</u> | <u>Comments</u> |
|--|----------------|-------------|-----------------|
| 1. Determine reason for valuation. | _____ | _____ | _____ |
| 2. Existing client? Is independence compromised based on reason for valuation? | _____ | _____ | _____ |
| 3. New client? Determine if engagement is acceptable and complete appropriate new client registration forms. | _____ | _____ | _____ |
| 4. Obtain engagement letter. (See sample in Appendix 1.) | _____ | _____ | _____ |
| 5. Determine system for keeping client informed of progress. | _____ | _____ | _____ |
| 6. Determine date of valuation. | _____ | _____ | _____ |
| 7. Determine valuation approaches that may be used and communicate same to client. (This may be a part of the engagement letter.) | _____ | _____ | _____ |
| 8. Obtain knowledge and history of the business being valued. | _____ | _____ | _____ |
| 9. Determine if business has any preexisting agreements that may affect, control, or set the value. | _____ | _____ | _____ |
| 10. Determine if outside sources exist to aid in the valuation (for example, IRS Revenue Rulings, AICPA Practice Aids, court cases, guideline companies, sales). | _____ | _____ | _____ |
| 11. Determine if any future events may impact the value of the business. | _____ | _____ | _____ |
| 12. Determine method of valuation. | _____ | _____ | _____ |
| 13. Determine if an appraisal of any assets will be required and hire qualified appraiser. | _____ | _____ | _____ |
| 14. Gather and compile company information. | _____ | _____ | _____ |
| 15. Be sure workpapers are documented and organized for future reference. | _____ | _____ | _____ |
| 16. Document sources of information relied upon in preparing valuation. | _____ | _____ | _____ |
| 17. Test valuation for reasonableness and determine if more than one method may be required. | _____ | _____ | _____ |
| 18. Review procedures and documentation to be sure appropriate guidelines have been followed. | _____ | _____ | _____ |

BUSINESS VALUATION

| | <u>Done By</u> | <u>Date</u> | <u>Comments</u> |
|--|----------------|-------------|-----------------|
| 19. Prepare representation letter. (See sample in Appendix 1.) | _____ | _____ | _____ |
| 20. Prepare report cover letter (see sample in Appendix 1) along with necessary disclosures. | _____ | _____ | _____ |

APPENDIX 3: Research Checklist and Sources

This sample research checklist should be modified to reflect library resources in the individual appraiser's community. As an individual appraiser increases the size of his or her personal library of valuation sources, it is important to use these sources first because, of course, they are readily available. Examples of information that are recommended for an office library are labeled "Office" in the sample checklist.

Also, note that the sources listed in the *left* column of the checklist are those that are usually *most useful* and that sources in the right column can be considered ancillary.

EXHIBIT A: Research Checklist*

COMPANY NAME: _____

VALUATION DATE(S): _____

SIC: _____

Date completed/Source

_____ *Standard Industrial Classification Manual 1987*

_____ per company tax returns

_____ per *RMA Annual Statement Studies*_____ per *Predicasts F&S Index* (10 digits)**COMPANY HISTORY, OPERATIONS, PERSONNEL**

_____ Material supplied by company

_____ Local yellow pages
(especially ads)_____ Local law library—state
statute under which
company incorporated

_____ Local and regional newspapers

_____ *Business Record*

_____ Other newspapers

_____ Other periodicals

_____ (State) business directory

_____ (State) manufacturers register

_____ (State) directory of manufacturers

_____ *Thomas Register of American
Manufacturers*_____ *S&P's Register of Corporations*_____ *Million Dollar Directory*_____ *Ward's Business Directory of U.S. Private
and Public Companies***INDUSTRY INFORMATION****Lists of guideline companies/competitors**_____ Competitors supplied by
company_____ Public companies by SIC from
Volume T-Z, *Standard
Corporation Descriptions*

_____ Public companies by SIC

_____ *Moody's Company Data
on CD-ROM*_____ *Manufacturing USA*_____ *Service Industries USA*_____ Public companies, *Value Line*_____ Public and private companies, *S&P's
Register*, vol. 3_____ Local companies, (state) business
directory_____ Local companies, (state)
manufacturers register_____ Local companies, (state) directory of
manufacturers_____ Public companies, *Directory of Corporate
Affiliations*

*left column—sources usually most useful

right column—additional sources

_____ Local companies by subject heading, local yellow pages

_____ Public & private companies by product manufactured, *Thomas Register*, Vol. 1-15

_____ Public & private companies by SIC or geography, *Million Dollar Directory*

_____ Public companies (from *Moody's Industrial Manual*)

_____ *Ward's Business Directory of U.S. Private and Public Companies*

_____ *MacRae's Blue Book*

Information on companies

_____ *S&P's Register*, Volume 1

_____ S&P Stock Reports

_____ *Value Line Investment Survey*

_____ *Moody's Company Data* on CD-ROM

_____ *Standard Corporation Descriptions*

_____ *S&P's Security Owner's Stock Guide*

_____ *S&P's Earnings Guide*

_____ Annual reports, Form 10-K
Form 10-Q, Form 8-K

_____ Atlas/map—company location, competitors' locations

_____ *Moody's Manuals*

_____ *Directory of Corporate Affiliations*

_____ *Value Line Selection & Opinion*, Stock Highlights

_____ InfoTrac Company Profiles

(on computer with *Magazine Index*)

_____ *SEC Filing Companies*

_____ *Million Dollar Directory*, Vol. 1-3

_____ *Thomas Register*, Company Profiles

_____ *Predicasts F & S Index*, vol. 2

_____ Other articles in periodicals (see Indexes)

_____ *Daily Stock Price Record*

_____ *S&P OTC Profiles*

_____ *S&P Stock Yearbook*

_____ *Moody's Handbook of Common Stocks*

_____ *Moody's Handbook of OTC Stocks*

_____ *Ward's Business Directory of U.S. Private and Public Companies*

_____ *NASDAQ Fact Book*

_____ *MacRae's Blue Book*

_____ *Hoover's Handbook of American Business*

Industry financial data

_____ *RMA Annual Statement Studies*

_____ *Financial Studies of the Small Business*

_____ Trade association data

_____ *Industry Norms & Key Business Ratios*

_____ *S&P's Analysts Handbook*

_____ *Almanac of Business & Industrial Financial Ratios*

Information on status, trends, future of the industry

_____ Office files by industry

_____ *U.S. Industrial Outlook*

_____ *S&P's Industry Surveys*

_____ *Credit Considerations* (RMA)

_____ *Lending to Different Industries*

_____ *Value Line Investment Survey*

_____ Trade association info (*Encyclopedia of Associations*)

_____ *Manufacturing USA*

_____ *Service Industries USA*

_____ *Market Share Reporter*

_____ *Mergerstat Renew*

_____ *Mergers & Acquisitions*

_____ Articles in periodicals (see Indexes)

_____ *Inside U.S. Business*

_____ *Small Business Sourcebook*

_____ Government documents

_____ *Industry Analysts in the Federal Government*

_____ *Sources of State Information on Corporations*

_____ *Mergers & Acquisitions Sourcebook* (State) Commerce

_____ *Statistical Abstract of the U.S.*

_____ *Dow Jones-Irwin Business and Investment Almanac*

Information on the economy/demographics

- _____ Office files
- _____ Chemical Banking Corp. (formerly Manufacturers Hanover) *Financial Digest*
- _____ *Federal Reserve Statistical Release*—financial markets
- _____ *Federal Reserve Bulletin*—financial markets charts
- _____ *Value Line Selection & Opinion*
- _____ *fedgazette* National Economic Summary
- _____ *Sales & Marketing Management*
- _____ Survey of Buying Power
- _____ *Editor & Publisher Market Guide*
- _____ *Community Quick Reference*
- _____ *Sourcebook of ZIP Code Demographics*
- _____ *Sourcebook of County Demographics*
- _____ *The Lifestyle ZIP Code Analyst*
- _____ *Economic Indicators Handbook*
- _____ *Markets of the U.S. for Business Planners 1992*
- _____ Local Chamber of Commerce (call for information)
- _____ Government documents
- _____ *State and Metropolitan Area Data Book*
- _____ *County and City Data Book*
- _____ *Grant Thornton Manufacturing Climates Study*
- _____ *Statistical Abstract of the U.S.*
- _____ Federal Reserve publications (see separate list)
- _____ Statistical Profile of (State)
- _____ *A Five-year Economic Development Plan* (State)
- _____ (State) Economy: Dimensions of Change
- _____ (State) Economy: Growth & Diversification
- _____ (State) Economic Trends Report
- _____ Vital Statistics of (State)
- _____ (State) Retail Sales & Use Tax Report
- _____ *Economic Developments*
- _____ *Economic Indicators* (regional)
- _____ *Economic Report of the President*

INDIVIDUAL INDUSTRY INFORMATION**Agriculture**

- _____ Office files
- _____ *Agricultural Outlook*
- _____ *Facts on State Agriculture*
- _____ *State Agricultural Statistics*
- _____ *A Glossary of Food & Ag Policy Terms*
- _____ *Agricultural Letter*
- _____ *Ag Credit Conditions Survey*
- _____ *FAPRI U.S. & World Agricultural Outlook*
- _____ *FAPRI 10-yr. International Ag Outlook*
- _____ (State) Dept. of Agriculture (call for information, especially Statistics Division)
- _____ Federal Reserve publications (see separate list)
- _____ *National Food Review* (Jan-Mar 1990)
- _____ *Feedstuffs* Reference Issue
- _____ *Biological & Agricultural Index*

Banking

- _____ *Sheshunoff (Bank Report)* report on subject bank
- _____ Office files
- _____ *Swords The Banking Company Report*
- _____ *Polk's Bank Directory*
- _____ Federal Reserve publications (see separate list)
- _____ State bank directory
- _____ *Moody's Manual*—Banking & Finance

Food industry

- _____ Office files
- _____ *Thomas Food Industry Register*

Health care

- _____ Office files (medical)
- _____ *Dun's Guide to Healthcare Companies*
- _____ *Cumulative Index to Nursing & Allied Health Literature*
- _____ State library medical indexes
- _____ State library medical periodicals
- _____ *Med Line* on compact disk

Insurance

- _____ Office files
- _____ *Best's Insurance Reports*
- _____ *Insurance Periodicals Index*
- _____ *Insurance Almanac*
- _____ *Insurance Facts*

Utilities

- _____ Office files
- _____ *Gas Facts*, American Gas Assoc.
- _____ Other AGA publications
- _____ *Public Utilities Fortnightly*
- _____ Other articles in periodicals (see Indexes)
- _____ *Moody's Manual—Public Utility*

Wholesalers/Distributors

- _____ *American Wholesalers and Distributors Directory*

INDEXES TO PERIODICALS

- _____ *Predicasts F & S Index*
- _____ *Business Periodicals Index*
- _____ *Wilson Business Abstracts* on CD-ROM (includes *Business Periodicals Index*)
- _____ Local or regional newspaper index
- _____ *SRI*
- _____ *Academic Index* (on computer)
- _____ *Wall Street Journal/Barron's Index*
- _____ *New York Times Index*
- _____ *PAIS Bulletin*
- _____ *Applied Science & Technology Index Magazine Index* (on computer)
- _____ *Readers' Guide to Periodical Literature*
- _____ *ASI*
- _____ *Harfax Guide to Industry Special Issues*
- _____ *Social Sciences Index* on compact disc
- _____ *Business Publications Index and Abstracts 1986*
- _____ other indexes

FEDERAL RESERVE PUBLICATIONS

In addition to those already shown

- | | |
|---|--|
| <p>_____ <i>Economic Perspectives</i>/FRB Chicago</p> | <p>_____ <i>Federal Reserve Bulletin</i> _____ <i>National Economic Trends</i>/ FRB St. (city) _____ <i>Monetary Trends</i>/ FRB St. (city) _____ <i>Fedgazette</i>/FRB (city) _____ <i>Review</i>/FRB (city) _____ <i>Quarterly Review</i>/FRB (city) _____ <i>Economic Review</i>/FRB KC _____ <i>District Economic Conditions</i>/ FRB Mpls _____ <i>Business</i>/FRB (city) _____ FRB (city)</p> |
|---|--|

OTHER REFERENCES

- _____ Encyclopedia—Information on state economy, cities, industry;
primarily use local library copy
- _____ Brokerage company reports—Call for industry and company information
- _____ *Federal Fast Finder*
- _____ *Census Catalog & Guide 1989*

- O *Federal Fast Finder*—Telephone directory of the federal government
- O *Federal Reserve Bulletin*—Interest rates, financial markets, articles on economy, banking, industry; monthly
- O *Federal Reserve Statistical Release*—Interest rates; financial markets; monthly
- O *fedgazette*, Federal Reserve Bank of Minneapolis, Regional Business and Economics Newspaper, June 1989—current—Articles, charts and graphs on regional and national economy and industry; see especially National Economic Summary; quarterly
- O *Financial Digest*, Chemical Banking Corp. (formerly Manufacturers Hanover)—Commentary on economy; tables on financial markets; published every two weeks
- O *Financial Studies of the Small Business*—Data by industry names, size of companies; annual
- M/S Government documents—Use indexes to find documents containing information on economy, industry
- O *Grant Thornton Manufacturing Climates Study*, 1986—current—Economy and industry by region and state; annual
- L *Harfax Guide to Industry Special Issues*—Index to publications by industry
- L *Hoover's Handbook of American Business*—Profiles of 500 major United States companies; also includes lists of top companies in major industries and by various other criteria; profiles include limited financial data, background/history of the company, key competitors, other basic data
- O (State) Data Book 1985
- O *Industry Analysts in the Federal Government*—Names, addresses, phone numbers
- L *Industry Norms and Key Business Ratios*, Dun & Bradstreet—Data by SIC; published every two years
- M InfoTrac Company Profiles—On same computer as *Magazine Index*; summary information such as line of business, SIC code, location, officers, market territory
- L *Inside U.S. Business*, 1987—Commentary on history and condition of a limited number of industries
- D *Insurance Almanac*
- O *Insurance Facts 1985–86 Property/Casualty Fact Book*
- M *Insurance Periodicals Index*
- O/M (State) Manufacturers Register—Company name, address, phone, names of principals, number of employees, year established, SIC/products, distribution; lists of state businesses by SIC
- O (State) Retail Sales and Use Tax Report—Information on state communities and counties
- O *Lending to Different Industries (RMA)*—Articles by industry from 1978–1992 issues of *Journal of Commercial Bank Lending*
- O *(The) Lifestyle ZIP Code Analyst 1992*—Various demographics organized by ZIP code
- O *MacRae's Blue Book*, "serving the original equipment market"—facts about manufacturers throughout the United States; includes a capital rating representing a firm's invested capital; Vol. 1—Corporate Index, Vol. 2 & 3—Product Classifications Index
- M/S *Magazine Index*—At main library, on same computer as InfoTrac Company Profiles; index to common periodicals, 1988 to current
- M *Manufacturing USA 1989 Gale Directory*—Data by SIC; lists top fifty companies in industry (public and private), trends, inputs, and outputs, concentrations of industry in the United States
- S *Market Share Reporter 1991*—An annual compilation of reported market share data on companies, products, and services; organized by two-digit SIC code
- M *Markets of the U.S. for Business Planners 1992*, 2 vols.—Historical (1969 to 1988) profiles of 183 United States urban economies by major section and industry, with maps, graphics, and commentary (Ref. HC 106.8 .M 333)
- M *Med Line*—Index to medical articles in periodicals; on compact disc; updated quarterly

- M *Mergers & Acquisitions* (periodical)—Information on industry mergers and acquisitions by SIC; articles on variety of business topics; published every two months
- O *Mergers & Acquisitions Sourcebook*, 1985, 1988—Information on industry mergers and acquisitions by SIC
- O *Mergerstat Review*—Information on mergers and acquisitions by industry; other data on M & A activity; annual
- M *Million Dollar Directory*, Vol. 1 to 3—Company name, address, phone, names of principals, sales, number employees, stock exchange, SIC/products & services. Volume 4—Lists of public and private companies by SIC, geography. Annual
- O *Monetary Trends*, Federal Reserve Bank of St. Louis, 4/82—current—Minimal commentary on economy; charts and graphs; monthly
- L *Moody's Company Data*, Moody's Investors Service—On CD-ROM; 10,000 public company profiles and financial data; can access lists of companies by SIC code
- L/O *Moody's Handbook of Common Stocks*—Company profiles, NYSE, ASE; annual
- L/O *Moody's Handbook of OTC Stocks*—Company profiles; annual *Moody's Handbooks*
- L *Moody's Manuals* (Banking and Finance, Industrial, OTC Industrial, Public Utility, Transportation, International)—Company profiles, information from annual reports; annual. Blue-pages inserts show stock and bond, public utility, and other market data. Master index to all volumes is separate booklet.
- O *NASDAQ Fact Book*—Stock information on companies listed on NASDAQ National Market and NASDAQ Securities; annual
- O *National Economic Trends*, Federal Reserve Bank of St. Louis, 3/82—current—Minimal commentary on economy; charts and graphs; monthly
- O *National Food Review*, Farm Commodity Programs and Their Effects, January–March 1990, United States Dept. of Agriculture—Discussion of federal farm programs, what they are, how they are supposed to work; includes a glossary of terms used in commodity programs
- L *New York Times Index*
- L *PAIS Bulletin* (Public Affairs Information Service)—Index to articles and information in periodicals and government documents
- M *Polk's Bank Directory*—Basic information on banks, organized by state; also shows population of communities
- L *Predicasts F & S Index*—Index to articles in periodicals. Vol. 1 arranged by SIC; front list shows industry names and ten-digit SIC; also list of articles on economy. Vol. 2 arranged alphabetically by company name. Quarterly, then bound annually
- L *Public Utilities Fortnightly*—Periodical
- O *Quarterly Review*, Federal Reserve Bank of Minneapolis, Spring 1987—current—Articles on economy, banking; quarterly
- O/L *RMA Annual Statement Studies*—Need five years' data by SIC; annual
- L/M *Readers' Guide to Periodical Literature*
- O Office files—Include collections of material organized by industry topics/subtopics, economy/subtopics; valuation topic files; previously completed reports
- O *Review*, Federal Reserve Bank of St. Louis, 5/85—current—Articles on economy, banking, industry; published every two months
- L *S&P OTC Profiles*—Limited company profiles on selected companies; index is in *S&P Stock Reports*; quarterly
- L *S&P Stock Reports*—Profiles and financial data on companies traded on NYSE, ASE, and OTC; index is in front of NYSE and ASE first volumes; *OTC Profiles* index follows this index
- L *S&P Stock Yearbook*—Company profiles of S&P 500; annual
- L *S&P's Analysts Handbook*—Data by industry name, annual with monthly supplements
- O *S&P's Earnings Guide*—Gives Wall Street consensus of earnings estimates on over 3,000 public companies; monthly

- L S&P's *Industry Surveys*—Commentary by industry, updated about every two years; Current Analysis precedes industry information, updated every six months; also includes some information on the economy in vol. 1
- L S&P's *Register of Corporations*, Vol. 1—Company name, address, phone, names of principals, sales, number of employees, stock exchange, SIC/products & services. Vol. 3, *Indexes*—Lists of public and private companies by SIC; annual
- O/L S&P's *Security Owner's Stock Guide*—Stock information, abbreviated financial data on companies listed on major stock exchanges; monthly
- O SEC *Filing Companies* 1987, 1990—Names and stock exchange of companies filing reports with the SEC; free from Disclosure, Inc.
- S/L SRI (Statistical Reference Index and abstracts)—State has complete set. Index to microfiche (State has most of the microfiche covered by SRI to 1992.)
- O/L *Sales and Marketing Management*—Annual Survey of Buying Power—data on cities, counties, states; articles on business; monthly
- M *Service Industries USA*, first edition 1992, Gale Directory—Data by SIC; lists top fifty companies in industry (public and private), trends, inputs and outputs, concentrations of industry in United States
- O *7th District Economic Data* 1986, 1982, Federal Reserve Bank of Chicago
- O *Sheshunoff Bank Report*, Sheshunoff & Co., Inc.—Detailed information on individual bank and its comparable banks. Order by name and location of bank being appraised and date of valuation.
- L *Small Business Sourcebook*—Information by industry, trade associations, trade journals
- L *Social Sciences Index*—Index to articles in periodicals; on compact disc; updated quarterly
- L/O *Sources of State Information on Corporations*—Names, addresses, phone numbers
- L *(The) Sourcebook of County Demographics*—Information from the 1990 Census organized by county, all states
- L *(The) Sourcebook of ZIP Code Demographics*—Information from the 1990 Census organized by ZIP code
- L/M *Standard Corporation Descriptions*—Public company profiles and financial data. Volume T–Z has blue-pages insert that lists public companies by SIC. Other inserts tie subsidiaries to parent company.
- O/L *Standard Industrial Classification Manual 1987*—SIC code(s) and definition(s)
- O *State and Metropolitan Area Data Book* 1986, United States Department of Commerce, Bureau of the Census
- O/L *Statistical Abstract of the U.S.*—1986, 1988, 1989, 1990 at Office
- O Swords Associates *The Banking Company Report*, certain issues 1/81–7/85, all issues 2/86–current—Commentary on bank industry, data on industry and individual bank results, stock info; monthly
- L/M Telephone directories for most major cities, especially see the yellow pages and ads for information on companies
- M *Thomas Food Industry Register* (formerly *Thomas Grocery Register*)—Three-volume set includes lists by state of supermarket chains, convenience stores, wholesalers/distributors, food service operators, brokers/manufacturers' agents, importers, exporters, warehouses, transportation; brief profiles of companies
- L/M *Thomas Register of American Manufacturers*, Two-volume Company Profiles—Company name, address, phone, asset rating, importer/exporter, products. Volumes 1 to 15—Lists of public and private companies by products manufactured; minimal company information. Other volumes—Collection of manufacturers' brochures. Annual
- O/L *U.S. Industrial Outlook*—Commentary by industry; also includes some information on economy
- O *Value Line Investment Survey*—Lists of public companies by industry; company profiles and financial and stock data; commentary on industry
- O *Value Line Selection & Opinion* Stock Highlights—Check index and/or individual issues in binder for features on individual companies
- O Vital Statistics of (State) 1987, 1988—Concerning births, deaths, marriages, dissolutions by state, county, cities

- L *Wall Street Journal and Barron's Index*
- S *Ward's Business Directory of U.S. Private and Public Companies*—Company name, address, phone; lists of companies by SIC
- M *Wilson Business Abstracts*—On CD-ROM; encompasses *Business Periodicals Index*; indexing 1/86 through 5/31/90; abstracts and indexing 6/90—current; updated quarterly

Law Library Tax Room:

U.S. Tax Court Reports—Volumes cover six months; alphabetical index by case name

U.S. Tax Cases, Commerce Clearing House—Reports U.S. District Courts, U.S. Claims Court, U.S. Court of Appeals, and U.S. Supreme Court and landmark state court decisions re: federal taxation; cumulative index by year, alphabetical index by case name

American Federal Tax Reports, 2d Series—Contains unabridged federal and state court decisions arising under the federal tax laws; alphabetical-by-case-name Table of Cases volume covers several years (for example, 1988 through first half 1991)

TC Memorandum Decisions, Prentice Hall—Each volume contains full text of all memorandum decisions of the U.S. Tax Court rendered during a specific year; alphabetical-by-case-name Cumulative Table of Cases volume covers several years

Tax Court Memorandum Decisions, Commerce Clearing House—Full texts of all Tax Court Memorandum decisions during period specified; index is alphabetical by case name

INVESTMENT VEHICLES

1. INTRODUCTION

- 1.1 Debt Instruments and Equity Instruments
- 1.2 Risk and Return
- 1.3 Investment Considerations

2. DEFINITIONS

3. BANK INVESTMENTS

- 3.1 Certificates of Deposit (CDs)
- 3.2 Jumbo Certificates of Deposit
- 3.3 Banker's Acceptances
- 3.4 Repurchase Agreements

4. BONDS

- 4.1 T-bills
- 4.2 Treasury Notes
- 4.3 Treasury Bonds
- 4.4 Zero Coupon Treasury Securities
 - 4.4.1 Certificates of Accrual on Treasury Securities (CATs)
 - 4.4.2 Separate Trading of Registered Interest and Principal of Securities (STRIPs)
 - 4.4.3 Treasury Investment Growth Receipts (TIGRs)
- 4.5 U.S. Savings Bonds and Inflation-Protection Securities
 - 4.5.1 Series EE Bonds
 - 4.5.2 Series HH Bonds
 - 4.5.3 Inflation-indexed debt instruments
- 4.6 Agency Bonds
 - 4.6.1 Government sponsored agencies
 - 4.6.2 Federally sponsored enterprises
- 4.7 State and Municipal or Tax-Exempt Bonds
 - 4.7.1 Revenue bonds
 - 4.7.2 General obligation or full-faith-and-credit bonds
 - 4.7.3 Assessment bonds
 - 4.7.4 Other characteristics of government bonds
- 4.8 Mortgage-Backed Securities
 - 4.8.1 GNMA securities
 - 4.8.2 FHLMC and FNMA securities
 - 4.8.3 Collateralized mortgage obligations
 - 4.8.4 Reverse mortgages
- 4.9 Bond Ratings
 - 4.9.1 Junk bonds

- 4.10 Corporate Bonds
 - 4.10.1 Bond indentures
 - 4.10.2 Value and denominations
 - 4.10.3 Short-term versus long-term bonds
 - 4.10.4 Call feature
 - 4.10.5 Serial bonds
 - 4.10.6 Debenture bonds
 - 4.10.7 Interest on bonds
 - 4.10.8 Income bonds
 - 4.10.9 Bond quality ratings and services
 - 4.10.10 Zero coupon bonds
- 4.11 Payment-in-Kind (PIK) Bonds

5. COMMON STOCK

- 5.1 Stock Certificate and Par Value
 - 5.1.1 Initial public offerings
- 5.2 Preemptive Rights
- 5.3 Voting Rights
- 5.4 Cumulative Voting
- 5.5 Cash Dividends
- 5.6 Stock Dividends
- 5.7 Stock Splits
- 5.8 Other Types of Dividends
- 5.9 Valuing Common Stock
 - 5.9.1 Earnings per share
 - 5.9.2 Cash flow per share
 - 5.9.3 Book value
 - 5.9.4 Price-earnings (PE) ratio
 - 5.9.5 Yield
- 5.10 Advantages and Disadvantages of Common Stock
- 5.11 Brokerage Firms

6. OPTIONS AND WARRANTS

- 6.1 Puts
- 6.2 Calls
- 6.3 Other Options
- 6.4 Premiums
- 6.5 Trading Options
- 6.6 Warrants

7. PREFERRED STOCK

- 7.1 Preemptive Rights
- 7.2 Par Value
- 7.3 Voting Rights
- 7.4 Dividends

- 7.5 Convertible Feature
- 7.6 Call Feature
- 7.7 Sinking Funds
- 7.8 Valuing Preferred Stock
 - 7.8.1 Earnings per share before preferred dividends
 - 7.8.2 Times dividend earned
 - 7.8.3 Book value
 - 7.8.4 Yield
- 7.9 Advantages and Disadvantages of Preferred Stock
 - 7.9.1 Advantages
 - 7.9.2 Disadvantages

8. MUTUAL FUNDS

- 8.1 Closed-end Funds
- 8.2 Open-end Funds
- 8.3 Investment Objectives
- 8.4 Real Estate Investment Trusts (REITs)
- 8.5 Securities Investor Protection Corporation (SIPC)
Insurance

9. COMMODITIES

- 9.1 Cash Markets
- 9.2 Futures Markets
- 9.3 Speculators
- 9.4 Margins
- 9.5 Margins on Commodity Exchanges
- 9.6 Hedgers
- 9.7 Long and Short Positions
- 9.8 Spread Transactions
- 9.9 Sources of Information in Commodities
- 9.10 Types of Commodities Traded

10. LIFE INSURANCE

- 10.1 Whole Life
- 10.2 Universal and Variable Life
- 10.3 Retirement Annuities

11. TAX-SHELTERED RETIREMENT PLANS

- 11.1 Individual Retirement Accounts (IRAs)
- 11.2 Keogh Plans
- 11.3 Qualified Retirement Plans
 - 11.3.1 Profit-sharing plans
 - 11.3.2 Stock bonus plans
 - 11.3.3 Pension plans

INVESTMENT VEHICLES

- 11.3.4 Employee stock ownership plans (ESOPs)
- 11.4 FDIC Insurance

12. TAX-DEFERRED INCOME PLANS

- 12.1 Annuities
 - 12.1.1 Retirement CDs
- 12.2 Tax Shelter Limited Partnerships
 - 12.2.1 Tax considerations

13. INVESTMENT ADMINISTRATION AND STRATEGIES

- 13.1 Economic Analysis
 - 13.1.1 Gross National Product (GNP)
 - 13.1.2 Federal Reserve Board Index of Industrial Production
 - 13.1.3 Government and private studies
- 13.2 Stock Market Analysis
 - 13.2.1 Major market indexes
 - 13.2.2 New York Stock Exchange
 - 13.2.3 American Stock Exchange
 - 13.2.4 NASDAQ
 - 13.2.5 Local and regional exchanges
 - 13.2.6 Over-the-counter (OTC) market
 - 13.2.7 Foreign exchanges and securities
- 13.3 Investments Held in Street Name

REFERENCES

1. INTRODUCTION

1.1 Debt Instruments and Equity Instruments

Investment vehicles can take the form of any asset that is held to provide an income stream or growth appreciation over a period of time. Although physical custody of an asset usually occurs with investments in collectibles, real estate, or commodities, most investments are held *on paper* in the form of instruments.

Investment instruments held on paper ease the transferability of title and establishment of clear obligation or ownership. The majority of such investments can be classified as debt or equity instruments.

Debt instruments represent obligations of one party to another for borrowed funds. Not only do government and corporate bonds fall into this broad classification, but also bank savings accounts and certificates of deposit (CDs).

Equity instruments represent ownership or potential ownership interest in assets. Capital stock, representing ownership of a corporation, is viewed as a typical equity instrument. However, ownership of commodities such as precious metals or agricultural products can also be held on paper through equity instruments.

1.2 Risk and Return

The difference between investment vehicles is often most pronounced when it relates to risk and return on investment. The proper investment objective is to achieve the greatest return on an investment while minimizing risk of loss. One characteristic of investments, however, is that the potential return tends to rise as the level of risk increases.

A stockholder in a publicly traded company bears the inherent risk that lower corporate earnings will lower the stock's price or dividend yield. On the other hand, the prospect of improved corporate earnings provides a shareholder with the opportunity for significant gain. Companies in new or emerging markets tend to have greater stock price volatility, thereby adding to the risk factor.

Fixed-income securities, such as bonds, generally entail significantly lower risk if held to maturity. The greatest risk is that of default. However, bonds traded prior to maturity face additional risks from ever-changing interest-rate markets. In a rising interest-rate environment, a bondholder faces risks of not receiving the entire investment if a bond is sold prematurely.

The level of return and amount of risk that given investors will accept depends on their goals and constraints. An investor with significant disposable income is likely to have constraints very different from those of someone who has less available for investment. Similarly, the investor with young children, a home mortgage, and an automobile will likely have different goals than a retired person free of debt.

To manage risk, portfolio theory suggests that an investor's first decision should focus on the allocation of investments between equities, cash or cash equivalents, and fixed-income securities. (Real estate can be added as a fourth class, if desired.) The relative mix between these investment classes—called *asset allocation decisions*—is determined by an analysis of such factors as age, years to retirement, goals, tolerance for risk, present wealth, and financial responsibilities.

The table of investment allocation percentages that follows presents illustrative investment allocations for a conservative investor with a \$100,000 portfolio. Exhibit 1, page 7, shows a risk-return ladder and exhibit 2, page 8, shows an investment allocation pyramid.

INVESTMENT ALLOCATION PERCENTAGES BASED ON AGE

| Age | <i>Liquid Investments</i> % | <i>Income-Producing Investments</i> % | <i>Growth-Oriented Investments</i> % |
|------------|------------------------------------|--|---|
| 20 years | 10–70* | 10–20 | 10–50 |
| 30 years | 10–20 | 10–20 | 70–80 |
| 40 years | 10–15 | 10–20 | 70–85 |
| 50 years | 10–15 | 15–25 | 60–75 |
| Retirement | 15–20 | 40–60 | 20–40 |

*The large spread reflects the fact that some people will be saving to buy a home, and others will have already bought one or do not intend to buy one.

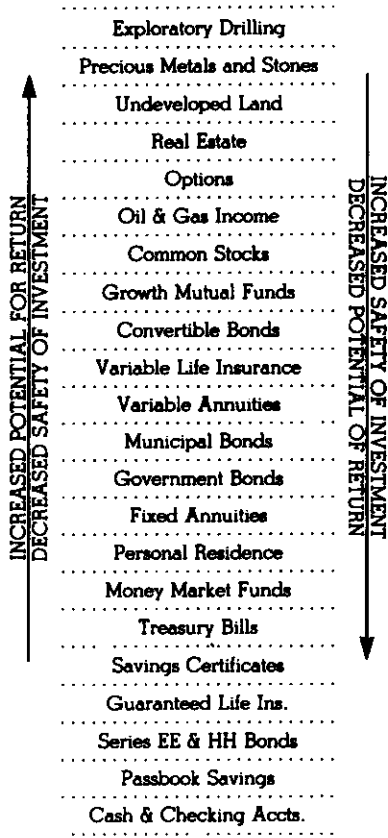
Source: *Personal Financial Planning Manual* (New York: AICPA, 1990), pp. 3–6.48.

A few concepts are common to all investment allocation alternatives:

- *Market risk.* Market risk is the risk of price fluctuations resulting from market conditions that tend to affect all securities of a particular kind. For example, the prices of most common stocks are affected by trends such as bull or bear markets. Sudden political turmoil, negative economic news, or the overheating of a bull market can cause sharp price *corrections* across entire financial markets. Market risk may also cause the price of certain investments, such as closed-end mutual funds, master limited partnerships, or certain insurance products, to vary from the value of their underlying assets.

Exhibit 1

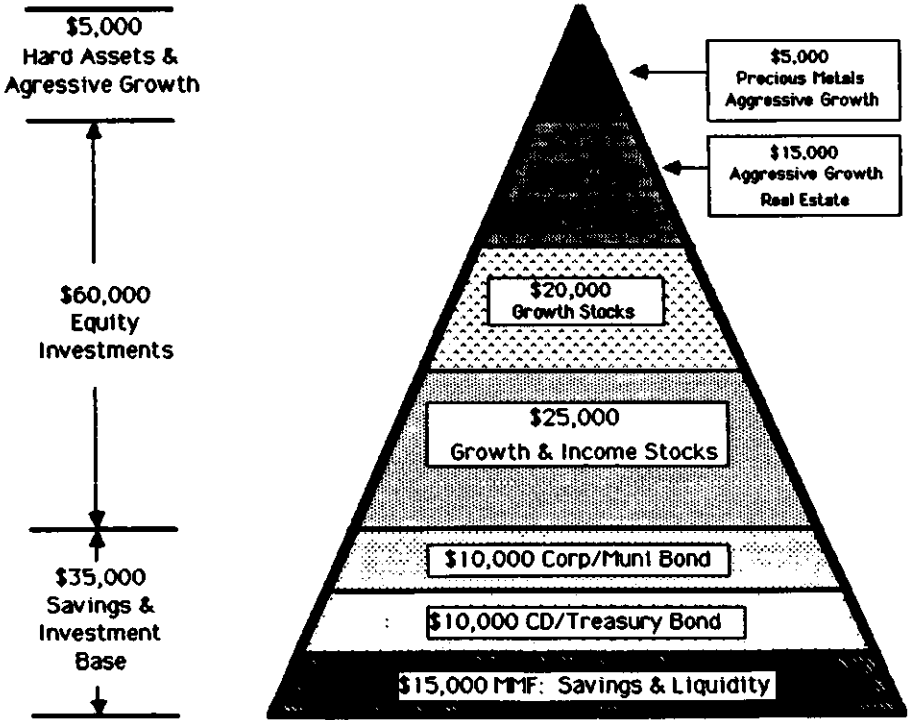
The Risk-Return Ladder



Robert T. LeClair, *A Consumer's Guide to Investing for Financial Independence*. Adapted with permission. Longman Financial Services Institute, Vernon, CT.

Exhibit 2

\$100,000 Pyramid for Conservative Investor



William G. Droms, "Investment Risk and the Individual Investor," in *Asset Allocation for the Individual Investor*, The Institute of Chartered Financial Analysts. Homewood, Ill.: Dow Jones-Irwin, 1987. Used with permission.

- *Business risk.* Business risk is the risk that the company or venture will have management or business problems. The possibility that the price of XYZ Utility Co. stock will fall if its nuclear facility is closed, or that the price of ABC Manufacturing Co. stock will fall if its product becomes obsolete because of technological advances, are examples of business risks. Occasionally, negative developments within a competitor's business can send sympathetic shock waves throughout a particular industry even though the development may have no direct impact on the company's operation.
- *Interest rate risk.* Interest rate risk results from increases and decreases in investment prices caused by changes in interest rate levels. Stocks, real estate, and especially bonds are interest-rate sensitive.
- *Purchasing power risk.* Investors suffer from purchasing power risk if the total return on their investments is less than the rate of inflation. All investments, but especially long-term fixed income securities, are subject to purchasing power risk. This presents a dilemma for ultraconservative investors with a strong aversion to market risk. By accepting low guarantee yields, such investors may, in fact, be guaranteeing a loss to inflation.

1.3 Investment Considerations

The types of investments an investor is likely to choose depend on specific goals, needs, interests, experience, and financial resources. The ultimate objective of investors is to maximize return and minimize risk. Beyond risk aversion, the considerations an investor will have are likely to be as unique as each investor:

- *Safety.* If an investor desires safety of the dollar, conservative investments are advisable. Blue-chip stocks, high-rated bonds, and other relatively low-risk investments are appropriate. Safety also requires careful analysis and attention to economic and industry trends, since many relatively safe investments are still subject to market risk, business risk, and interest-rate risk. Diversification in a number of investments that differ by industry, geography, and maturity, such as through money market or mutual funds, can reduce an investor's risk.
- *Liquidity.* If an investor desires liquidity and easy access to funds, short-term, easily accessible investments are advisable. Money market funds, short-term certificates of deposit, and savings accounts would be appropriate investments. Liquidity should not be confused with safety. For example, an aggressive mutual fund may be highly risky, but with telephone transfer and redemption privileges, it may be quite liquid.

- *Income or Growth.* Income-oriented investments are geared to produce current income through dividends or interest. Growth-oriented investments usually have lower current yield, but offer greater potential for appreciation in principal value.
- *Tax advantages.* Tax-advantaged investments provide a method of converting dollars that would otherwise be paid in taxes into additional net worth for the investor. This is done by taking advantage of statutory provisions that partially or completely exempt certain types of income or defer reporting it until some future time, thereby allowing the investor to use the funds currently.
- *Future security.* The investor interested in securing the future for a family may do well to purchase investments that provide for a return far into the future. Life insurance provides both death benefits and investment features. Annuities, pensions, and retirement accounts provide both favored tax status and retirement security. Long-term government securities can be purchased to provide for later educational needs of children. Trust funds divert income and also provide financial protection for children.
- *Inflation hedge.* Potential hedges against inflation and defensive investments in times of uncertainty are tangible investments such as gold, silver, and precious gems and coins. Investors in this category must watch the market for these investments carefully; the market tends to be extremely volatile and extremely risky.

2. DEFINITIONS

Government-backed Securities. Government-backed securities are one of the safest investment alternatives available. U.S. savings bonds, Treasury securities, and many state and municipal bonds are backed by the treasuries of government units and the full faith and credit of the government unit involved. Although a default on government securities is theoretically possible, in reality it is highly uncommon.

Although government-backed securities carry a fixed yield-to-maturity, they are still subject to market fluctuations during the life of the security, as market interest rates change. The investor needs to fully understand that the backing of the federal or state government will not protect against a drastic drop in market value should interest rates fluctuate over the life of the security.

Insured Investments. Insured investments are basically risk-free. Some of the best-known insured investments are bank investments insured by the Federal Deposit Insurance Corporation (FDIC). In 1989,

the FDIC was given the additional duty of insuring deposits in savings associations (S&L's). As a result, the FDIC insures deposits in banks using the Bank Insurance Fund (BIF), and insures deposits in savings associations using the Savings Association Insurance Fund (SAIF). Both BIF and SAIF are backed by the full faith and credit of the United States. The FDIC insures deposits in commercial banks and ensures that accounts will be protected up to a \$100,000 limit in the event of a bank insolvency. Investments in other financial institutions are protected through regulations of the comptroller of the currency, the Federal Reserve, and various state regulations. These agencies examine the financial stability and asset-to-liability ratios of financial institutions.

Current Yield. Current yield is the percentage the annual interest or dividend payment bears to the investment market price. For example, a 6 percent bond with a \$1,000 face value and a price of \$800 would have a current yield of $\$60/\800 or 7.5 percent. Current yield is most useful in appraising bonds that may be held only in the short term. Current yields are reported in the *New York Times*, the *Wall Street Journal*, and other financial publications.

Yield-to-Maturity. Yield-to-maturity is the compounded rate of return over the life of an interest-bearing investment. It measures the return on the investment and is especially useful in comparing bonds that may be held long term.

Yield-to-Call. This is the compound rate of return on an interest-bearing investment, assuming the issue will be called for redemption by the issuer at the earliest date permitted in the indenture. The lower of yield-to-call or yield-to-maturity is the more realistic rate of return to be anticipated by an investor.

Coupon Rate. The coupon rate is the rate of interest paid on the bond's face value. It is normally printed on the face of the bond and never changes. The coupon amount is the basis on which two other yields—the current yield and yield-to-maturity—are measured.

Holding Period Return. The holding period return refers to the rate of return realized over the holding period of the security. It is calculated by dividing the total investment income during a given period by the purchase price or sum invested. The numerator, or income, is the amount received on an investment over and above the amount initially invested. It is the total value minus the basis. For example, if an investor purchases a stock for \$72 per share, holds the stock for a year, and then sells it for \$75.50 after a dividend payment of \$3.70, the holding period return is calculated as $\$75.50 - \72.00 equals $\$3.50 + \3.70 , or $\$7.20$ total gain, divided by the invested amount of $\$72.00$, for a holding period return of 10 percent.

Net Present Value (NPV). Present value is the discounted value of future cash flows, represented by the present value of the total benefits less the present value of the total investment. Net present value can be used to compare the total benefits from an investment with the capital required to make the investment in today's dollars. For example, by applying a present-value factor, one may determine that receiving \$1,000 two years from now is equivalent to receiving, perhaps, \$850 today.

Net Future Value (NFV). Net future value is the future value of the total benefits of an investment less the future value of the capital required to make the investment. Net future value can be used to compare the consequences of investing versus not investing. The future value of the investment contributions represents what the investor will have in the last year of the projection if the investor does not make the investment and invests the capital elsewhere at a certain reinvestment rate.

Internal Rate of Return (IRR). Internal rate of return is the discount rate that yields an NPV of zero. The IRR is not always a reliable measure of an investment, since it has two potential faults. First, IRR assumes that as the benefits and the returned principal from the investment are received, they are reinvested at the same rate as the investment that internally generated it. The investor must reinvest the benefits in alternative investments that yield a return as high as the investment being reviewed. This may be unrealistic when the IRR is relatively high or low. Second, when there are negative benefits, there may be more than one solution to the IRR. Negative benefits occur if taxable income generates a tax cost greater than the cash disbursements for the year.

Adjusted Rate of Return (ARR). Adjusted rate of return, an alternative to the more traditional IRR, is a more realistic measure of an investment's value because it allows adjustment of reinvestment and tax rates. The use of the ARR permits reinvestment of smaller cash flows at different rates.

3. BANK INVESTMENTS

Bank investments include items such as money market funds, savings accounts, and certificates of deposit. These items make up a large portion of short-term, relatively liquid investment sources. Although short-term investments usually have a lower yield than longer-term securities, they have many advantages:

- They provide liquidity and are easily accessible.
- Many are insured and virtually risk-free.
- They do not require investment sophistication and are easy to understand.
- They are generally good for small investors because they do not require large sums.
- Short-term interest-bearing investments, such as money market funds, make excellent investments during periods of generally rising interest rates because their yield moves in direct relation to market interest rates, and they are not subject to a decline in market value, which could plague long-term bonds and even equity securities at these times.

Short-term investments also have several disadvantages:

- Under FDIC limits, they are not insured for amounts above \$100,000.
- Most certificates of deposit contain early withdrawal penalty costs that can drastically reduce the yield if not held to maturity.
- In periods of falling interest rates, many other investments, such as long-term debt and equity securities, generally provide a substantially higher yield.

3.1 Certificates of Deposit (CDs)

Certificates of deposit are issued by commercial banks and savings and loan associations. They pay a yield often based on the going Treasury bill (T-bill) rate. These certificates can be purchased in a variety of denominations and with maturity dates that range from thirty days (short-term) to longer than five years (long-term). The minimum purchase amounts usually become higher as the maturity period becomes shorter. Interest rates on certificates normally remain fixed over their maturity and investors face an interest penalty for early withdrawal. Interest rates generally increase as the term of the certificate increases.

3.2 Jumbo Certificates of Deposit

Jumbo certificates of deposit are issued in various denominations by commercial banks and savings and loan associations. Interest rates on these CDs are often high to attract large investors; their maturity dates can range from thirty days to several years. Jumbo CDs are generally issued for a minimum investment of \$100,000. The interest rate is

generally the highest available given this level of safety. Jumbo CDs issued up to \$100,000 are therefore a minimal risk. These CDs can also be used as collateral for loans. Jumbo CDs have several disadvantages, including full taxation of the earnings, interest penalty for early withdrawal, and lack of capital appreciation. Large-denomination CDs are rated by *Moody's* and other investment services.

3.3 Banker's Acceptances

A banker's acceptance is created when a bank "accepts" or signs a letter of credit for a business. By so doing, the bank accepts responsibility for payment of the business debt. The letter of credit then becomes a banker's acceptance or the equivalent of a promissory note written by the bank.

Banker's acceptances are frequently sold to acceptance dealers. One reason a bank may sell the acceptance is to recoup the money it invested in the loan before the loan expires. Banker's acceptances may be resold to numerous other parties before the loan is repaid. The investor who last owns the acceptance when the debt becomes due has a right to collect from the borrower. Should the borrower default, the investor can also pursue payment from the accepting bank. Banker's acceptances have a very low risk with a moderate return.

3.4 Repurchase Agreements

Repurchase agreements are contracts in which an investor or security dealer sells a United States security to a bank or other corporation and agrees to repurchase the security later at a specified time and price, including interest. The security itself serves as collateral. Repurchase agreements are a common institutional investment and generally require a large investment amount. The investment period ranges from one day to several months, and the purchaser earns interest competitive with money market rates.

4. BONDS

A bond is a loan to the bond issuer, who must pay back the principal of the bond with interest. A bond represents a creditor position, rather than ownership, as with stocks. For example, to cover a \$10 million debt, a bond issuer may sell 10,000 bonds with a \$1,000 face value, a sale known as a *bond issue*. Bonds generally are issued for the long term,

and are marketable during this term, with a value that moves inversely to changes in market interest rates. For example, a \$10,000 bond issued at 8 percent would be marketable for considerably less than \$10,000 if interest rates were to move to 10 percent (since an \$8,000 bond at 10 percent yields the same annual interest payment), and could be marketed for considerably more than \$10,000 if interest rates were to fall to 6 percent.

Corporate bonds are usually general debentures. That is, bond holders are second in line for payment behind secured creditors in case of default. In contrast, mortgage bonds are secured by specific real estate of the issuer.

Behind every bond issue is a legally enforceable contract called an *indenture* which describes the relationship between the bond issuer and the original purchaser. Bond issuers must inform all original purchasers in writing of what the money will be used for, what interest the purchasers will receive, when the bonds will mature, and of other pledges and restrictions of the indenture.

All U.S. government securities fall into the general categories of treasury and agency securities. U.S. government bonds are generally seen as a source of risk-free interest income because they represent the safest investment grades of debt available.

Federal securities are divided between marketable and nonmarketable issues. Marketable issues make up about two-thirds of the federal debt and include T-bills, Treasury notes, Treasury bonds, and certificates of indebtedness. Nonmarketable issues are mostly U.S. savings bonds. Interest income from U.S. Treasury securities is exempt from state and local income taxes.

All new issues of T-bills, Treasury notes, and Treasury bonds are in book-entry form. No certificates are issued for any of these securities. A receipt or account statement serves as the record of ownership.

Investors may use the Treasury Direct Securities System, whereby book-entry accounts are maintained on the records of the Department of the Treasury, Bureau of the Public Debt. Securities held in Treasury Direct can be purchased at original issue directly from a Federal Reserve Bank or Branch, or from Public Debt. Broker commissions are eliminated on Treasury Direct purchases.

Investors receive a statement of account after establishing an account in Treasury Direct, and whenever certain transactions occur within the account. Principal and interest payments are processed electronically by direct deposit into the investors' account at their locally authorized financial institution.

In early 1998, Treasury announced a number of changes to the Treasury Direct program:

- Investors may now pay for securities directly with a debit to their bank account. Previously, investors had to pay with a cashier's check or with a certified check.
- Investors may now reinvest maturing securities by calling a toll-free number which can handle calls from touch-tone phones 24 hours a day, 365 days a year. Previously, investors had to reinvest by mail.
- Investors may now sell securities directly by mailing a form to the Chicago Federal Reserve Bank, which will accept three price quotes from dealers and accept the highest bid. The Bank will charge a \$34 fee for each security sold. Previously, holders had to sell the securities through a bank or dealer.

Forms and information about the Treasury Direct program may be obtained on the Internet at www.publicdebt.treas.gov.

4.1 T-bills

T-bills are short-term notes that mature in thirteen, twenty-six, or fifty-two weeks after date of issue. New bills are usually offered by the federal Treasury every week. T-bills are sold at a discount from the face value of the bill, a difference that represents the investment value of T-bills. For example, a \$10,000 thirteen-week or 90-day T-bill might be purchased for \$9,875 at approximately a 5 percent effective annual interest rate. The \$125 difference represents the income gained from the bill. T-bills can be purchased in a minimum amount of \$10,000 and in multiples of \$5,000 thereafter.

4.2 Treasury Notes

Treasury notes resemble certificates except for the time of maturity. Newly issued notes usually have a maturity period of two to ten years. They pay a fixed interest rate semiannually and their market prices, which fluctuate continuously, can rise and fall in inverse relationship to market interest rates. New issues of Treasury notes can be obtained from Federal Reserve Banks without a fee for the service under the Treasury Direct System. Treasury notes can be purchased in minimum denominations of \$5,000 if the maturity is three years or less and \$1,000 for maturities of four to ten years.

Since only new Treasury issues can be purchased directly from the government, previously issued notes and bonds must be purchased through banks or brokers while incurring an additional commission cost. For issues after 1986, the Treasury no longer prepares engraved or

registered securities. New issues are done by book entry only. Registered bonds are not readily marketable and should generally be avoided.

4.3 Treasury Bonds

Treasury bonds have the longest maturity period of all the Treasury issues, ranging from ten to thirty years, are sold at face value, and pay semiannual interest. Treasury bonds are issued in denominations of \$1,000. Because of their longer maturity, they generally carry a higher interest rate. If long-term bonds are traded before maturity, their values can be volatile in periods of rising or falling interest rates. Therefore, the investor needs to be aware of cyclical changes in interest rates and other economic trends.

Treasury bonds can be obtained through banks, brokerage firms, and government securities dealers, both for new issues and for secondary market issues.

4.4 Zero Coupon Treasury Securities

As discussed in section 4.10.10, zero coupon bonds are issued at a substantial discount from par with all interest payable at maturity. Nonetheless, interest is taxable annually as it accrues. U.S. Treasury zero coupon securities are state tax exempt and have the financial security of U.S. government backing. Zero coupon Treasury securities are available from a number of sources.

4.4.1 Certificates of Accrual on Treasury Securities (CATs)

In 1982, Saloman Brothers began issuing Certificates of Accrual on Treasury Securities, or CATs. These fully registered certificates are available in \$1,000 maturity values with all interest payable at maturity.

4.4.2 Separate Trading of Registered Interest and Principal of Securities (STRIPs)

The U.S. Treasury introduced zero coupon securities, better known as STRIPs, in 1985. STRIPs are similar in characteristics to CATs but are available in book-entry form only.

4.4.3 Treasury Investment Growth Receipts (TIGRs)

Merrill Lynch made available Treasury Investment Growth Receipts, or TIGRs (pronounced *Tigers*). Characteristics are the same as other Treasury zeroes, but like CATs, TIGRs are available in registered certificate form.

4.5 U.S. Savings Bonds and Inflation-Protection Securities

Savings bonds represent the nonmarketable issue of U.S. securities. They cannot be traded on the securities markets and are not transferable or negotiable. They can be purchased and redeemed from the U.S. Treasury through commercial banks, or directly from the Bureau of Public Debt, Washington, D.C. 20226 (1-800-USBONDS, or 1-800-872-6637). Series EE bonds can be charged on VISA and MasterCard charge accounts. They are most attractive to small investors and are sold in relatively small denominations. Savings bonds present little or no investment risk, but their return is also relatively low compared to other government issues.

There are two types of savings bonds on the market—Series EE and Series HH, which replaced the old Series E and H bonds issued between 1941 and 1952. Series E and H bonds no longer yield interest and should be exchanged for Series EE and Series HH bonds. Accrued interest on matured Series E Bonds is not taxable until cash is received. Taxation on the interest can be deferred if the Series E bond is exchanged for a Series HH bond.

Bond holders should check maturity dates annually to determine if any bonds have matured. Series E bonds issued before 1965 reach maturity after 40 years, and discontinue accruing interest upon maturity. Also, unless Series E bonds are traded in for Series HH bonds within 12 months of maturity, accrued interest on the Series E bonds is taxable in the year of maturity.

Certain interest income from U.S. savings bonds used for higher education tuition and fees is exempt from taxation. Section 135 of the Internal Revenue Code defines the requirements for the interest income to be tax-exempt. Limitations exist on the use of the redemption proceeds, and a limitation on the tax-exempt status of the income is based on the adjusted gross income of the taxpayer redeeming the bonds. Certain other restrictions also exist as defined in Section 135 of the Internal Revenue Code.

4.5.1 Series EE Bonds

Series EE bonds have a minimum purchase price of \$25 (face value \$50) and a maximum of \$15,000 (face value \$30,000) that may be purchased by an individual in a calendar year. The investment return on Series EE bonds is from the appreciation in value of the bond. Series EE bonds are purchased for half the face value of the bond.

The time required for a bond's value to be equal to its face value is based on the minimum guaranteed rate in effect at the time the

bond is purchased. The maturity period is twelve years if the minimum guaranteed rate is 6 percent. For example, a bond purchased for \$500 can be redeemed after twelve years for \$1,000.

The interest on EE bonds held five years or longer is calculated to equal 85 percent of the average market yield on five-year Treasury notes, compounded semiannually. Bonds purchased after March 1, 1993, and held less than five years earn interest at a fixed rate of 4 percent.

Series EE bonds may be exchanged at redemption for Series HH bonds at a minimum of \$500 face value. Interest on Series EE bonds may be tax-deferred until maturity, or the taxpayer may elect to report the interest income annually.

4.5.2 Series HH Bonds

Series HH bonds have a maturity period of ten years. The investment value of HH bonds is the semiannual interest payments, which yield an average of 5 percent to 10 percent depending on market factors. The minimum purchase price of Series HH bonds is \$500; the maximum annual purchase limit is \$20,000. Unlike Series EE bonds, Series HH bonds are purchased at the face value of the bond.

Series HH bonds can be obtained in only two ways. The first is in exchange for Series E or EE bonds or savings notes worth \$500 or more in redemption value. Bonds are eligible for exchange six months after they are issued. Series EE bonds can be exchanged up to one year after maturity. If an investor has more than \$500 in exchange bonds, but not enough for the next larger size of HH bonds, cash may be added to make up the difference. The only other way Series HH bonds can be obtained is by reinvesting proceeds from the sale of mature Series H bonds. Interest on these bonds is taxed as current income, while Series EE bond interest may be treated as current income or income deferred until redemption. Both bonds may be redeemed any time after six months from the purchase or issue date. Series HH bonds may not be exchanged for Series EE bonds.

4.5.3 Inflation-indexed debt instruments

The Treasury issued "Treasury Inflation Protection Securities" starting January 29, 1997. These securities are adjusted for inflation and deflation, and provide for semiannual payments of interest and a payment of principal at maturity. In general, each payment is adjusted to take into account any inflation or deflation that occurs between the issue date of the security and the payment date.

The principal amount of these securities is adjusted for inflation and deflation based on monthly changes in the CPI for All Urban

Consumers, published by the Bureau of Labor Statistics of the Department of Labor. The inflation-adjusted principal amount of the security for the first day of any month is determined by multiplying the principal amount at issuance by a fraction, the numerator of which is the value of the index for the adjustment date and the denominator of which is the value of the index for the issue date. The inflation-adjusted principal amount of the security for a day other than the first day of the month is determined based on a straight-line interpolation between the inflation-adjusted principal amount for the first day of the month and the inflation-adjusted principal amount for the first day of the next month. The value of the index used to determine the adjustment for the first day of a particular month is the value of the index reported for the third preceding month.

Each semiannual payment of interest is determined by multiplying a single fixed rate of interest by the inflation-adjusted principal amount of the security for the date of the interest payment. Therefore, although the interest rate is fixed, the amount of each interest payment varies with changes in the principal of the security as adjusted for inflation and deflation.

The securities also provide for an additional payment at maturity if the security's inflation-adjusted principal amount for the maturity date is less than the security's principal amount at issuance. The amount of the additional payment is equal to the excess of the security's principal amount at issuance over the security's inflation-adjusted principal amount for the maturity date.

4.6 Agency Bonds

An agency bond is a security offered by a federal agency created by Congress. There are two types of federal agencies: (1) agencies that are a part of the federal government and (2) federally sponsored but privately owned agencies that have a public purpose. Most agency debt is issued by federally sponsored agencies.

Agency bonds have characteristics similar to other governmental bonds. Agency bonds are not as secure as other federal obligations because the federal government makes no direct guarantee that the principal and interest of these bonds will be paid. They, therefore, have higher yields than other federal bonds. In practice, though, the federal government has an implied guarantee protecting any of its own agencies from default, and in times of agency financial crisis in the past, the Treasury has provided help. The greatest risk to the investor may be a delay in interest payments or principal payments, but an investor's expectations may also be thwarted by interest rate risk or by early retirement of the debt.

4.6.1 Government sponsored agencies

Direct government agencies that issue bonds have an implied government backing and are considered to be of extremely sound quality. They are as follows:

- Federal Farm Credit Banks (FFCB)
- Federal Land Banks (FLB)
- Federal Home Loan Banks (FHLB)
- Federal National Mortgage Association (FNMA) (Debentures and Notes)
- The Financing Corporation (FICO)
- Student Loan Marketing Association (SLMA)
- Resolution Funding Corporation (REFCORP)

4.6.2 Federally sponsored enterprises

Federally sponsored enterprises were created by congressional action, but may or may not have complete government backing of their securities. Nonetheless these securities are considered to be of very high quality. They are as follows:

- Export–Import Bank of the United States (Eximbank)
- General Services Administration (GSA)
- Washington Metro Area Transit Authority
- Tennessee Valley Authority (TVA)
- United States Postal Service
- National Power Corporation (NPC)
- Maritime Administration (Merchant Marine)

4.7 State and Municipal or Tax-Exempt Bonds

State and local governments issue bonds referred to as *municipals* or *tax-exempts*. Municipals offer both security and favorable tax status, although recent tax-law changes have removed the favorable tax status for some forms of municipal bonds. Most municipal bonds are issued by local-government counties, cities, and townships, school districts, state and local commissions, agencies, universities, and colleges. The wide variety of issuers provides an opportunity for broad diversification among bondholders.

Municipal bonds are unsecured debenture contracts that promise to pay principal and interest solely from tax or operating revenues. Bonds are issued in straight and serial maturities. Serial bonds pay off part of the debt periodically, usually every six months. If a debt is not paid through serial payments, a sinking fund is used to set aside money to pay off the bond at maturity. The two basic types of municipals are revenue bonds and general obligation bonds.

The Tax Reform Act of 1986 removed the tax exemption for interest earned on certain types of state and local obligations. Interest remains tax exempt on obligations issued by a qualified governmental unit to finance activities of the government unit itself. For example, financing of general government operations for construction of schools and highways continues to qualify for the interest exemption.

Interest on government bonds used for nonexempt private activities generally is taxable if the bond was issued on or after September 1, 1986. Bonds that finance sports or convention or trade show facilities are also taxable after that date.

Certain bonds, while remaining tax exempt, produce interest income categorized as a tax preference item for purposes of the alternative minimum tax. Included in this category is interest earned on certain nonessential bonds issued after August 7, 1986.

(Text continued on page 21)

4.7.1 Revenue bonds

Revenue bonds are bonds issued by a political subdivision, government, or public authority that pays the debt out of revenues of the project being financed. Some revenue bonds may also have additional support from tax revenues. These bonds are sometimes called combination bonds.

There are three types of revenue bonds: utility, quasi-utility, and nonutility. Each type includes or represents a certain kind of service project or entity such as public transportation—a bridge, tunnel, or highway—or an airport or hospital.

Revenue bonds tend to be, at least theoretically, less secure than general obligation bonds because they are dependent upon the success of the project they are financing. For example, a bond debt incurred to build a toll bridge would be paid off through the toll charges for the use of the bridge. If those charges become insufficient to meet the bond obligation, the bondholder has little recourse. These bonds generally carry a higher interest rate, however, and it is not unusual for a state or other government subdivision to intervene in the case of revenue-bond default.

4.7.2 General obligation or full-faith-and-credit bonds

General obligation bonds are guaranteed by the political subdivision's power to tax. Although there is no property securing the bonds, holders receive an unconditional guarantee of payment. General obligation bonds account for most of the debt incurred by subfederal government units. Revenues for payment on the bonds are generally raised through property taxes.

To be fully secure, general obligation bonds must be issued by a government unit that has an unqualified authority to issue the bonds. Legal consultants are employed to study the constitution, statutes, charters, and bylaws of the issuing entity to ensure that it meets all the legal requirements. If the bonds are legal, the consultant will issue an opinion attesting to that fact. This opinion will not prevent a loss if it is incurred, but it does provide assurance that everything is in good order for issuance. A copy of the legal opinion is usually provided to each buyer.

4.7.3 Assessment bonds

Assessment bonds make up a very small portion of municipals. They are usually issued to raise money to improve existing government facilities such as sewers, sidewalks, and streets. Payments on the bonds are made from the proceeds of special assessments on the property owners

who benefit from the improved property. The assessment is set up so that a portion is specifically designated for payment of bond obligations. The risk related to these bonds corresponds to the potential decline in the value of the property and the possibility that property owners simply refuse to pay, even under threat of attachment of the property.

4.7.4 Other characteristics of government bonds

Two features that may be available with municipals are the put bond and the variable rate bond. A put bond allows the bondholder to sell the bond back to the issuer at a predetermined price. The variable rate bond pays fluctuating interest rates, according to market conditions. Both of these features are offered to bondholders as a hedge against the risk of an unprofitable investment as a result of rising interest rates.

One of the most attractive features of municipals is their tax-exempt status. Income from certain municipals is exempt from federal taxation. In many states, income from municipals within the state is also exempt from state taxation. They are therefore particularly attractive to high-income buyers. Although interest rates and yields on municipals are usually lower than on other bonds, their tax-exempt status may generate a better yield after taxes. For example, a taxpayer in a 39.6 percent federal tax bracket buying a 5.25 percent tax-exempt bond would receive an after-tax yield equivalent to that of a taxable bond of 8.7 percent.

4.8 Mortgage-Backed Securities

Home ownership is possible for most individuals only through the use of mortgages. Mortgage-backed securities are secured by a pool of mortgages and offer a relatively secure, income-oriented investment. For many mortgage-backed securities, a government agency provides a guarantee, or assurance against default is provided by a private firm. Payments on the mortgages are made to a bank or to a mortgage banker, which collects the monthly payments of interest and principal, removes a servicing fee, and passes the remainder through to the investors.

Mortgage-backed securities generally have a higher stated yield than direct government securities. However, it is normally very difficult to determine an effective yield to maturity. Since the mortgage pools return principal as well as interest monthly, the principal received must be reinvested to continue earning.

In an environment of falling interest rates, the level of principal repayments can increase dramatically due to homeowners refinancing at lower rates. Accordingly, the stated maturity term is often severely eroded and an investor is forced to reinvest larger amounts at lower

prevailing rates. Because of the repayment acceleration, mortgage-backed securities often do not enjoy the gains produced by fixed income securities when rates fall.

4.8.1 GNMA securities

The Government National Mortgage Association (GNMA) issues mortgage-backed securities. These securities are commonly known as *Ginnie Maes*. Mortgages are purchased from private lenders by the GNMA at low yields to encourage certain types of home ownership. The GNMA then sells pools of these mortgages to investors at current market yields. The difference between the low yield of the mortgages and the yield to the investors is paid by GNMA as an incentive to stimulate housing activity.

Since the GNMA securities are issued against a specified pool of mortgages guaranteed by certain government agencies, from an investment perspective they are effectively guaranteed by the U.S. government. Principal and interest payments are made monthly on GNMA securities, similar to the payment for other mortgages. The minimum denomination on new GNMA pools is \$25,000.

4.8.2 FHLMC and FNMA securities

Similar to GNMA securities, the Federal Home Loan Mortgage Corporation (Freddie Mac) and Federal National Mortgage Association (Fannie Mae) sell pools of mortgages to investors. Unlike GNMA, however, these securities are generally available in denominations of \$1,000.

4.8.3 Collateralized mortgage obligations

Collateralized mortgage obligations (CMOs) actually represent serial bonds that produce income on a quarterly basis. CMOs are structured into two or more classes, each of which has its own coupon rate and maturity. Interest is paid to all interest-paying classes, but principal is paid to only one class at a time. While CMOs enjoy a high quality of collateral, they are subject to interest-rate risk, particularly for long-term CMOs. Some CMOs are collateralized by various federal agencies, whereas others are collateralized by conventional mortgages.

Interest and principal payments on CMOs come from the mortgage payments of the home owners. The CMOs then make fixed-rate interest payments to eligible security holders on a quarterly basis. CMOs are divided into short-, intermediate-, and long-term classes. As principal on the mortgages is paid by the home owners, it is applied to each investment class of the CMO in succession. As one investment class is totally paid off, the next investment class begins to receive principal payments.

CMOs are divided into an interest-paying bond class and a deferred-interest bond class. The interest-paying bond class offers investors current income. Interest payments are made to the bondholders from the cash resulting from the pool of underlying mortgages. Any remaining cash flow is then used to retire the shortest maturity bonds in the class. Deferred-interest bonds differ from the interest-paying bonds in that payments are not distributed until all previous classes have been retired. Interest accrues on the unpaid balance and the principal amount grows at each payment date. The deferred-interest bonds are ideal for retirement and profit-sharing accounts, since payments do not occur until some point in the future.

Real Estate Mortgage Investment Conduits (REMICs) represent collateralized mortgage obligations and work similarly.

4.8.4 Reverse mortgages

Reverse mortgages are targeted to older taxpayers who have substantial equity in their homes. Under a reverse mortgage, a borrower (normally a retired individual) taps into the equity of a home to pay expenses, make improvements to the home, or simply to have cash on hand. The loans are made in a nonrecourse manner, resulting in the sole recourse of the lender for repayment being foreclosure upon and sale of the property. As such, the borrower is not obligated for more than the home is worth and neither the borrower nor the borrower's estate is liable for any deficiency.

Homeowners are allowed to borrow against the equity in a home in an amount based on the age of the borrower, the amount of equity along with the appraised value of the home, and the payment option selected by the borrower. Payment options include a lump sum payment from the lender to the borrower at closing, a line of credit available to the borrower, or some combination of the two. The ability to obtain a reverse mortgage is neither dependent on the borrower's income or credit history because the reverse mortgage is nonrecourse and the amount that can be obtained by the borrower is based upon the value of the home and the life expectancy of the borrower.

At present, secondary market sources have been unwilling to purchase reverse mortgages, with the result that most mortgage lenders are unable or unwilling to offer the product. The Federal National Mortgage Association (FNMA) has introduced a homekeeper loan program which allows mortgage lenders to offer reverse mortgages by providing a secondary market source to which these loans may be sold. Because of the small secondary market for these reverse mortgages, they do not represent viable investment vehicles at this time. As the

secondary market increases, investment opportunities in these securities should expand as with other mortgage-backed securities.

4.9 Bond Ratings

The potential bond purchaser needs to investigate the legality and financial position of a municipal bond issue. Bond-rating services are available for this purpose. *Moody's Municipal and Government Manual* is a factual, interpretive rating service for almost all state and municipal bonds. *Standard & Poor's Bond Guide* is another well-known bond-rating guide, as is *Fitch's Investors Service*. Bonds are rated from Aaa to D (for default—meaning the payor is late in making one or more of the scheduled interest payments), with several subratings within a triple-A rating for the best-quality bonds. Conversely, C-rated bonds are considered risky or poor quality bonds. Bonds rated B or below are not investment grade; that is, in most states they may not legally be purchased by persons or institutions acting in a fiduciary capacity.

4.9.1 Junk bonds

Lower quality bonds generally provide higher yields, at the price of higher risk. These high yield, or “junk bonds,” are normally rated Ba and below. While these bonds provide the highest levels of income, they also provide the greatest potential for default. The prices of junk bonds often fluctuate a great deal, based on the fortunes of the bond issuer. Junk bond prices are also impacted in the short term by interest rate fluctuations. Accordingly, junk bonds carry a high degree of risk and should be used cautiously by investors.

4.10 Corporate Bonds

Corporate bonds represent legal debt of a corporation that finds it necessary to raise capital by borrowing. There are several types of corporate bonds. Besides ordinary corporate bonds, there are discount and zero-interest (coupon) bonds, silver-gold indexed bonds, put bonds, and variable-rate bonds. Some bonds also offer the bondholder a share in the growth of earnings.

4.10.1 Bond indentures

The promises made by a corporation to a bondholder upon the sale of a bond are set out in the bond indenture. The agreement itself is usually made between the corporation and a representative of the bondholder, such as a commercial bank or trust company. The use of

such a representative or trustee is the only practical way the corporation can issue to individual bondholders. The indenture usually describes the authorization of the issue; the interest rate; the property pledged as security; and the rights, restrictions, and remedies of the parties upon default.

4.10.2 Value and denominations

A common value of a bond is \$1,000, although bonds with a \$5,000 or \$10,000 value are not uncommon. This value is known as the par value, face value, or maturity value.

4.10.3 Short-term versus long-term bonds

Maturity dates of corporate bonds vary. Long-term bonds generally have maturity lengths of over ten years. Short-term bonds mature within five years and intermediate bonds, in five to ten years. The longer the maturity, the more a bond is subject to interest rate risk and purchasing power risk. Recently some Fortune 500 companies have successfully sold fifty-year bonds.

4.10.4 Call feature

Most modern corporate bonds are callable at the discretion of the issuer, an option known as the *call feature*. The call feature allows the corporation flexibility in retiring outstanding bond debts. Bonds are usually called at a price higher than par value to compensate the bondholder for the loss of earnings from early retirement of the bond. The difference between the par value and call price is referred to as the *call premium*. The time and the amount at which a bond can be called are usually spelled out in the indenture.

4.10.5 Serial bonds

Some corporate bonds are serial bonds—actually a series of bonds with different maturity dates. An issue matures every six months or at another regular interval. The yield varies with the maturity date. Generally, serial bonds are not callable because the corporation is already systematically retiring the debt.

4.10.6 Debenture bonds

Not all bonds are secured by a pledge of the corporation's personal property or real estate. A debenture bond carries a full-faith-and-credit obligation whereby the corporation pledges its assets, earnings, and character to fulfill its bond obligation. The corporation's assets could

be used to satisfy unpaid bond interest or principal. In the case of default, bondholders become general creditors. All assets not specifically pledged, or any funds remaining after payments of secured debts from assets previously pledged, are available to pay the legal claims of the general creditors.

4.10.7 Interest on bonds

Interest on a bond is usually paid semiannually, by check or coupon, and either directly or to the bondholder's representative or trustee. The par, or face amount, of the bond multiplied by the stated interest rate determines the dollar amount of interest to be paid for a year. The amount is fixed for the life of the bond. If interest payments are not paid on time, the bond is in default and all interest and principal normally become due and payable pursuant to an acceleration clause in the bond agreement. This acceleration provision primarily establishes the bondholder's claim to assets and does not ensure repayment of the principal. The trustee is usually responsible for acting on behalf of and for protecting the bondholder's interests.

4.10.8 Income bonds

Income bonds pay interest only if there are sufficient earnings. In some cases interest payments must also be approved by the board of directors. Unpaid interest may be cumulative and payable later. Income bonds are often issued pursuant to a corporate reorganization or recapitalization.

Income bonds vary in detail. Some are convertible into common stock. A portion of the interest paid may be mandatory or contingent on earnings. Interest is usually paid only once a year.

A bond indenture may contain protective covenants that serve to preserve the bondholder's investment. An example would be a limitation on dividends payable on common stock to protect the financial status of the company.

Many income bonds have proved to be good investments, and many have mortgage security and sound indentures.

4.10.9 Bond quality ratings and services

As with government bonds, professional rating services are available to investors who want to investigate the advisability of purchasing a certain corporate bond. Ratings are based on the reputation of the bond issuer—its interest payment record, its profitability, and so forth. *Moody's Industrial Manual* and *Standard & Poor's Bond Guide* are two well-known, well-respected rating services available to investors. Rating services differ, but the highest ratings given are often AAA for the most secure,

followed by AA, A, B, and so on, with many intermediate steps to the lowest ratings.

4.10.10 Zero coupon bonds

Zero coupon refers to a bond that pays no current interest. Instead, the bond is purchased at a deep discount and redeemed after a holding period for face value. The gain on zero coupon bonds is comparable to the gain from interest paid on other bonds. Interest is actually compounded each year on a zero coupon, but the bondholder does not receive it. Rather, it is “reinvested” into the bond so that the face value of the bond increases every year until it reaches total face value at the end of the term.

Even though interest is not actually paid annually, the increase in face value is treated as annual income taxable to the bondholder. (Some tax-exempt bonds are available in zero coupon form as discussed at section 4.4. The increase in value is not taxable.) The zero coupon bond is not unlike a savings account or certificate of deposit for which the interest gain is continually reinvested.

4.11 Payment-in-Kind (PIK) Bonds

Bonds having interest paid in the form of additional securities are known as “payment-in-kind” (PIK) bonds. These bonds allow investors to combine the advantages and disadvantages of equity investments, as described in Section 5.10 of this chapter, with the advantages and disadvantages of debt securities.

5. COMMON STOCK

Stocks represent an ownership or equity interest in a corporation. Although investment in stocks entails a greater risk of loss than does that in bonds, the potential for a greater gain is also present. A gain or loss on a stock investment is subject to market risk, to the earnings of the company, and to the dividends paid. Common and preferred stocks are the two basic types of stock traded. (Preferred stocks are discussed in section 7, below. See also the discussion of Stock Market Analysis in section 13.2, below.)

Common stock represents an interest in the residual earnings of the corporation after taxes, general liabilities, bondholders, and preferred stockholders have been paid. Common stock bears the greatest burden of risk of the enterprise but receives the greatest share of the returns if the corporation is successful.

5.1 Stock Certificate and Par Value

Ownership of common stock is evidenced by a stock certificate. The certificate states the number of shares owned and par value, if any. Par value is the face value at or above which shares must be issued. Low par values make it easier to sell the stock, and corporations that pay state excise and franchise taxes on par values pay lower taxes when par values are lower. In terms of the actual value of a stock at any given time, however, par value is meaningless. Investors should be interested in the value of stock as established by earnings and capital gains and not by the par value of stock. Some stocks are issued with no par value.

5.1.1 Initial public offerings

When a company goes public through an initial public offering (IPO), a brokerage firm, acting as underwriter, purchases stock from the company and resells it on a listed stock exchange. The initial prospectus, commonly called a red herring, provides prospective investors with complete details of the company, operating results, and the stock offering. The majority of stock issued in an IPO is reserved for institutional investors, although individuals can also participate in IPO offerings.

5.2 Preemptive Rights

Common stockholders enjoy a number of rights or privileges that correspond with their stock ownership. First, a preemptive right allows stockholders the first opportunity of purchasing from a new issue of shares so that they may retain their same overall ownership percentage of all outstanding shares. Shareholders then retain the same proportionate voting control and an undiluted share in the corporation's earnings and assets. It is quite common for the preemptive right to be waived via the articles of incorporation and, thus, not to be of benefit to shareholders. Some states make the preemptive right an automatic part of all corporate charters.

5.3 Voting Rights

Common stockholders have a right to vote on major issues (such as corporate mergers or new product lines) and election of directors. A small number of issues of common stock are classified into class A and class B shares. This is known as *classified common stock*. Historically, classified stock has represented an attempt by management to raise capital through the sale of public stock while retaining complete control

of corporate decision-making. Class A stock was sold to the public and paid dividends but gave no voting right. Class B stock was voting stock and was held by management. Classified stock is not listed on the New York Stock Exchange. Most classified stock now issued is sold by new companies that want to retain management control while raising capital.

5.4 Cumulative Voting

Stocks with full voting rights permit a stockholder to vote as many votes as shares held. Each share is entitled to one vote; therefore, a shareholder with 100 shares could vote 100 shares for each director. About one-half of the states' laws of incorporation mandate cumulative voting. The rest allow it if provided for in the firm's articles of incorporation. With cumulative voting, each shareholder may cast all the cumulative votes for only one director or divide them among several. By concentrating votes on one director, shareholders otherwise in the minority can get representation on the board of directors.

5.5 Cash Dividends

The board of directors determines when and to what extent common shareholders are entitled to dividends. Cash dividends may be fixed in amount and represent a percentage of the earnings and cash flow per share. The *payout ratio* is that percentage of a firm's annual profits paid out as dividends annually to its shareholders. This ratio will vary over time and among companies and industries as dividends increase or decrease in relation to a company's prosperity.

The majority of all common stocks listed on the New York Stock Exchange pay dividends. Companies with greater excess cash flow naturally tend to declare higher dividends. Companies intent on retaining profits within the company for debt retirement, repurchase of stock, or expansion are called growth companies. As such, growth companies tend to have relatively low or nonexistent dividend payments. The investor appeal for growth companies lies in the prospect for future higher earnings rather than the current dividend income.

5.6 Stock Dividends

Although most dividends are paid in cash, some dividends are paid with stock. Stock dividends are paid in shares of the issuing company's stock. Stock dividends are usually stated as a percentage of shares outstanding. For example, a 2 percent stock dividend would give a holder of 100 shares two additional shares.

Stock dividends are usually issued by young companies, growth companies, or companies that are interested in conserving cash for further internal reinvestment of capital. Only a very small number of the companies listed on the New York Stock Exchange pay stock dividends. The percentage rate for stock dividends is usually below 10 percent, with a range from 2 to 5 percent being common.

5.7 Stock Splits

A stock dividend that pays more than 25 percent is usually referred to as a stock split. A stock dividend or split will increase the number of outstanding shares, but the effect on market price is unpredictable. Since the increased shares are in the hands of existing shareholders, however, the value remains unchanged. The primary reason for a stock split is to reduce the market value of the stock, making it more affordable for small investors.

5.8 Other Types of Dividends

In rare instances, dividends are paid through methods other than cash and stocks. A property dividend consists of one of the company's products, property, or securities of other companies that the issuing company owns. Extra dividends may be declared on a regular or irregular basis and represent dividends above those paid regularly. An extra dividend normally will not be paid unless the earnings substantially exceed those anticipated in the normal course of business.

5.9 Valuing Common Stock

An investor can determine the value and the risk involved in the purchase of a given stock by one of several methods. The four calculations discussed are preliminary indicators of whether a stock is worth further investigation. The figures derived from these calculations can be found in securities manuals and analytical reports.

5.9.1 Earnings per share

Earnings per share is derived by taking the net income after taxes, less preferred dividends, and dividing the result by the weighted average of outstanding common stock and common stock equivalents for the year. Common stock equivalents include stock options, warrants, convertible debt, and similar instruments.

5.9.2 Cash flow per share

Cash flow per share is calculated in a manner similar to earnings per share. This ratio is becoming increasingly important in analyzing stock performance because it adjusts earnings for special one-time charges against income or the amortization of intangible assets that do not require current cash flows. The ratio also distinguishes companies that are relatively debt free from those highly leveraged.

5.9.3 Book value

The net asset value per share or book value measures the amount of equity the corporation has with respect to each share of common stock. It is determined by taking the net balance-sheet cost of corporate assets less liabilities and dividing by the number of shares of common stock outstanding. Book value has little actual effect on market price—normally only indirectly when market price is low in relation to book value.

5.9.4 Price-earnings (PE) ratio

The price-earnings ratio is the market price of the stock expressed as a multiple of the earnings per share. For example, a stock with annual earnings of \$5 per share that sells for \$60 per share would have a price-earnings ratio of 12. The price-earnings ratio is also referred to as the stock's *earnings multiplier*. It is primarily an indicator of the degree of confidence investors have in the stock. The lower the price-earnings ratio, the less optimistic the evaluation of its future earning potential. Stocks with price-earnings ratios of 15 to 30 are believed to have significant growth prospects.

5.9.5 Yield

Yield is the percentage the annual dividend bears to the current price of the stock. For example, a stock that pays annual dividends of \$4 and sells at \$50 has a yield of 8 percent. The yield represents the cash flow the stock will generate if it is purchased at the current price and suggests the future return on investment, assuming no change in dividend payout.

Some investors invert the price-earnings ratio and compute the earnings-to-price ratio, earnings yield, or the percentage that the annual per-share earnings bear to the stock price. Thus, a price-earnings ratio of 12 or $60/5$ is inverted to read $5/60$. Earnings yield reflects what the firm earned per share expressed as a percentage of the stock's market price. The dividend yield and price-earnings ratio are listed in most financial publications.

5.10 Advantages and Disadvantages of Common Stock

Advantages. The major advantages of common stocks are dividend increases and potential for appreciation in value. Many common stocks, except closely held stocks, have a high degree of liquidity because they can usually be easily marketed. The minimum investment necessary to acquire common stocks is small, since even as little as one share can be purchased. Conservative dividend-paying stocks are relatively less volatile in price and produce a steady stream of income. Alternatively, non-dividend-paying stocks are often favored by people in higher tax brackets because all potential profits are deferred in the appreciation of the stock's market value. Then, any capital gain is taxed at a maximum 20-percent federal rate rather than the higher rates applicable to dividend income.

Disadvantages. Major disadvantages of common stocks relate to the fact that many common stocks lack price and earnings stability and returns are variable. There is no assurance that the owner will receive dividends. Prices can fluctuate wildly and future earnings are difficult to estimate. The common stockholder bears the risk of the success or failure of the corporation in proportion to the percentage of stock owned, although the stockholders may not be liable for the debts of the corporation.

A high level of expertise is necessary because stock market investing requires the critical timing of transactions and close monitoring of stocks. Many investors can better diversify their portfolio and take advantage of professional stock management by investing in mutual stock funds as discussed at section 8.

5.11 Brokerage Firms

There are many alternatives to executing securities transactions in today's market. Full-service and discount brokers exist, and now on-line services can be used to execute securities trades.

The advantage of full-service brokerage firms is that they communicate key financial information and key industry reports to their investors, inform investors of the status of their accounts at all times, offer general assistance in terms of portfolio diversification and selection of security transactions, and in general, offer thorough communication with the investors regarding market trends and specific investment trends.

Discount brokers tend to focus less on communication and information with the customers, and more on a simple execution of a securities trade at a lower cost. Similarly, on-line brokerage services allow execution of trades using the Internet and other on-line mechanisms. Even

with discount brokers, valuations can normally be checked with touch-tone phones and via on-line services.

In general, investors looking for recommendations based on the findings of research analysts tend to use full service brokerage firms, while investors doing their own stock selection often use discount brokers and on-line services to execute their trades.

6. OPTIONS AND WARRANTS

Options are contracts that give the purchaser a right to buy or sell shares of a particular security at a specified price within a predetermined period. There are two basic types: puts and calls.

Security brokers normally bring option buyers and sellers together and act as agents to carry out the sale. Every option has three prices: (1) the market price of the optioned security, which continually fluctuates; (2) the purchase price or premium, which is the price the option buyer or seller pays to the option writer; and (3) the exercise price, the price at which the option buyer or seller may buy (call) or sell (put) the optioned security.

New puts and calls are originated every three months, with maturity terms as long as nine months. This practice allows investors who buy and sell options to choose from a variety of maturities. The quarterly expiration of such contracts is often referred to as the *triple-witching hour* and can be marked by wide swings in market activity and pricing.

6.1 Puts

A put gives the purchaser a legal right to sell or “put” shares to another. This negotiable or transferable contract allows the owner to sell a specified security within a fixed period of time at a fixed price. This predetermined price is known as the exercise price, the striking price, or the

(Text continued on page 33)

contract price. The buyer of a put hopes the price of the optioned security will fall.

6.2 Calls

A call is an option, also negotiable, to buy securities or “call in” shares for purchase of a specified security, within a fixed time period, at a specified price. The buyer of a call hopes the price of the optioned security will rise.

6.3 Other Options

Other kinds of options are created with a combination of puts and calls:

- A *straddle* results when a put and a call are placed on the same security at the same exercise price for the same time period.
- A *strip* results when two puts and one call are placed on the same security at the same exercise price for the same time period.
- A *spread* results when a put and a call option are placed on the same security for the same time period, but at *different* exercise prices.
- A *strap* results when two calls and one put are placed on the same security at the same contracted exercise price for the same time period.

6.4 Premiums

The premium or purchase price the buyer of the option pays to the option writer is based on the stock price, the option period, the riskiness of the stock, and the exercise price. Thus an option call on a higher-priced stock will likely be more expensive than one for a lower-priced stock because the option writer has a greater potential for loss if prices drop on a higher-priced stock than on a lower-priced stock. Premiums also tend to be higher if the time period in which the option buyer can exercise the option is longer, since the probability of a loss for the option writer increases with the time the option remains open. A risky security will also bring a higher premium, since a significant price change may be of high value to the option owner. The exercise price of the option is usually close to the market price of the stock on the day the option is written. Sometimes, however, the exercise price is “points away,” or several dollars above or below the market price. If

the exercise price is several dollars from the current market price, the probability of the option being exercised changes.

6.5 Trading Options

Options can be sold. If sold, the time period of the option will carry over from the seller to the buyer. For example, John Doe purchases a nine-month call, keeps it for three months, and sells it to Stan Smith. Stan Smith will be purchasing a six-month call.

Options are bought and sold on put and call markets. The Chicago Board Options Exchange (CBOE) was the first organized options exchange and secondary options market. The American Stock Exchange (AMEX) and other securities exchanges now also trade options.

Options, the prices of which are listed daily in many newspapers, can be purchased through stockbrokers.

6.6 Warrants

A warrant is an option to buy unissued shares of common stock. Like calls, they are a contract to buy shares at a fixed price for a fixed time period. A warrant, however, is different from a call in several ways. Warrants are written by the corporation that issues the optioned stock, not by an option writer. Warrants are sometimes given by the issuing corporation with a new issue of bonds or preferred stock, thus making the new issue more attractive to buyers. Some warrants can be perpetual and never expire, and—like options—they can be traded.

The exercise price of a warrant is the amount the owner must pay to purchase the fixed number of shares. The minimum value of a warrant is determined by subtracting the exercise price from the market price per share multiplied by the number of shares obtained with one warrant. For example, if a warrant gives the owner a right to purchase two shares of stock at an exercise price of \$100 per share while the market price is \$120 per share, the minimum value per warrant would be \$40, calculated as follows:

Price per share – exercise price \times 2 = Minimum value
per warrant.

$$\$120 - \$100 = \$20$$

$$\$20 \times 2 = \$40.$$

The minimum value per warrant changes in larger proportion than the stock price as the stock price changes. Thus, if the price per share rose to \$140 in the above example, the minimum value of the warrant

would double to \$80 ($\$140 - \$100 = \40; then $\$40 \times 2 = \80). It is also possible for the minimum value per share to be negative, that is, to have no value.

Like options, warrants are sold on exchanges; they are also frequently sold by speculators. The terms governing a warrant are generally set out in the warrant agreement.

7. PREFERRED STOCK

Preferred stock is distinguished from common stock primarily by the fact that preferred stockholders are normally entitled to dividend payments before common stockholders are paid. Preferred stock represents a hybrid between bonds and common stock. It usually offers a greater rate of return than bonds do, but with a slightly greater risk. Similarly, the rate of return is usually lower than that available with common stock, but preferred stock is also less risky than common stock.

7.1 Preemptive Rights

Preferred shareholders enjoy the same preemptive right to purchase new issues of stock that common stockholders enjoy. Shareholders are able to maintain their proportionate share of ownership in the corporation, limited only by state statute, the articles of incorporation, or a waiver of the right. If preferred stock is nonvoting, a shareholder would be more likely to waive the preemptive right than voting common stock shareholders would be.

7.2 Par Value

As with common stock, preferred stock usually has a par value. When it does, the dividend rights are usually stated in terms of a percentage of the par value. No-par preferred stock also would have a specified dividend rate stated in dollars. Par value is, therefore, useful only as a good measure of sale price at the time of original issue.

7.3 Voting Rights

Preferred stock is usually nonvoting stock. Preferred stockholders are essentially guaranteed a dividend payment if there are sufficient earnings, so voting rights are unnecessary. Most preferred stock has contingent voting rights—in time of corporate financial trouble, preferred

stockholders would have the right to elect some of the directors. Preferred stockholders normally also have the right to vote on the issuance of additional preferred shares or bonds, company mergers and consolidations, and certain charter amendments.

Nonvoting stock may also become voting stock if dividends are not paid for a specific length of time. The trend is to give shareholders more voting rights.

7.4 Dividends

Dividends on preferred stock can be cumulative or noncumulative and participating or nonparticipating. Cumulative dividends accumulate if the company fails to pay the periodic dividends. For example, if a corporation fails to pay dividends for two years, in the third year (assuming dividends are paid) the stockholder is entitled not only to dividends for the third year but also to the accumulated unpaid dividends for the first and second years. Participating dividends get to share, beyond their stated dividend rate, in earnings with common shares. Participating dividends allow an equal share in the earnings with common shares, but very few preferred stocks are participating.

7.5 Convertible Feature

Some firms issue preferred stock that can be converted into common stock. Thus converted shares come with the right to share in any increase in common-stock value. Convertible preferred stock is a highly regarded investment because it combines the relative security of preferred dividends with the potential growth of common stock. The period during which the stock may be converted is usually limited. Frequently, the time limits do not allow conversion until several years after the stock has been issued; the stockholder may then convert for an indefinite time period or for a limited time. Once converted into common stock, the security cannot be converted back into preferred stock.

7.6 Call Feature

As in the case of bonds, many preferred stocks are callable at the discretion of the corporation. The purpose of calling preferred stock is to force retirement of the issue when the conversion value is well above the call price. The call provision allows the company to retire all or part of the issue at a price stated in the original agreement. To compensate the investor for the call, the company usually pays higher

dividends as a call premium. The call provision, however, allows the corporation to end the relatively fixed charges associated with preferred stock dividends.

7.7 Sinking Funds

A good percentage of preferred stocks, usually those of railroads and utilities, have sinking funds. Sinking funds require corporations to purchase and retire a certain percentage of the issue each year. The amount to be retired may be fixed or may depend upon sales volume and earnings. Frequently, the shares to be retired are selected by lot, particularly if the corporation cannot buy shares on the open market at or below the call price. Sinking funds are beneficial for the investor because they progressively reduce the number of shares outstanding while increasing the security behind those that remain.

7.8 Valuing Preferred Stock

As with common stock, there are four basic measures of the value of preferred stocks.

7.8.1 Earnings per share before preferred dividends

The earnings per share show the number of earned dollars per share from which preferred dividends may be paid. The figure is derived by dividing the net after-tax income by the total shares outstanding (whether from the same or different issues). For example, a company with 100,000 preferred shares outstanding and \$1,000,000 in net income would have earnings per share of \$10, indicating that \$10 was available to pay preferred dividends. Earnings per share is generally reported in the major analytical services.

7.8.2 Times dividend earned

A second measure of the value of preferred stock is referred to as *times dividend earned, overall basis*. This measure is most useful in comparing the quality of preferred stocks within the same industry. It is derived by dividing the company's profit before interest and taxes by the total interest and preferred dividend requirements.

7.8.3 Book value

The book value or net assets per preferred share is useful to determine the net assets that support each preferred share. It is calculated by

taking net assets minus all debts and dividing by the number of preferred shares outstanding.

7.8.4 Yield

The yield of a stock is a measure of the annual dividend rate as a percentage of the stock price. It measures the current profitability of a given preferred stock. This measure is more significant with preferred stock than with common stock since common stockholders may be entitled to undistributed earnings that are retained in the corporation. The yield is calculated in the same manner as are common stock yields (the annual cash dividend divided by the current stock price).

7.9 Advantages and Disadvantages of Preferred Stock

7.9.1 Advantages

The major advantage of preferred stock is its preferred dividend status over common stock. Preferred stock also receives a preference in bankruptcy litigation. It is generally more risky than bonds but less risky than common stock. Convertible preferred stock is particularly advantageous because it combines the safety of preferred shares with the potential for greater gain through common-stock conversion.

Corporations that invest in common and preferred stocks of other corporations are entitled to exclude 70 percent of the amount of dividends earned (80 percent if the receiving corporation owns 20 percent or more of the paying corporation) for regular income tax purposes. To qualify for this tax treatment, the corporation must comply with requirements for holding periods and affiliations. The dividends received deduction does not apply to Subchapter S Corporations (see chapter herein).

7.9.2 Disadvantages

The potential for unlimited gain available with common stock is not available with preferred stock. This difference is the price paid for the lesser risk. In addition, preferreds are sometimes callable at the option of the company, thus lowering the investment gain of the preferred shareholder. At least traditionally, preferred shareholders have had no voice in the management and control of the corporation. Only under certain circumstances are preferred shareholders allowed to vote.

8. MUTUAL FUNDS

Mutual funds managed by investment companies invest in a large portfolio of diverse stocks and bonds. This method provides the investor relative safety and security through diversification in addition to professional portfolio management. Diversification is a means of reducing investment risk. Investment companies are regulated by the Investment Company Act of 1940, which tries to protect the public from fraud and dishonesty. There are two basic types of investment companies in the United States: closed-end and open-end (usually called *mutual funds*).

8.1 Closed-end Funds

Closed-end funds buy and hold portfolios of stocks and bonds. Unlike open-end funds, which continually sell and redeem shares, closed-end funds sell only a fixed number of shares at initial offering, which subsequently trade on exchanges like other stocks. While open-end funds always sell at net asset value, closed-end funds trade at prices above or below the net asset value.

The fixed number of shares of closed-end funds allows the investment manager to keep orderly investment strategies. Open-end funds, on the contrary, may be forced to buy or sell securities at inopportune times because of heavy investor purchases or redemptions.

8.2 Open-end Funds

An open-end fund continually offers shares for sale and will always redeem existing shares for cash at the request of the shareholder. Open-end mutual funds make up the vast majority of all investment companies.

Many open-end funds charge a sales commission or *load* of between 2 percent and 10 percent of the net asset value of the securities. For example, a purchaser of \$1,000 in shares may actually purchase only about \$915 in assets, with the difference representing the “load charge” on the purchase.

No-load funds, as the name implies, carry no sales commissions or other up-front costs to invest. However, an investor should determine whether such funds carry additional charges and back-end (or sales or exit) loads. No-load funds are sold directly to investors without commissions paid to sales representatives, sometimes through the mail and other direct means.

Many open-end funds belong to fund families, permitting investment switching between funds with different investment objectives at

little or no cost (but deemed as a taxable transaction) as changes in the investment climate are perceived.

Open-end funds may become closed to new investors when they become so large that it becomes difficult to profitably invest all of the fund's assets according to the fund's objectives.

8.3 Investment Objectives

The Investment Company Act of 1940 regulates the operation of investment companies, requiring that mutual funds state their fundamental investment policies clearly and requiring shareholder approval for any change in policy. Investment policy is an important factor for investors. A fund could have a policy of investing in more diverse but speculative securities with added risk, but also added potential for gain. Another fund may invest only in conservative, well-known, strong securities. The investor can therefore invest money with funds that have policies to match the investor's goals. It is vital that the fund's prospectus be read before investing. Most funds have a minimum initial investment and allow additional minimum investments over time.

Mutual funds can be divided into several classes, depending upon their holdings, described in the following paragraphs.

Balanced. Funds that change the relative mix of their investments but tend toward a maximum of 60 percent in equities (stocks) and 40 percent in fixed-income securities, with the remainder in cash or cash equivalents.

Contrafunds. Funds that seek capital appreciation by investing in companies that are currently *out-of-favor* but show above-average long-term growth potential.

Equity Income. More conservative funds investing in conservative, dividend-paying stocks and income-producing bonds and convertible bonds. In rising markets, equity income funds produce capital gains and, in down cycles, provide steady income.

Global. Funds that invest in U.S. and foreign securities. Global funds are able to follow bull markets throughout the world, including the United States. They have the additional income or loss factor created by currency exchange rate fluctuations.

Gold and Precious Metals. Funds that invest in bullion and mining stocks. A good hedge during inflationary periods or risk of war, they can be highly volatile in the same manner as sector funds.

Growth. Aggressive funds that look for undervalued stocks with an emphasis on long-term appreciation.

Growth and Income. Growth funds with some emphasis on current income through dividends.

High-Grade Corporates. Bond funds that invest primarily in issues rated BBB or better by Moody's or Standard & Poor's.

High-Grade Tax-Exempts. Funds investing in state and municipal obligations with a rating of BBB or better.

High-Yield Corporates. Bond funds that seek the highest return, often from "junk bonds," and that are, therefore, the riskiest of bond funds.

High-Yield Tax-Exempts. Funds that invest in state and municipal obligations while seeking the highest yield possible.

Index. Funds that invest in a representative portfolio of securities included in a well-known market index. The objective of index funds is to mirror the performance of the market as a whole.

Intermediate-Term Tax-Exempts. Funds investing in state or municipal obligations with an average weighted maturity of less than twenty years.

International. Funds that invest primarily in foreign securities. They are heavily influenced by foreign currency exchange rates in addition to the strength or weakness of the individual securities themselves.

Maximum Capital Gains. Among the most aggressive stock funds, maximum capital gain funds aim to achieve above-average returns through investment in stocks that have potential for short-term appreciation, but that may be subject to greater loss during down cycles.

Money Market Funds. Funds that invest in Treasury bills, commercial paper, and other short-term money market investments, generally with an average maturity of thirty days. Money market funds are generally open-end, no-load funds that invest in a large and diverse number of money market instruments. They retain a small operating fee and pass the rest of the interest income to shareholders. Some funds also offer check-writing privileges and telephone transfer.

Mortgage-Backed Securities. Funds that invest primarily in GNMA and FNMA issues.

Option Income. Specialized funds that invest in stock options in the hopes of profiting in market swings.

Regional. Funds that invest in companies of a particular geographic region to take advantage of disparity in economic strength often existing in regions of the country.

Sectors. Funds that invest in a number of issues within one particular industry. Sector investing requires a keen eye for the markets because sectors lack the diversification of other funds and rise and fall swiftly.

Small-Company Growth. Aggressive stock funds that invest in small emerging growth issues.

U.S. Government Securities. Funds that invest primarily in issues of the U.S. government and its agencies.

8.4 Real Estate Investment Trusts (REITs)

A Real Estate Investment Trust (REIT) allows many investors to combine capital to acquire or provide financing for real estate. A REIT essentially operates similar to a mutual fund for real estate, in that investors obtain the benefit of a diversified portfolio of real estate under professional management. Shares of a REIT are freely traded, often on a major stock exchange.

REITs generally do not pay corporate income tax, nor do REITs pay income tax in most states. Accordingly, almost all of the income of a REIT can be distributed to shareholders without double taxation. However, unlike a partnership, a REIT cannot pass tax losses through to the investors.

Complex rules exist within the Internal Revenue Code for corporations or trusts to qualify as a REIT. REITs are owned by individual investors, along with pension funds, insurance companies, bank trust departments and mutual funds. Income distributions occur from REITs, and they also enjoy the potential of long-term appreciation. Because REITs are actively traded in the secondary market, investor liquidity is high. Like stocks and mutual funds, publicly traded REIT share prices change daily, based on the anticipated growth of the underlying real estate, the underlying asset value of the real estate, income distributions occurring out of the REITs, and so forth.

8.5 Securities Investor Protection Corporation (SIPC) Insurance

Securities owned by an investor, including mutual funds, held in an account by a broker, or a brokerage subsidiary of a bank, are protected against loss by the Securities Investor Protection Corporation (SIPC). SIPC is a non-government entity funded by assessments paid by SIPC members. SIPC protects customer accounts held by its members up to \$500,000, including up to \$100,000 in cash, if a SIPC broker member or bank brokerage subsidiary fails.

SIPC protection differs from FDIC insurance on bank deposits in that SIPC offers no protection insuring against loss in the value of an account, while FDIC insurance protects the deposit amount up to the \$100,000 limit. That is, under SIPC protection, the value of an investment can either increase or decrease, depending on the market demand for the investment, and SIPC offers no protection against such a change in market value.

9. COMMODITIES

The commodities market involves the trading of tangible assets such as crops, precious metals, livestock, grains, currencies, and real property. Major U.S. commodity exchanges include the Chicago Board of Trade, the Chicago Mercantile Exchange, the New York Mercantile Exchange, the New York Cotton Exchange, the New York Coffee and Sugar Exchange, and the Commodity Exchange, Inc.

9.1 Cash Markets

Commodities can be traded in both a cash market and a futures market. Cash markets trade commodities that are available for immediate sale. Grain elevators and stockyards where farmers sell their products for cash are examples of cash markets, just as stock exchanges are the cash markets for stocks and bonds.

9.2 Futures Markets

The futures market involves trading for commodities that are due for delivery in the future. Futures contracts that call for delivery in less than a month are referred to as *spot contracts*.

Commodities traded on the futures market must meet certain requirements. The commodity should be homogeneous and capable of being graded. The commodity must have sufficient supply for there to be a large enough market to trade, and there should be enough competition for each commodity so that one producer cannot control the market.

9.3 Speculators

Speculators hope to profit through price changes by continually buying and selling commodity contracts. They are not interested in the actual delivery of the commodity but use margins to try to increase their profits (see section 9.4, below).

9.4 Margins

Margins are small down payments that bind purchase contracts. Margins are used by commodity exchanges to guarantee that purchasers will perform as expected. They essentially allow the speculator to buy commodities on credit.

9.5 Margins on Commodity Exchanges

Low margins make commodity trading extremely risky. Daily price limits therefore are set to keep prices from rising or falling more than a certain amount per pound or other unit. Both margin requirements and daily price limits change frequently, so the investor must continually check to see if there has been a change. In addition, commodity futures are time-limited, unlike other types of investments where a depressed investment can be potentially “held” indefinitely until the investment improves. Futures contracts must be fulfilled at the expiration date or delivery date. The investor knows when the contract expires and when to sell to avoid having to accept delivery.

9.6 Hedgers

Hedgers use futures contracts to avoid having to sell at a lower price or pay a higher price for a commodity later. Hedgers will contract for a position on the commodities market before what they perceive as an anticipated price change or to protect (“lock in”) a current price.

9.7 Long and Short Positions

The commodities market is often referred to as the zero-sum game. This means that for every long position there is a short position. A price movement causes one position to gain and forces a corresponding loss to the other position. The market, therefore, tends to level off between positions.

A spread transaction involves the purchase of a future to be delivered in one month coupled with a sale of a future, in the same commodity, to be delivered in a different month. The purpose is to profit from the price difference between the futures. This price difference is known as the basis.

9.8 Spread Transactions

One form of spread transaction is an intracommodity spread, which involves the purchase of one future and the sale of a different future for the same commodity. The object is to predict a future price difference.

While many speculative commodity transactions may be losses, leverage can be so great that only one profitable transaction can more than offset several losses. Thus, commodity trading requires a great deal of cash reserve, market knowledge, and self-possession. Even among

professional commodities traders, the great majority of transactions are closed out showing losses.

9.9 Sources of Information in Commodities

As is evident in the use of spread transactions, the prices on the commodities market are determined in large part by supply and demand and by the expectations of speculators about supply and demand. Speculators need information about inventories held in storage, current harvests, exports and imports, and changes in government policy. Commodity information can be found in the publications of the U.S. Department of Agriculture, situation reports that discuss the issues affecting specific commodities, and material from research organizations that publish analyses about certain commodities. Several major city newspapers have commodities information, and brokerage houses frequently publish newsletters on the positions of various commodities.

9.10 Types of Commodities Traded

A large variety of commodities are traded on the futures market. These include farm products such as grains, meats, and other food goods such as sugar, coffee, rice, and potatoes. Metals that are frequently traded include gold, silver, platinum, and copper. Worldwide currencies are traded, as are U.S. securities. Certain money market instruments are also traded, as are cotton, hemp, wood products, and rubber.

10. LIFE INSURANCE

Many life insurance products offer investment advantages in addition to death benefits. (Insurance and investment aspects of life insurance alternative products are discussed in detail in the Insurance chapter of this manual.)

10.1 Whole Life

The whole life policy covers the insured for his or her entire life.

Basic elements. Whole life policies have three basic parts: premium, death benefit, and cash value. The cash value represents the investment aspect of whole life, which arises from the interest gain that is achieved from the annual increase in cash value of the policy.

Participating. Participating whole life policies also pay dividends and are usually issued by mutual companies. Dividends are paid annually and are calculated as a proportion of the value of the policy: a \$10,000 policy with a 4 percent dividend would pay a \$400 annual dividend.

Tax aspects. The cash value of a whole life policy is tax-deferred. It is not taxed until withdrawal and then it is taxed only to the extent the cash value exceeds the total premiums paid throughout the policy life. The cash value of a whole life policy is taxed only to the owner of the policy. It is not taxed if paid at the death of the insured. Dividends on whole life policies are also tax-free. The IRS considers the dividends a refund of prior premium payments.

10.2 Universal and Variable Life

Universal and variable life insurance provide flexibility not available with other types of life insurance products on the market.

Basic elements. As with whole life, universal and variable policies have three parts: premium, death benefit, and cash value. These policies are not unlike a savings account that pays death benefits upon the death of the insured. Basically, as the insured pays premiums, the cash value grows. The company deducts its expenses and the mortality cost of providing the death benefit, and the remainder of the cash value is reported in an annual statement showing all transactions in the account.

Cash value. The money that accumulates as the cash value is available to the insured. The insured may borrow or withdraw all or any of it. Interest is earned on whatever accumulates and remains in the “cash value account.” Most universal policies guarantee a minimum investment rate (such as 5 or 6 percent). Although the rate could go higher, this guarantee becomes important if interest rates drop. Interest rates on universal policies tend to be competitive with the interest rates available on other investments. Variable policies allow the owner to invest the cash value in a number of investment opportunities.

10.3 Retirement Annuities

Annuities pay the insured a fixed periodic sum for the duration of the insured's life. The amount of gain or investment value of an annuity contract depends on how long the insured lives.

Cost. Annuities are sold at a price that depends on the age and sex of the insured. The price is set in limits of how much monthly income can be purchased for \$1,000.

Benefits. Payments on an annuity may yield only a tiny fraction of the amount invested if the insured dies early. Therefore the insured

may purchase an annuity that guarantees payment for a minimum number of years. Retirement annuities are not unlike an endowment policy. Joint and survivor life annuities pay married couples benefits as long as either lives, although the payment may be reduced when one spouse dies.

11. TAX-SHELTERED RETIREMENT PLANS

11.1 Individual Retirement Accounts (IRAs)

Individual Retirement Accounts (IRAs) have been one of the more popular investment vehicles available, with the added benefit of tax advantages. (Contributions may be tax deductible, and earnings are tax deferred.) Generally, the taxpayer must be under age 70^{1/2} in the year in which the IRA contribution is made. However, there is no age limitation on the ability to use a Roth IRA. The taxpayer can contribute up to \$2,000 or 100 percent of compensation, whichever is less. Starting in 1997, IRA contributions of up to \$2,000 can be made for each spouse (including, for example, a homemaker who does not work outside the home), if the combined compensation of both spouses is at least equal to the contributed amount.

To qualify for favorable tax treatment, contributions to IRAs must be made by April 15 of the year immediately following the year for which the tax advantage is desired. Taxpayers are also allowed to move funds from one account to another without losing their favored tax status, subject to certain limitations.

The Tax Reform Act of 1986 placed additional limitations on eligibility for IRA deductions. Taxpayers who are not covered by an employee pension or profit-sharing plan can fully deduct IRA contributions to the maximum allowed amount described above. Starting in 1998, an individual may fully deduct an IRA contribution even if the individual's spouse is an active participant in an employer-sponsored retirement plan. The deduction, however, phases out for taxpayers with AGI between \$150,000 and \$160,000. Single persons who are covered by an employee pension or profit-sharing plan retain the full deduction for 1998 up to \$30,000 of adjusted gross income. For married persons filing jointly, the full deduction is allowable for 1998 up to \$50,000. If adjusted gross income (AGI) exceeds these amounts, the tax-deductible portion of an IRA contribution can be determined by subtracting AGI from \$40,000, if single, or from \$60,000, if married and filing jointly. Twenty percent of what is left is the tax-deductible portion.

Payments to IRAs can be made through financial institutions, insurance companies, mutual funds, or through an account managed by the taxpayer. When withdrawals are made from IRAs the taxpayer has an ordinary income gain. Unless the taxpayer is at least age 59½ or can meet certain other requirements, there is also a 10 percent penalty for early withdrawal that is due in addition to the tax on the ordinary income gain.

Starting in 1998, Roth IRAs are available to taxpayers. Contributions to a Roth IRA are nondeductible, but qualified distributions are eventually totally tax-free. Roth IRA contributions are phased out for single taxpayers with AGI between \$95,000 and \$110,000 and for joint filers with AGI between \$150,000 and \$160,000.

A number of special rules are associated with Roth IRAs. In general, qualified distributions are totally nontaxable and are not subject to the 10 percent early withdrawal penalty. Qualified distributions must satisfy a five-year holding period and must be:

- Made on or after the date on which the taxpayer reaches age 59½
- Made to a beneficiary on or after the taxpayer's death
- Made to the taxpayer because of a condition of disability, or
- Made to the taxpayer for qualified first-time homebuyer expenditures.

Any unqualified distributions from a Roth IRA are treated as being made first from contributions, and are tax-free to that extent.

11.2 Keogh Plans

Keogh plans are designed for self-employed individuals. As with the IRAs, payments to the Keogh plans are tax-deductible and interest earnings are tax-exempt. After retirement, however, payments from the plan are taxable.

Keogh plans must be approved by the Treasury to qualify for favorable tax treatment. They cannot be later changed without permission of the Treasury.

Keogh plans allow 15 percent of the taxpayer's income to be tax-deductible up to an annual maximum of \$30,000. In certain cases, up to 25 percent of income can be used. Keogh contributions may also be invested in banks or savings and loans, mutual funds, annuity contracts, and individual retirement bonds.

Another form of self-employed retirement plan, the *Simplified Employee Pension (SEP/IRA)*, combines many of the characteristics of a Keogh plan with the simplicity of an IRA.

Strict discrimination rules apply to Keogh and SEP/IRA plans. For example, if a self-employed owner is to be covered, he or she must cover all full-time employees on a nondiscriminatory basis, subject in some cases to certain vesting requirements.

11.3 Qualified Retirement Plans

Qualified retirement plans are pension plans that offer deductible payments to employers and tax-deferred earnings to recipients or employees. To be tax-sheltered, however, plans must meet certain requirements imposed by the Treasury. The two basic Treasury requirements are that the benefit allocations must follow a certain formula and that benefits must apply equally to all members of the plan. (See the chapter, Employee Retirement and Deferred Compensation Plans in this manual.)

11.3.1 Profit-sharing plans

Under profit-sharing plans, the employer contributes from annual profits to an investment trust. The benefits are then distributed to employees under prescribed conditions.

11.3.2 Stock bonus plans

Stock bonus plans provide benefits through employer stock contributions.

11.3.3 Pension plans

Pension plans provide benefits to employees through systematic contributions for specific benefits to the employees. Pension plans offer a much more definite final benefit to employees than either profit-sharing or stock bonus plans.

Pension plans often include life insurance coverage and may be contributory or noncontributory. Contributory plans receive contributions from both the employer and the employee. An insured plan requires the employer to make payment to an insurance company for the purchase of either group or individual annuities. Trusteed plans pay benefits to a trust, with a bank or trust company acting as a trustee.

Pension plans are regulated by both the Treasury and the 1974 Employee Retirement Income Security Act (ERISA). The IRS sets the standards that plans must meet and approves proposed plans. The pension act imposes rules of conduct, funding requirements, and fiduciary responsibility on trustees and investment managers. The Pension

Benefit Guaranty Corporation (PBGC) insures the vested benefits of employees in specific types of plans.

11.3.4 Employee stock ownership plans (ESOPs)

Employee stock ownership plans (ESOPs) are often used as employee pension and profit-sharing plans, although they may be used primarily as a corporate financing device. ESOPs are popular because they allow a company to retain pre-tax earnings by selling stock to its employee stock ownership trust. A company may deduct up to 25 percent of covered payroll for its contributions to certain qualified benefit plans. ESOP-backed pension plans, however, tend to be more risky than other plans because they are not diversified and are subject to any financial setbacks the company might have. The distribution of shares to an ESOP may also dilute the earnings per share and net worth of stock already outstanding.

(Text continued on page 49)

11.4 FDIC Insurance

Prior to December 20, 1993, IRA and Keogh funds were insured separately from each other and from any other funds of the depositor. Effective December 20, 1993, IRA and Keogh funds are still separately insured from any nonretirement funds. However, the combined total of these retirement funds is aggregated and insured up to \$100,000.

Time deposits made prior to December 20, 1993, are not subject to the new aggregation rules until the deposits mature, are rolled over or renewed.

Employer sponsored retirement plans are generally eligible for Federal Deposit Insurance Corporation (FDIC) insurance of up to \$100,000 per participant.

12. TAX-DEFERRED INCOME PLANS

12.1 Annuities

Annuities allow investors to establish a retirement plan while providing a tax-sheltered investment. Annuities pay a fixed sum annually for a given time period. They can be purchased in a lump sum or through a series of premium payments. Tax-deferred annuities present a valuable long-term investment option. They allow the investor to earn interest on the principal, tax-deferred, until the investor withdraws certain amounts or begins to receive payments under the annuity.

Should the investor die before converting the contract to an annuity, the funds in the account are paid directly to the beneficiary, without probate. Annuity contracts may be used as collateral for a loan, or the investor can borrow directly on the contract. Withdrawals of principal and interest from one company with immediate investment in a similar contract with another company is a tax-free transfer.

Annuity contracts can be purchased through insurance companies, brokerage firms, and mutual funds. Some contracts charge a sales commission; others charge none. Contracts that charge no sales commission, however, frequently charge a fee when the contract is surrendered for cash, while those with a sales commission allow surrender at no charge.

12.1.1 Retirement CDs

Some banks have recently marketed annuity-type instruments termed *Retirement CDs*. The Retirement CD is a certificate of deposit issued by a bank, for which the purchaser chooses a maturity date. The CD is insured by the FDIC.

The purchaser may withdraw up to two-thirds of the accumulated balance at maturity. The remainder is paid in installments over the purchaser's expected life. The purchaser's beneficiaries receive any balance if death occurs prior to the payout of the entire accumulated balance. If the purchaser lives longer than the expected life, payments continue, resulting in payments in excess of the maturity balance.

Banks marketed these CDs without obtaining a letter ruling or other IRS advice regarding the tax treatment of these CDs. Banks sold this investment claiming the interest accumulating to maturity would not be subject to tax until payout began at and after the maturity date.

Proposed regulations (Prop. Reg. 1.1275-1) have been issued by the Treasury Department requiring payments under the annuity to begin within one year of initial investment to defer taxation of the interest. These proposed regulations adversely affected the sale of the Retirement CDs; as a source of retirement income, these CDs rely on a much longer nonpayout period to be attractive.

12.2 Tax Shelter Limited Partnerships

Tax shelter limited partnerships allow an investor to participate with other investors in an economic venture while taking full advantage of the tax incentives available. The investor should be sure that the tax shelter has some economic merit and does not produce all its advantages from tax incentives. Limited partnerships invest in many areas, including real estate, leasing activities, oil and gas, research and development, and agriculture.

The limited partner is primarily an investment partner and generally has no part in the management or everyday operation of the partnership, which is the role of the general partner. (Partnerships are discussed in detail in another chapter in this manual.)

Tax shelter limited partnerships are long-term investments that may not produce a cash flow for several years and may not return capital to the investor for five to ten years. Therefore, the investor must have adequate liquidity and cash flow, since there is not a broad market for the resale of limited partnership interests.

As discussed in the following paragraph, the Tax Reform Act of 1986 has severely limited the tax advantages of passive losses arising from limited partnerships. Since the tax advantages are eliminated or minimized, the economic aspects of such an investment must be given even greater significance.

12.2.1 Tax considerations

As the name implies, tax shelter limited partnerships must be matched closely to an investor's personal tax situation. Most limited partnerships

produce passive losses in their early years that can only be used to offset passive income from other sources. Also, the use of “tax preference” items to generate deductions may subject the investor to an alternative minimum tax situation.

13. INVESTMENT ADMINISTRATION AND STRATEGIES

To make successful investments, the investor must be aware of what is going on in the world. Societal, economic, political, industrial, and international trends and events have an important impact on the value and strength of investments.

13.1 Economic Analysis

Attention to the national economy may help the investor make decisions not only for the present but also for several years into the future. If strong economic growth and stability is expected, an investor may be smarter to invest in stocks and other corporate securities. If the economy is expected to turn down, an investment in fixed-income instruments such as bonds may be safer than common stock. If one segment of the economy is expected to grow faster than others, the investor may want to focus on that segment.

13.1.1 Gross National Product (GNP)

The Gross National Product (GNP) is the broadest measure of activity and is useful in determining the present state and to some extent the near future of the national economy. The GNP theoretically represents the dollar value of all goods and services produced in the economy over a given time period.

It is important to look at the GNP in real rather than nominal terms. A large increase in the GNP is not necessarily indicative of a large increase in real growth. The growth must be measured in terms of both dollars from the current year and constant dollars (inflation-adjusted). This comparison is necessary to measure the effects of inflation on the GNP. An increase in GNP may reflect a real decrease in the absolute purchasing power of the dollar rather than overall growth.

The GNP should be used with other economic indicators and measures to determine more specifically where a strength or weakness exists.

13.1.2 Federal Reserve Board Index of Industrial Production

The Federal Reserve Board (FRB) Index of Industrial Production is one of the most widely used indexes of industrial activity. It measures the current value of industrial production relative to a base year. The FRB index analyzes many segments of the economy and uses a base year to show growth in later years relative to that year.

Market groupings and industry groupings are set out separately. The index is then further broken down by products and materials, manufacturing, construction, nonagricultural employment, retail sales, and personal income. The FRB index indicates strengths and weaknesses in specific industries.

13.1.3 Government and private studies

Economic trends can also be studied from numerous federal government and private publications (some of these are cited in the references). Business periodicals such as *Forbes*, *Business Week*, *Money*, and *Fortune* are also good sources of investment information.

13.2 Stock Market Analysis

The stock market probably has one of the most well-developed systems of evaluation of any investment vehicle. The strength of the stock market and the movement of individual stocks is easily determined through the numerous available indexes, quotations, and indicators.

13.2.1 Major market indexes

The major market indexes provide a fairly accurate measure of market activity. They are computed by adding the prices of the securities in the averages and dividing by a number that has been set periodically to reflect stock splits and dividends.

The Dow Jones averages are probably the best known and oldest stock market indexes. They include the Dow Jones Industrial Average (DJIA), the Dow Jones Transportation Average (DJTA), the Dow Jones Utility Average (DJUA), and the Dow Jones Composite Average (DJCA). All are published in the *Wall Street Journal*, the *New York Times*, and other newspapers as well as in financial publications.

The Dow Jones Industrial Average covers thirty stocks in a variety of industries; the companies listed are considered representative of their industries in general. The DJIA is intended to reflect the market as a whole but does not include all types of securities.

The Dow Jones Transportation Average is a market indicator for twenty stocks in the transportation industries such as airlines, railroads, and trucking companies. The Dow Jones Utility Average lists fifteen gas and electric utilities. The Dow Jones Composite Average consists of the sixty-five securities listed in the other three Dow Jones indexes, representing a combination of industrial, transportation, and utility companies.

As with the DJIA, the latter three Dow Jones indexes are also computed by dividing the total prices of the securities by a certain divisor. While the DJIA, the DJTA, and the DJUA reflect the activity only in those industries, the DJCA provides an overall view of the market.

Standard & Poor's also maintains several indexes monitoring the market values of up to 500 stocks. These include the S&P 500, Industrials, Transportation, Utilities, Financials, and the Midcap 400.

The NASDAQ exchange has several widely followed indexes as well as the AMEX, Value-Line, Russell 2000, and Wilshire 5000.

13.2.2 New York Stock Exchange

The New York Stock Exchange (NYSE), often referred to as "the big board," measures the price trends of about 1,600 common stocks. The NYSE provides important information in an abbreviated easy-to-read format. It lists the high and low price per share for the prior 52-week period, the name of the company, the type of stock, the dividend and percent dividend yield, the price-earnings ratio, the number of sales for the day in lots of 100, the high, low, and closing prices for the day, as well as the net change from the previous trading session. These elements are listed in the order just described in the several columns of the NYSE pages of major U.S. newspapers.

13.2.3 American Stock Exchange

Another stock exchange is the American Stock Exchange (AMEX). The securities traded on the AMEX tend to be from smaller companies than those on the NYSE. The AMEX is also a large market for foreign securities. The AMEX index measures market trends on this exchange.

13.2.4 NASDAQ

The NASDAQ over-the-counter index is the most widely watched in the secondary market. The National Association of Securities Dealers Automated Quotations (NASDAQ) is not an actual stock exchange but rather a nationwide electronic network of brokers. Only the most actively traded over-the-counter (OTC) stocks are included in the NASDAQ indexes.

13.2.5 Local and regional exchanges

There are fourteen regional and a number of local exchanges located in various parts of the country. The Midwest Stock Exchange in Chicago, the Pacific Stock Exchange in California, and the Philadelphia Stock Exchange are probably the three best-known smaller exchanges. Regional and local exchanges are organized much like the NYSE and trade mostly in small regional and local companies.

13.2.6 Over-the-counter (OTC) market

The OTC market consists of a network of brokers for securities that are not listed on any of the exchanges. The OTC market trades stocks of over 30,000 smaller companies, all U.S. government bonds, state and municipal bonds, and most corporate bonds. Stocks traded locally OTC are usually listed in regional daily newspapers.

13.2.7 Foreign exchanges and securities

Certain foreign exchanges trade foreign stocks internationally. Major foreign exchange indexes are as follows:

- Tokyo — Nikkei Average
- London — Financial Times 30-share
- Frankfurt — FAZ
- Zurich — Credit Suisse
- Paris — CAC General
- Milan — Stock Index
- Sydney — All ordinaries
- Hong Kong — Hang Seng
- Singapore — Straits Times
- Johannesburg — Johannesburg Gold
- Toronto — 300 Composite
- Spain — Madrid Stock Exchange
- Mexico — Mexican Bolsa
- Worldwide — Dow Jones World Index

Trading in foreign securities tends to be more risky for the American investor than trading in American securities. Less public information is available on foreign securities and lax accounting principles may not be consistently applied. Fluctuation in exchange rates for foreign currencies also creates risk. Some foreign governments may be unstable,

making the already narrow market for certain foreign securities even more unfavorable. International mutual stock funds, however, can spread this risk among many investments and countries while providing professional management of the portfolio. Foreign investing also allows individuals to participate in economies having higher growth rates than the United States. This phenomenon is particularly apparent in developing countries that are adopting capitalism.

When purchasing a foreign stock, it is common to receive an American Depository Receipt (ADR). These certificates give evidence of ownership, while the actual stock of a foreign company remains in that country.

13.3 Investments Held in Street Name

Investors have the option of holding securities in *street name* as opposed to personally holding the security. Holding a security in street name means the investor has physically given a broker the security. Such a transfer provides the following advantages:

- Possibility of a same day sale
- Protection from loss of the security
- Statements provided by the brokerage firm detailing the current market value of the security
- Automatic sweep of earnings (interest, dividends) to an interest bearing account set up with the brokerage firm
- Use as collateral for a margin loan

A disadvantage to holding the security in street name results if the relationship between the investor and the brokerage firm sours. The transfer of the security back to the investor or to another firm may take several days to a couple weeks.

REFERENCES

- Alexander, Gordon J., Jeffrey V. Bailey, and William Sharpe. *Investments*, 5th ed. Upper Saddle River, N.J.: Prentice Hall, 1994.
- Amling, Frederick and William G. Droms. *Investment Fundamentals*. Orlando, Fla.: Dryden Press, 1994.
- Beidleman, Carl R. *Cross-Currency Swaps*. Burr Ridge, Ill.: Irwin Professional Publishing, 1991.

- Block, Stanley B. and Geoffrey A. Hirt. *Foundations of Financial Management*, 8th ed. Burr Ridge, Ill.: Irwin Professional Publishing, 1996.
- . *Fundamentals of Investment Management*, 6th ed. Burr Ridge, Ill.: Irwin Professional Publishing, 1998.
- Cohen, Jerome B., et al. *Investment Analysis and Portfolio Management*, 5th ed. Burr Ridge, Ill.: Irwin/McGraw-Hill, 1993.
- Dunnan, Nancy. *Dun & Bradstreet Guide to Your Investments, 1997*. New York: HarperCollins Publishers, 1997.
- Fabozzi, Frank J. *Capital Markets: Institutions and Instruments*, 2d ed. Upper Saddle River, N.J.: Prentice Hall, 1996.
- . *Foundations of Financial Markets and Institutions*. Upper Saddle River, N.J.: Prentice Hall General Reference & Travel, 1993.
- . *Handbook of Fixed-Income Options: Strategies, Pricing and Applications*. Burr Ridge, Ill.: Irwin/McGraw-Hill, 1996.
- Gup, Benton E. *Basics of Investing*, 5th ed. New York: John Wiley & Sons, Inc., 1992.
- Haft, Robert J., and Peter M. Fass. *Investment Limited Partnerships Handbook*. (Securities Law Series.) St. Paul, Minn.: West Group, 1992.
- Harper, Victor L. and Arthur S. Brinkley. *Question and Answer Book of Money & Investing*. Holbrook, Mass.: Adams Media Corporation, 1995.
- Ibbotson, Roger G. *Global Investing*. New York: The McGraw-Hill Companies, 1992.
- Jacobs, Sheldon. *The Handbook for No-Load Investors*. Burr Ridge, Ill.: Irwin Professional Publishing, 1996.
- Joehnk, Michael D., and Lawrence J. Gitman. *Fundamentals of Investing*, 7th ed. New York: Addison-Wesley Educational Publishers, 1998.
- Jones, Charles Parker. *Investments: Analysis and Management*, 6th ed. New York: John Wiley & Sons, Inc., 1997.
- Kinsman, Robert. *Hidden Patterns: Power Money in the Stock Market*. Burr Ridge, Ill.: Irwin Professional Publishing, 1994.
- Levine, Summer N., and Caroline Levine. *Irwin Business & Investment Almanac, 1996*. Burr Ridge, Ill.: Irwin Professional Publishing, 1996.
- Lippman, David B. *Investment Essentials*. (CPE course manual.) New York: American Institute of Certified Public Accountants, Inc., 1995.
- . *Investment Strategies in the '90s*. (CPE course manual.) New York: American Institute of Certified Public Accountants, Inc., 1994.

- Maginn, John L., and Donald L. Tuttle, eds. *Managing Investment Portfolios*. 2d ed. Boston: Warren, Gorham & Lamont, 1991.
- Malkiel, Burton Gordon. *A Random Walk Down Wall Street Including a Life-Cycle Guide to Personal Investing*, 6th ed. New York: W.W. Norton and Company, Inc., 1995.
- Mayo, Herbert B. *Financial Institutions, Investments and Management: An Introduction*, 6th ed. Orlando, Fla.: Dryden Press, 1997.
- Pierce, Phyllis S., ed. *The Irwin Investor's Handbook 1996*. Burr Ridge, Ill.: Irwin Professional Publishing, 1996.
- Pring, Martin J. *All-Season Investor: Successful Strategies for Every Stage in the Business Cycle*. New York: John Wiley & Sons, Inc., 1992.
- . *Investment Psychology Explained: Classic Strategies to Beat the Markets*. New York: John Wiley & Sons, Inc., 1995.
- Shim, Jae K., Joel Siegel, and Jonathan Lasner. *One Hundred One Investment Decision Tools: Barometers, Instruments, and Keys (Where to Find Them & How They're Used)*. Chicago: International Publishing Corporation, 1993.
- Siegel, Joel G. and Jae K. Shim. *Vest Pocket Investor: Everything You Need to Know to Invest Successfully*. Burr Ridge, Ill.: Irwin Professional Publishing, 1995.
- Standard & Poor's Stock and Bond Guide*. New York: The McGraw-Hill Companies. Updated annually.
- Teweles, Richard, and Edward S. Bradley. *The Stock Market*, 7th ed. New York: John Wiley & Sons, Inc., 1998.

BANKRUPTCY/INSOLVENCY

1. INTRODUCTION

2. BANKRUPTCY OVERVIEW

3. ALTERNATIVES TO BANKRUPTCY

3.1 Voluntary Liquidation

3.1.1 Assignments for the benefit of creditors

3.2 Bulk Transfer

3.2.1 Requirements

3.2.2 Advantages and disadvantages

3.3 Receiverships

3.4 Mediation

3.5 Composition and Extension Agreements

3.5.1 Requirements

3.6 Asset, Liability, and Company Maneuvers

3.6.1 Asset maneuvers

3.6.2 Liability maneuvers

3.6.3 Company maneuvers

4. TYPICAL ACCOUNTANTS' ROLES IN BANKRUPTCY

4.1 Limited Roles in Chapter 7, 13, and 12 Cases

4.2 Chapter 11 Commonly Requires the Assistance of an Accountant

4.2.1 Trustee

4.2.1.1 U.S. Trustee's office

4.2.1.2 Court appointment

4.2.1.3 Becoming a trustee

4.2.2 Examiner

4.2.2.1 Reconstruction

4.2.2.2 Restate financial statements

4.2.2.3 Improve controls

4.2.2.4 Determine value

4.2.3 Expert witness

4.3 Help Clients Prepare for or Avoid Bankruptcy

5. THE INS-AND-OUTS OF WORKING IN BANKRUPTCY

5.1 Who Retains and Pays the CPA

5.2 What to Watch Out For

5.2.1 Obtain prior court approval

5.2.2 Verify the benefit to the estate

5.2.3 Narrate and itemize work performed

- 5.3 Obtain Your Own Counsel
- 5.4 File a Fee Application
- 5.5 Receiving Payment
- 5.6 Finding Opportunities

6. ORGANIZATION OF THE BANKRUPTCY SYSTEM

- 6.1 Court Hierarchy
- 6.2 Courts and Jurisdiction
- 6.3 1984 Bankruptcy Code Amendments
- 6.4 Trial by Jury

7. TERMINOLOGY AND DEFINITIONS

8. CHAPTER 7: LIQUIDATION

- 8.1 Introduction
- 8.2 Commencement
 - 8.2.1 How to file
 - 8.2.2 Who may file
 - 8.2.3 Effects of filing
- 8.3 Collection of All Debtor Assets
 - 8.3.1 Appointment of a trustee
 - 8.3.2 Creditors' Section 341 meeting
 - 8.3.3 The debtor's estate
- 8.4 Liquidation of Assets Through Sale
- 8.5 Distribution of Sale Proceeds
- 8.6 Discharge of Debtor's Debts
 - 8.6.1 Nondischargeable debts
 - 8.6.2 Effects of discharge

9. CHAPTER 13: ADJUSTMENT OF DEBTS OF AN INDIVIDUAL WITH REGULAR INCOME

- 9.1 Introduction
- 9.2 Limitations
 - 9.2.1 Eligibility for relief
 - 9.2.2 Monetary limitations
 - 9.2.3 Prior bankruptcies of the debtor
- 9.3 Commencement
- 9.4 Appointment of a Trustee
- 9.5 Statement and Plan
 - 9.5.1 Required provisions
 - 9.5.2 Permissive provisions
 - 9.5.3 Payment period
- 9.6 Confirmation
 - 9.6.1 Creditors' Section 341 meeting

- 9.6.2 The confirmation hearing
- 9.6.3 Objections to confirmation
- 9.7 Discharge
 - 9.7.1 Full or expanded discharge
 - 9.7.2 Hardship or partial discharge
 - 9.7.3 Nondischargeable debts
 - 9.7.4 Effect of discharge
 - 9.7.5 Revocation of discharge

10. CHAPTER 11: REORGANIZATION

- 10.1 Introduction
- 10.2 Commencement
- 10.3 Operating the Business
 - 10.3.1 Debtor in possession
 - 10.3.2 Appointment of a trustee
- 10.4 Formulating a Plan
 - 10.4.1 Required provisions
 - 10.4.2 Impaired classes under the plan
 - 10.4.3 Who may file a plan
- 10.5 Creditor Acceptance of the Plan
 - 10.5.1 Acceptance by impaired classes
 - 10.5.2 Acceptance by unimpaired classes
- 10.6 Confirmation
 - 10.6.1 Requirements for confirmation
 - 10.6.2 Cramdown
 - 10.6.3 Effect of confirmation

11. CHAPTER 12: ADJUSTMENT OF DEBTS OF A FAMILY FARMER WITH REGULAR ANNUAL INCOME

- 11.1 Introduction
- 11.2 Eligibility
- 11.3 Operation of the Farm; Appointment of a Trustee
- 11.4 Filing the Plan
- 11.5 Creditor Protections
- 11.6 Approval of the Plan
- 11.7 Discharge

12. EXEMPTIONS

- 12.1 Introduction
- 12.2 Claiming Exemptions
- 12.3 Federal vs. State Exemptions: Sometimes a Debtor's Choice
- 12.4 Federal Bankruptcy Exemptions
 - 12.4.1 The homestead exemption

- 12.4.2 The grubstake exemption
- 12.4.3 Exemptions specific to specific property
- 12.4.4 The “right to receive” and “tracing property”
- 12.5 Avoiding Liens on Exempt Property

13. CONVERSION OF CASES

14. DISMISSAL OF CASES

- 14.1 Chapter 7
- 14.2 Chapter 13
- 14.3 Chapter 11
- 14.4 Chapter 12

15. TRANSFERS OF PROPERTY

- 15.1 Introduction
- 15.2 Pre-bankruptcy Transfers
 - 15.2.1 Preferences
 - 15.2.2 Fraudulent conveyances
 - 15.2.3 Unrecorded transfers
 - 15.2.4 Transfers avoidable under state law
 - 15.2.5 Statutory liens
- 15.3 Postpetition Transfers
- 15.4 Limitations on the Trustee’s Avoiding Powers

16. CREDITORS’ RIGHTS AND PROTECTIONS

- 16.1 Proof of Claims and Interests
- 16.2 Requirements for Filing
- 16.3 Objections to a Claim
- 16.4 Disallowance of Claims
 - 16.4.1 Reconsideration of disallowed claims
 - 16.4.2 Estimating contingent and unliquidated claims
- 16.5 Priorities
 - 16.5.1 First priority
 - 16.5.2 Second priority
 - 16.5.3 Third priority
 - 16.5.4 Fourth priority
 - 16.5.5 Fifth priority
 - 16.5.6 Sixth priority
 - 16.5.7 Seventh priority
- 16.6 Super-Priorities
 - 16.6.1 Super-priority to secured creditors
 - 16.6.2 Super-priority when there is conversion
 - 16.6.3 Debts incurred by a trustee

BANKRUPTCY/INSOLVENCY

16.7 Involuntary Petitions

16.7.1 Filing an involuntary case

16.7.2 Prerequisites of filing

16.7.3 Grounds for relief in an involuntary petition

16.7.4 Involuntary gap period

16.7.5 Appointment of an interim trustee

16.7.6 Resolving the involuntary petition

17. INCOME TAX IMPLICATIONS

17.1 Bankruptcy

17.2 Insolvency

REFERENCES

1. INTRODUCTION

Bankruptcy is a federal debtor's relief provision and a creditor's remedy. Current federal bankruptcy law derives from the Bankruptcy Reform Act of 1978. That reform act repealed the Bankruptcy Act of 1898 and is found in Title 11 of the United States Code. It is the fourth major bankruptcy act to be enacted by Congress since 1800. All code section references in this chapter refer to the bankruptcy code as set forth in the 1978 reform act.

This chapter was written in an effort to introduce CPAs to bankruptcy practice. By becoming better informed on this subject, CPAs can help protect their current clients. As well, this area offers many opportunities to generate additional business income. While this material touches on the technical aspects of bankruptcy, it also discusses the roles available to the CPA and identifies a few avoidable pitfalls.

2. BANKRUPTCY OVERVIEW

The most commonly used alternatives provided under the Bankruptcy Code are described in Chapters 7, 11, 13, and 12.

Chapter 7 provides for the liquidation of a debtor's assets. This alternative is available to both businesses and individuals and is equivalent to closing the doors and calling it quits. Simply stated, the appointed trustee attempts to pay off as many creditors as possible with whatever assets are available.

Chapter 11 is also available to both businesses and individuals. A Chapter 11 filing is referred to as a *reorganization*. However, a reorganization can mean one of two things: a *rehabilitation* or an *orderly liquidation*. It provides time for businesses or individuals to "get their acts together" without having to worry about the immediate repayment of current creditors. Also, unlike Chapter 7, this option typically permits those electing it to remain in control of their assets and continue to manage their own situation during the course of the bankruptcy proceedings.

Chapter 13 is a pared-down version of Chapter 11, often called an *individual wage earner* or *small business reorganization*. The process is easier and more cost efficient than its counterpart, Chapter 11. The legal costs are reduced because the process is not as complex and therefore requires less formal paperwork. The election of Chapter 13 is restricted; the limitations are covered in detail later in this chapter.

Chapter 12 was enacted because family farmers could rarely opt for the simpler Chapter 13 alternative. The financial limitations surrounding Chapter 13 were not sufficient to handle the typical debt

associated with running a farming operation. Unfortunately, farmers needing to reorganize could rarely justify the Chapter 11 alternative, because it was often too complicated, time-consuming, and expensive to be a workable solution. Chapter 12 was designed to allow family farmers facing bankruptcy a chance to reorganize their debts and keep their land.

With this brief introduction, let's take a little closer look at the following bankruptcy alternatives:

- Chapter 7 (liquidation)
- Chapter 11 (reorganization)
- Chapter 12 (adjustment of debts of a family farmer with regular annual income)
- Chapter 13 (adjustment of debts of an individual with regular income)

Note that chapters 1, 3, and 5 of the Bankruptcy Code contain provisions that apply generally to all bankruptcy cases. In addition to the statutory provisions of the Bankruptcy Code, many rules regarding bankruptcy cases are also found in the Rules of Bankruptcy Procedure, which govern the procedural aspects of bankruptcy litigation.

Section 525 of the Bankruptcy Code provides protection to bankrupt debtors from discrimination by governmental units and private employers. Governmental units may not deny, revoke, suspend, or refuse to renew a license or permit, and may not deny, terminate, or discriminate with respect to the employment of a person who is, or has been, a debtor under the Bankruptcy Code. Private employers are prohibited from terminating or discriminating with respect to the employment of any debtor who has been bankrupt. These prohibitions apply equally to individuals who are or were associated with the debtor. The purpose of the antidiscrimination provision is to protect the "fresh start" that the code intended to give to the debtor.

As Section 525 covers only governmental units and private employers, Section 524, concerning the effects of discharge, should be read in conjunction with Section 525. Thus, for example, a university that withholds transcripts from an alumnus for nonpayment of tuition, even after the alumnus received a discharge, could be prohibited from doing so under Section 524, but would not be covered under Section 525.

3. ALTERNATIVES TO BANKRUPTCY

A business may use several alternatives to bankruptcy to deal with financial crisis. The method chosen will depend on the unique factors of each case, such as the likelihood of recovery for the business, the liability-

to-asset ratio, and the desirability of risking the bankruptcy stigma. Many of the alternatives may be less costly, simpler, and less time-consuming than formal bankruptcy proceedings.

3.1 Voluntary Liquidation

Many forms of liquidation are available. It may be argued that the availability of liquidation methods is limited only by the creativity of the parties involved. Some of the more commonly used methods are outlined here.

3.1.1 Assignments for the benefit of creditors

A commonly used liquidation method is assignment for the benefit of creditors. Under this method, all of the debtor's property is transferred to a trustee or assignee for the benefit of the debtor-assignor's creditors. Although requirements vary by state statute, most assignments must be written and a majority of the creditors must agree to the assignment terms and conditions. Dissenting creditors who feel their interests are not protected may file an involuntary bankruptcy petition pursuant to Section 303. An assignment is most useful to debtors whose assets exceed liabilities in secured claims.

Assignment governed by statute. Assignments are generally governed by state law. There is little uniformity between statutes, which vary in length, detail, and complexity. For example, the Idaho statute offers no substantial guidance as to provisions for executing and administering assignments. The only requirement is that the assignee be a state resident. Presumably, parties are free to fashion an agreement to their own desires and needs. One problem with such scant guidance is that the rights and duties of parties-in-interest are not clearly defined and may depend on conflicting common law.

In contrast to the Idaho statute, the New York statute provides comprehensive detail for handling assignments. The New York statute contains many of the features of the Bankruptcy Code such as avoidance of transfers and preferences, court supervision, strict documentation requirements, and duties parallel to those in the code for assignees and assignors.

Statutes in other states vary between the simplicity of the Idaho statute and the complexity of the New York statute. Although most states provide assignment statutes, those that parallel the code too closely have been struck down on constitutional grounds as an interference with congressional intent to occupy the field. The presence of a discharge in the state statute appears to be a consistent test that the Supreme Court has used to strike offending statutory provisions.

Common law assignments. In states where there is no assignment statute, a debtor may be able to proceed under a common law assignment. The common law assignment was the forerunner of the present statutes. Debtors were deemed to have an inherent common law right to make assignments. Under common law, the debtor had wide discretion to fix the terms and conditions of the assignment. Presumably, debtors are free to do so in the remaining common law states unless the common law assignment has been held to be void.

3.2 Bulk Transfer

In a bulk transfer, the debtor agrees to sell its inventory and other assets to a third party, with the consideration being distributed to the debtor for the benefit of the creditors or directly to the creditors. The governing law is the Uniform Commercial Code, Article 6.

3.2.1 Requirements

Creditors must be given ten days' notice of the sale. A failure to comply with the notice requirements may result in an ineffective transfer, at least against unnotified creditors. The debtor/seller is also required to furnish a list of all creditors. The responsibility for completeness and accuracy rests with the seller. Errors and omissions will render the transfer ineffective only if the buyer had actual knowledge of them.

3.2.2 Advantages and disadvantages

Bulk sale is an inexpensive and relatively fast way for a debtor with mostly unsecured creditors to liquidate the business without judicial supervision. Creditors, however, are disadvantaged against a good-faith purchaser, who will prevail over competing claims by unlisted creditors. Another disadvantage arises when the seller sells the assets at an unreasonable price. As in assignments, however, the omitted creditor may be able to file an involuntary bankruptcy petition under Section 303 of the code.

3.3 Receiverships

Troubled companies may be liquidated by a general receiver state or district court in appropriate cases. A receivership may be the only court-supervised liquidation procedure available to debtors not eligible to file under the Bankruptcy Code.

Receiverships involve the appointment of a receiver to collect and preserve the debtor's assets for the benefit of creditors. In most states,

a creditor with an unsatisfied court judgment on a claim may commence a receivership action for liquidation if the corporation is insolvent. An action can also be commenced if an insolvent corporation admits that a claim is due and owing. A Federal Court may appoint a receiver in appropriate circumstances.

Under Section 303 of the Bankruptcy Code, the appointment of a receiver is grounds for sustaining an involuntary petition filed by creditors within 120 days of the receiver's appointment. The bankruptcy court may choose not to exercise jurisdiction if it believes that the interests of the creditors would be better served by a receiver.

3.4 Mediation

Mediation—that is, formal, statutory mediation—is a relatively new method for dealing with insolvency problems. It appears at the same time that alternative forms of dispute resolution such as negotiation and arbitration are becoming more popular. Mediation has been used to help bankrupt farmers work out agreements with creditors.

3.5 Composition and Extension Agreements

A composition is a contract between a debtor and creditor in which the creditor agrees to take a specified partial payment in full satisfaction of the debt. An extension is a contract between the debtor and creditor whereby the creditor agrees to extend the time period for payment of the debtor's claims. An agreement can combine aspects of both compositions and extensions.

3.5.1 Requirements

Compositions and extensions must be written. The provision of each agreement may be adapted to the needs of the case. Typical provisions cover the binding of creditors and debtor, the payment of small claims, the release of judgment liens, the timing and manner of payment, and defaults, accelerations, and covenants regarding the operation of the debtor's business during the term of the agreement.

The agreement must be accepted by substantially all affected creditors. Dissenting creditors may be bound under Sections 1126 and 1129. Dissenting creditors have the option of filing an involuntary petition under Chapters 7 and 11. The court may, however, dismiss such a petition if the interests of the creditors or debtor would be better served by the dismissal.

3.6 Asset, Liability, and Company Maneuvers

3.6.1 Asset maneuvers

Asset maneuvers involve the use of a debtor's assets as collateral for additional loans or for the partial sale of assets or complete liquidation to pay off debts. Assets may include both paper assets, such as accounts receivable, and intangibles, such as good will, as well as buildings, equipment, and real estate. Three common asset maneuvers are the use of assets to collateralize new loans, the sale of both unprofitable and profitable operations, and the complete liquidation of company assets. These maneuvers are frequently used in the order given as the financial problems of the debtor worsen. In fact, asset collateralization and the partial sale of assets may be used by solvent companies to benefit shareholders or for tax or other strategic purposes.

3.6.2 Liability maneuvers

Liability maneuvers involve a variety of strategies that use company liabilities to handle financial crises. The three main types of liabilities include current liabilities (loans and funds that must be repaid within a year); debts (money borrowed for a period exceeding a year); and equity (money obtained from stock and bond holders). Composition and extension agreements are two common methods of restructuring or reordering liabilities or debts (see section 3.5 of this chapter). Other methods include selling additional stock or obtaining a loan guarantee from investors in exchange for an interest in existing equity. Liability maneuvers tend to be more drastic than asset maneuvers, but may be one of the only ways for the debtor to solve a financial crisis.

3.6.3 Company maneuvers

Company maneuvers involve nonfinancial strategies to help save a failing business. They tend to be tailored to the specific problems of an individual company. Theoretically, company maneuver strategies are limited only by the ingenuity of management or outside consultants. Some of the more common maneuvers include establishing a new product line or focusing on a new market; changing company management; demanding concessions from company employees or suppliers; temporarily reducing or shutting down operations; and merging.

4. TYPICAL ACCOUNTANTS' ROLES IN BANKRUPTCY

4.1 Limited Roles in Chapter 7, 13, and 12 Cases

Except when the accountant acts as a trustee, Chapter 7, 13, and 12 cases rarely require a CPA. By design, Chapters 12 and 13 are simple to implement. Usually, the only parties involved in these situations are the debtor, trustee, lawyers, one or two secured creditors, and a judge. Creditors have little to say when these alternatives are filed, as long as the debtor makes the required monthly payments. As a matter of course, debtors have often made several payments before their bankruptcy plan is finally approved by the courts. Therefore, as long as the lawyer can show that the creditors are being repaid at a higher rate than if Chapter 7 were elected, the details of bankruptcy are worked out in very short order between the debtors and the debtors' lawyers. Since the assets in question are usually minimal, disputes are fairly rare. Therefore, the requirement for the expertise of a CPA is limited.

In Chapter 7 cases, the objective by definition is to liquidate all the debtor's assets and pay as many obligations as possible. Therefore, unless there is some question as to the value of some asset of the estate, there is little opportunity for CPA involvement in this bankruptcy election.

4.2 Chapter 11 Commonly Requires the Assistance of an Accountant

Chapter 11 cases are often complex. Considerable money is spent to allow individuals or businesses time to restructure and repay their outstanding obligations. Logically, since more money is at stake, at least some creditors will take an active interest in resolving this alternative. And when the parties disagree as to financial matters, opportunities for CPAs emerge.

Accurate and timely information is critical to the resolution of these matters. Therefore, CPAs are often hired to prove, disprove, inform, compile, present, testify, analyze, value and/or restructure data. The CPA can provide assistance to the debtor, to a creditor, to the creditors as a group, to the trustee, or to the judge. The following discusses various ways CPAs can play a role in bankruptcy.

4.2.1 Trustee

A trustee is someone appointed by the bankruptcy court to manage the assets of a debtor during bankruptcy. A trustee's job is to protect the creditors by obtaining as much money as possible from the debtor's estate.

The job of trustee changes with each type of bankruptcy as well as with the specific situation of the debtor. In a Chapter 7 filing, the main focus is usually to manage the liquidation of the assets. In a Chapter 11 filing, the emphasis changes because there is hope that the economic position of the debtor's estate can be improved over time. Therefore, a trustee in these cases may oversee a variety of circumstances, from liquidation of some assets to actually operating the debtor's business or estate. In filings under Chapters 13 and 12, the trustee's job is minimal as long as the debtor is making the prescribed scheduled payments; the trustee acts as a clearinghouse for the debtor's various incomes and expenses. If the scheduled payments are not being made, the trustee needs to either collect the past-due payments or approach the court to either dismiss the case or convert it to Chapter 7.

4.2.1.1 U.S. Trustee's office

The U.S. Trustee's office is a branch of the Justice Department located in Washington, D.C. Regional offices are located throughout the United States, with some states having several regional offices and others having none. The U.S. Trustee's office is charged with supplying trustees for the bankruptcy courts.

In all but a few states, trustees are selected by the U.S. Trustee's office. Some trustees' offices have lists of people who can serve as Chapter 11 and/or Chapter 7 trustees. Other offices just keep a file of Chapter 7 trustees and supply the Chapter 11 requirements from this one list. The U.S. Trustee's office monitors the trustees in an attempt to determine that the caseload is not only being managed, but that it is manageable.

4.2.1.2 Court appointment

The Bankruptcy Code authorizes the court to appoint a trustee. Once an order to appoint a trustee is entered, the U.S. Trustee's office is typically charged with selecting the individual who will act as trustee. Local custom often allows input to the U.S. Trustee's office from judges, creditors, and debtors. Therefore, there are times when a CPA can be appointed as a trustee because of requests arising out of local familiarity with a CPA's special knowledge or experience. Although this situation is often very desirable for the CPA, it is rare because the trustee appointment process can be very political, and the amount of influence

judges, creditors, or debtors have in the selection of a trustee varies from district to district.

Ongoing business bankruptcy cases can be lucrative for trustees. The U.S. Trustee's office first tries to provide this opportunity to its current trustees rather than to someone outside the system. But if the local practice has been to allow the judge, creditors, or debtors a great deal of influence in the trustee selection process, individuals outside the U.S. Trustee's system may have a much greater chance of being appointed.

4.2.1.3 *Becoming a trustee*

Before an applicant can become a trustee, he or she must pass a governmental background check. In other words, people having past problems such as a criminal record will not qualify for this position. Trustees must post bonds in the amount of the on-hand liquid assets they are going to manage.

Trustees are compensated in a variety of ways. Chapter 12 and 13 trustees are paid a percentage of the planned payments scheduled for the debtor in bankruptcy. Typically, the trustee's share is somewhere between 5 percent and 10 percent of the planned payments. For Chapter 7 cases, the trustee is paid \$45 for each filing plus a percentage of the proceeds from sales of assets. Chapter 11 trustees are dealt with differently. They file a fee application with the bankruptcy court, just like all other administrative claimants. The fees charged by trustees are based on the monies distributed to the creditors; the percentage allotted follows a schedule set forth in the Bankruptcy Code.

Even though more red tape is involved in compensation for Chapter 11 cases, they are often the most financially rewarding. Depending on the circumstances, payment in Chapter 11 cases can be automatic. For example, if the trustee is operating the debtor's business, he or she may be paid a monthly salary from the business and then only have to file a fee application for the trustee's time billed in excess of salary. Obviously, this kind of situation would significantly improve the trustee's cash flow in a bankruptcy engagement. Thus, in many areas, trustees must have served in simpler cases (e.g., Chapters 7, 12, or 13) before being considered for the more lucrative Chapter 11 cases.

4.2.2 Examiner

Most CPAs get involved in bankruptcy in the more traditional role of examiner. This need arises when the debtor, creditor(s), trustee, or judge requires information that is not readily available, due to the lack of or improper record keeping of the debtor, or of the entities in which the debtor has an interest.

4.2.2.1 Reconstruction

Often, CPAs are hired to reconstruct, analyze, or summarize financial information. This may be required to determine the debtor's tax liability, validate a creditor's claim, identify special financial transactions, pinpoint the time frames of those transactions, or derive a net book value. Just about every time a Chapter 11 bankruptcy occurs, there is a dispute of some kind between the debtor and the creditors as to what happened to the assets, why it happened, when the trouble started, whether the debtor intentionally attempted to deceive the creditors, or whether improperly prepared financial information was distributed. Questions like these are often answered by involving an independent party, like a CPA.

4.2.2.2 Restate financial statements

Many businesses, for various reasons, do not present their financial information according to generally accepted accounting principles (GAAP). Sometimes, bankruptcy courts or creditors will demand that a debtor's financial statements be converted to GAAP in order to obtain a true picture of a company's financial position. Logically, this is an opportunity for CPAs.

4.2.2.3 Improve controls

When a business continues to operate during bankruptcy, it makes sense that additional controls are often necessary. These controls may be intended to help the debtor better manage the business, to convince the creditors that the current assets are being adequately monitored, to provide the trustee with more timely information, or to prevent theft from disgruntled employees. Once again, many opportunities arise from Chapter 11 cases because there are ongoing transactions. These transactions create opportunities to make or lose money. The bankruptcy court is interested in any change in the debtor's financial condition, either good or bad. Therefore, improving or monitoring the financial controls of a business in bankruptcy is a definite opportunity for CPAs.

4.2.2.4 Determine value

Not only are CPAs often retained to analyze the value of a debtor's estate or business, they are often asked to derive an estimated value for a debtor's investment. For example, a debtor may own a minority interest in a small business. As far as the creditors are concerned, they want cash, not stock in another business. Therefore, in order to satisfy and protect the interests of both debtor and creditors, asset valuations become necessary.

The need to value a debtor's estate or business occurs because there is always an underlying question as to whether the creditors will be best served through liquidation or reorganization. For example, it may be

in the creditors' best interest to allow the debtor or trustee additional time to sell off a subsidiary whose going-concern value is far greater than its liquidation value. On the other hand, if an asset or business is likely to lose value with the passage of time, the creditors may want to exert pressure on the bankruptcy court to force liquidation of the debtor's assets.

4.2.3 Expert witness

An expert is someone with specialized knowledge hired to render an opinion on specific circumstances. Since bankruptcy involves debtors and creditors who are in adversarial positions, experts are brought in to validate arguments made by both sides. Because the debtor is generally attempting to hold on to every asset possible, and the creditors want to sell off everything of value, experts are sought out by both sides to make convincing arguments to the judge. Experts are hired to testify on almost everything, with financial matters topping the list. Therefore, since CPAs are considered experts in this area, there are many opportunities to assist either side in proving or disproving its position.

4.3 Help Clients Prepare for or Avoid Bankruptcy

The threat of bankruptcy is hardly limited to clients with financial problems. On the contrary, many financially well-heeled clients work in litigious environments. Doctors, lawyers, and people serving as board members could face financial ruin as a result of lawsuits. In order to protect such clients from disaster, it's important for CPAs to understand the bankruptcy law and its process.

For example, in Texas a married couple—using the state exemption law afforded under the Bankruptcy Code—may exempt the following assets (this is not an all-inclusive list):

- One acre of land plus improved property (for city dwellers) or 200 acres plus improved property (for rural residents)
- \$60,000 of certain categories of personal property, including
 - Home furnishings, including family heirlooms
 - Provision for consumption
 - Farming or ranching implements
 - Tools, equipment, books, and apparatus, including a boat, used in a trade or profession
 - Clothing, including jewelry

Two firearms

Athletic and sporting equipment

One vehicle for each family member who holds a driver's license

The present value of any life insurance policy

Current wages for personal services

Various retirement plans

At first glance, the \$60,000 Texas personal property exemption is surprising. While it does not seem excessive, consider that this amount is based on fair market value less any outstanding liens. Thus, if one drives two cars with a combined fair market value of \$20,000, but still owes \$18,000, for bankruptcy purposes the court considers the cars to equate to only a \$2,000 personal exemption. Obviously, a critical phrase in this exercise is "fair market value." Quite often, the fair market value of someone's used clothing, furniture, or equipment, is minimal.

Continuing to use the Texas law as an example, "one acre of land plus improved property" is any combination of land and improvements as long as it is the debtor's homestead or is used for business purposes. Therefore, a debtor could have one-half acre with a house and one-half acre with an office and exempt it all. If the homestead was worth \$500,000 and the office \$2,000,000 with total liens of only \$400,000, the \$2,100,000 in equity would be exempt under the bankruptcy laws in Texas.

Consider the allowed exemption of various retirement plans. Certain retirement plans are advantageous places to accumulate wealth that are not generally exposed to lawsuits. However, reading the fine print is critical. For example, while the law says that an individual's retirement plan is exempt, amounts contributed over and above the IRS maximum yearly allowable contribution, and the interest accumulated on that excess contribution, are not exempt under bankruptcy.

In addition to exemptions under bankruptcy, there are other pre-bankruptcy alternatives that can protect assets in excess of the state or federal exemptions. Assets such as priceless paintings, jewelry, and so forth can be placed in a trust for children, with the parents named as administrators. This not only allows the valuable objects to pass from generation to generation, but also removes them from the parents' personal estate. Note that these types of conveyances must be made at a time when bankruptcy is not being contemplated; otherwise, such conveyances can be reversed.

The point is that a CPA who does some homework regarding the bankruptcy code, state fraudulent conveyance acts, and state and federal exemption statutes is likely to identify many techniques to help protect some or all of a client's assets.

Obviously, this level of understanding of bankruptcy has value not only for secure clients, but for those having financial difficulties as well. While there are some time lines to manage, CPAs can help distressed clients minimize the financial impact of bankruptcy, too.

The time lines referred to have various associated comfort zones. Conveyances to relatives or other “insiders” are subject to reversal under the Bankruptcy Code if made within one year of the filing of the bankruptcy petition. Some state fraudulent conveyance laws, which are applicable in bankruptcy, cover a period much longer than one year. Therefore, CPAs need to be careful in discussing or recommending conveyances of assets. Despite this caveat, CPAs should consider transfers of assets as an appropriate and legal tool for protecting their clients’ estates. (It should be noted that fraud, alimony, and income taxes are not subject to discharge under bankruptcy.)

Taxes are in some cases the reason individuals and corporations file for bankruptcy protection. Since the interest-and-penalty meter continues to tick until payment in full is rendered, bankruptcy offers some leverage when tax amounts are substantial. Not only does it stop the meter from ticking, but the bankruptcy court can dictate to the IRS a repayment schedule (which has a maximum term of up to six years from the date of assessment).

5. THE INS-AND-OUTS OF WORKING IN BANKRUPTCY

As one would expect, there are many opportunities within the bankruptcy system, but there are many pitfalls as well. Knowing how the system works, or more important, knowing how to work the system, is essential to survive. For example, it is far easier to be hired to perform bankruptcy work than to get paid for it. Many CPAs have done valid work but will never see payment for their efforts. The following should shed some light on a few common stumbling blocks.

5.1 Who Retains and Pays the CPA

The agency hiring the CPA is of primary importance. The CPA can be hired by a creditor, creditors’ committee, trustee, or debtor-in-possession.

The creditors’ committee is created by the U.S. Trustee’s office. Typically, the top twenty unsecured creditors in a bankruptcy case are invited to serve on this committee. If three of the invited creditors decide

to volunteer, the group is formalized. The creditors' committee is created to protect the interests of all the unsecured creditors and is charged with monitoring the actions of the debtor-in-possession.

The debtor is referred to as debtor-in-possession because the debtor still controls his or her own assets. Should the creditors' committee lose faith in the debtor or determine that mismanagement is occurring, the committee (or any single creditor) can request the court to appoint a trustee to manage the debtor's estate. The creditor, creditors' committee, trustee, or debtor-in-possession can hire an attorney and other professionals to protect their interests.

If a creditor hires a CPA directly, then the creditor's obligation to pay is no different than that of any other client. If the CPA is even slightly uncomfortable with the situation, a retainer should be charged. The CPA can work from the retainer and never jeopardize any fees. Even though the CPA is being hired to perform work within the bankruptcy system, the court is not involved or in control of either the services rendered or the fees paid for those services.

If the creditors' committee, trustee, or debtor-in-possession hires the CPA, then the CPA is considered an administrative claimant and payment for services rendered comes from the bankruptcy estate's available funds through the fee application process. Even though administrative claimants are given payment priority over unsecured creditors, working for the bankruptcy court can be risky because if there are no funds in the debtor's estate, no one will get paid. Therefore, it is imperative that the CPA look at the magnitude of the debtor's estate to determine whether there will be adequate funds to pay for all the professional services (e.g., lawyers, CPAs, and experts) being requested.

5.2 What to Watch Out For

There are a couple of basic points that should be noted. First, the bankruptcy court does not add credibility to a client's ability or desire to pay for services rendered. At no time is it advisable to take on an undesirable client. Before accepting an engagement such as this, always interview the potential client to determine whether he or she is suitable for representation. A second general issue is the payment time frame. Collection in bankruptcy cases is often very slow. CPAs wait months, and even years, before payment of court-approved fees are made. Therefore, it is important that CPAs working in bankruptcy do not over-extend themselves or their firms. For example, when the services requested of a small firm require several months of billable hours, the job may be lucrative but it might also place too great a financial strain on the practice.

Several other areas can be costly for a CPA. Some of the most common include work performed

- Without prior court approval.
- That is of little or no benefit to the estate.
- Without the time adequately narrated or itemized.

5.2.1 Obtain prior court approval

Before any work is performed on a bankruptcy case, one must file an employment application. This outlines the work to be accomplished and the rates to be charged. The good news about this process is that CPAs don't need to be shy about their standard rates; rarely are a CPA's rates considered excessive because they are compared to the fees being charged by the lawyers. However, if the court thinks a CPA is padding his or her rates in order to take advantage of the bankruptcy system, the judge is likely to reduce the hourly rates being sought or just reject the employment application altogether.

If one does work without an approved employment application, a risk is being taken. While there are ways to resolve this situation, the court frowns on professionals who have not properly complied with the bankruptcy system's policies and procedures. Sometimes, because of this lack of compliance, the judge will either arbitrarily reduce the CPA's fee application (the bill) or just not approve it at all.

5.2.2 Verify the benefit to the estate

When attorneys or judges claim that the work performed was of little or no benefit to the estate, be prepared for the worst. Even a properly filed and approved work application does not guarantee that the work performed will be deemed of benefit to the estate.

For example, if a CPA who was hired to assemble GAAP financial statements for a two-year period worked 100 hours but did not complete the assignment, some might argue that the work was of no benefit to the estate. While this example seems fairly straightforward, many situations are not. For instance, if a CPA firm that took on the task of analyzing three years of past financial data and identifying all questionable transactions found none, some might argue that the work served no benefit to the estate because there was a hidden agenda. The creditors expected to find additional revenue sources by conducting the investigation. The point is to understand the expectations and agendas of the parties involved regarding the work requested, and to verify how that effort will be of benefit to the estate.

Besides lack of benefit to the estate, there are other reasons why parties might object to the fees associated with work performed by

CPAs. Many of these reasons may not be logical, but all objections will be heard. Objections can come from anyone: a creditor, the creditors' committee, trustee, judge, and/or debtor. Anytime there is an objection, payment for services will typically be held up for a minimum of several weeks until the court can schedule a hearing on the objection. If the concerns are deemed valid, the fees charged may be reduced or not approved at all.

Because the objection process is so powerful, some feel that working for the creditors' committee or the trustee carries more financial risk than working for the debtor. This is because it is much rarer for the debtor than for the creditors to object to professional fees charged. Since administrative fees are paid prior to unsecured creditor distributions, the more administrative claims paid, the less money is distributed to the creditors.

5.2.3 Narrate and itemize work performed

Districts and local practices may vary on fees payable by the court. However, a good rule of thumb is to report all time worked on a detailed bill using increments of one-tenth of an hour. Hence, forty-eight minutes spent on a specific task would be recorded as .8 hour. In addition, narrative describing all work performed should be included. The notation "financial statement preparation" is not adequate. The specifics of the work performed—for example, "reconciled bank statements for June, July, and August"—should be itemized on the bill presented to the court. If the time is not recorded to the satisfaction of the court, or if it is not adequately detailed, there is a likelihood that the judge will penalize the CPA or write down an arbitrary total fee amount.

Another area within the billing function is itemizing time in straight blocks, such as eight hours. This is often frowned upon because there is an assumption that breaks occur during a normal work day, such as for lunch, using the bathroom, and making telephone calls to the office. When eight hours of straight time were billed, the court might presume that the CPA was either charging for personal time or working inefficiently. In either case, time or fees are often docked. Therefore, if the same general function is performed over long periods, the work should be broken down into phases on the bill.

It is also important to understand local practices for issues like travel time and expenses. Bankruptcy courts rarely allow travel time to be billed at standard rates; however, this has been approved. For instance, if travel each way to the work location was an hour of air time, thirty minutes of productive work while in flight might be justified, depending on the work performed. A narrative presenting this justification would need to be included in the fee application. Expense reimbursement

varies from location to location. For example, one court may pay all expenses, while another might not pay for meals. Note that all expenses will be tested against the same standard, which is whether they are reasonable. The court can and will declare expenses to be excessive and reimburse only what it feels is fair. An hour or two spent investigating these local practices can be critical to engagement administration.

5.3 Obtain Your Own Counsel

Clearly, there are many ways to be swallowed up by the bankruptcy system. Therefore, it is important for CPAs to obtain their own counsel when working in bankruptcy.

The first reason for this is that CPAs are not normally permitted to address the court. Therefore, if arguments need to be made as to why certain work was of benefit to the estate or why specific expenses should be reimbursed, having one's own counsel is essential.

Another reason to retain counsel is that there are very specific procedures and time frames that must be followed in order for work to be approved and paid for within the bankruptcy system. By retaining counsel, one can become better informed.

The third reason is that informal discussions between counsel can sometimes be more advantageous than raising the issues in formal court hearings. When CPAs have their own counsel, it can be easier to timely resolve these issues.

5.4 File a Fee Application

If the CPA is an administrative claimant, CPA services are paid through the fee-application process. This application is typically difficult to prepare. Not only can it be lengthy, but every "i" must be correctly dotted and every "t" properly crossed. A fee application may not be filed more than once every 120 days unless the court orders otherwise.

Once a fee application has been presented, the judge may approve it as requested or may modify it. If the judge feels that the work performed was not worthy of the fees charged, or that it did not provide an equivalent value to the estate, the judge can write the fees down.

Many believe they can eliminate this arbitrary valuation by collecting a retainer up front. This works if a creditor is paying the CPA directly. However, if the retainer is paid from the debtor's estate, there is no reason to be over-confident. Anytime someone is paid from the debtor's estate prior to a bankruptcy plan's being confirmed by the court, the judge can disgorge those monies, that is, demand that they be remitted back to the debtor's estate. In other words, many retainers in bankruptcy

are more like loans. Also, before anyone can draw down on retainer funds, court approval is required.

5.5 Receiving Payment

Once the CPA's fee application is complete, a copy is sent to each of the debtor's creditors, unless local rules dictate otherwise. The creditors typically have twenty days to file an objection to the fee application. If there are any objections, the judge will set a hearing. Once the judge has heard the objections, a ruling will be made and the fee application will either be approved, adjusted and approved, or rejected, or a decision will be postponed pending additional information. If the fee application is approved, a court order must be signed authorizing payment before payment can be made. Sometimes a signed order will take only a day or so; other times it may take weeks or even months (for example, if an appeal is filed, it may be several months, or even years, before a final order is signed). After the judge signs the order, another issue takes the forefront, which is whether the debtor's bankruptcy plan has been confirmed.

If the debtor's bankruptcy plan has not been confirmed, payment of the fee application may still not occur. Unless the judge signing the order specified when the bill is to be paid (which is unlikely), payment is left up to the debtor or trustee. Therefore, one technique to consider is including in the fee application a payment provision specifying the payment time frame based on the court approval date. Judges often overrule this paragraph, but sometimes they do not.

If the bankruptcy plan has been confirmed, the debtor or trustee loses discretion regarding payment and must by law operate according to the plan. The plan will state which administrative claimants to pay and when. Should a plan be confirmed and an administrative claimant not be identified, problems occur. Therefore, all administrative claimants need to verify that they are included in the plan.

5.6 Finding Opportunities

CPAs are well qualified to identify ways in which they can work in bankruptcy, because they know what skills they bring to the table. The attorneys know what demands the bankruptcy system makes on them, but not necessarily how a CPA will fit in. The problem of marketing services in this group is compounded by the fact that the number of bankruptcy cases has and will continue to put a great deal of stress on the court system.

While the opportunities for CPAs are great, lawyers and judges rarely have time to seek out new expertise. Therefore, to break into this marketplace, CPAs need to be aggressive about soliciting an audience with local bankruptcy practitioners in order to inform them of the skills, experiences, and qualifications they can provide.

The greatest challenge in this selling exercise is to educate the bankruptcy practitioners about how accountants can provide assistance. Often, these people are more than willing to hire expertise when they know it exists and have determined how to use it. Therefore, the best way to find opportunities is to put together a marketing plan that consistently and repetitively reminds the local bankruptcy professionals of the various ways CPAs can make their jobs easier.

6. ORGANIZATION OF THE BANKRUPTCY SYSTEM

6.1 Court Hierarchy

Under the Supreme Court are eleven courts of appeal spread throughout the country. Each court of appeals has many district courts beneath it. The bankruptcy courts, which are an arm of the district courts, are next in the hierarchy.

The bankruptcy courts are very powerful and can have a very broad reach. These courts generally hear a variety of matters that encompass both state and federal law. Should a bankruptcy court's decision be appealed, the appeal would move up through the court hierarchy.

6.2 Courts and Jurisdiction

The United States Bankruptcy Court was established by the 1978 Bankruptcy Reform Act. It began on October 1, 1979, with bankruptcy judges appointed under the 1898 act serving until presidential appointments of bankruptcy judges made a new court effective on April 1, 1984. A pilot trustee program was also established in eighteen judicial districts.

The reform act granted the courts broad and complete jurisdiction over all matters and proceedings related to bankruptcy. All cases and civil proceedings that arose directly under the code or that arose in cases related to the code were within the court's jurisdiction. Bankruptcy judges were adjuncts to the district court and were appointed by the President to fourteen-year terms.

In 1982, the United States Supreme Court held that the broad grant of jurisdiction to the bankruptcy courts violated Article III of the Constitution. Congress responded with the 1984 amendments to the bankruptcy code.

6.3 1984 Bankruptcy Code Amendments

Under the Bankruptcy Amendments and Federal Judgeship Acts of 1984, bankruptcy judges became a unit of the district court known as the bankruptcy court.

Bankruptcy judges are now appointed to fourteen-year terms by the U.S. Court of Appeals. The district courts have original and exclusive jurisdiction over all Title 11 cases and original but not exclusive jurisdiction over all civil proceedings arising under Title 11 or related to Title 11.

District courts refer all bankruptcy cases and proceedings to bankruptcy judges. The district court, however, has the right to revoke its reference for cause and must revoke, upon a motion, when the proceeding involves bankruptcy and nonbankruptcy law.

Bankruptcy judges have the power to determine only “core” proceedings; however, they may hear noncore proceedings and may determine noncore proceedings if both parties consent. Their decisions are subject to review by the district court.

6.4 Trial by Jury

Under certain circumstances, a jury trial may be obtained in bankruptcy court. However, the odds are against it.

7. TERMINOLOGY AND DEFINITIONS

The terminology and definitions in Section 101 of the 1978 act are much more specific than they were under preceding bankruptcy law. Many previous terms have been discarded. It is therefore very important to check terminology to be certain of current definitions. Here are some frequently used terms:

Adjudication of a debtor as bankrupt has been replaced by *order for relief*, which occurs immediately upon filing a petition.

Bankrupt has been replaced by *debtor*.

A *case* is begun by filing a petition. A *proceeding* is any controversy or other matter requiring judicial action within a case. The terms *case* and *proceeding* are not interchangeable.

A *claim* is a right either to payment or to an equitable remedy for breach of performance if such breach gives rise to a right to payment.

A *commodity broker* is a futures commission merchant, foreign futures commission merchant, clearing organization, leveraged transaction merchant, or commodity options dealer.

Consumer debt is debt incurred by an individual primarily for a personal, family, or household purpose.

A *creditor* is an entity that has a claim against a debtor that arose at the time of, or before, the order for relief concerning the debtor; it is also an entity that has a claim against the estate of a kind specified in Section 348(d), 502(f), 502(g), 502(h), or 502(i) of the bankruptcy code.

A *debt* is a liability on a claim.

A *debtor* is a person concerning whom a bankruptcy case has been commenced.

A *family farmer* is (1) an individual or couple engaged in a farming operation when aggregate debt does not exceed \$1.5 million and when at least 80 percent of the debt arises out of a farming operation (excluding debt for the principal residence, unless such debt arises out of a farming operation), or when more than 50 percent of the individual's or couple's gross income for the taxable year immediately preceding the year of filing is from farming; or (2) a corporation or partnership in which more than 50 percent of the outstanding stock (not publicly traded) or equity is held by one family that conducts a farming operation, in which more than 80 percent of the assets are related to farming, and in which aggregate debt does not exceed \$1.5 million, at least 80 percent of which arises out of farming.

A *family farmer with a regular income* is a family farmer whose annual income is sufficiently stable and regular to enable the farmer to make payments under a Chapter 12 plan.

A *farmer* (except when the term appears in the term *family farmer*) is a person who received more than 80 percent of gross income from a farming operation during the taxable year immediately preceding the year that a Chapter 12 case is filed.

Farming operation refers to farming; tillage of the soil; dairy farming; ranching; production or raising of crops, poultry, or livestock; and production of poultry or livestock products in an unmanufactured state.

Financial institutions are commercial or savings banks, industrial savings banks, savings and loan associations, or trust companies.

A *governmental unit* is a department, agency, or instrumentality of the United States or of a state, commonwealth, district, territory, municipality, foreign state, or other foreign or domestic government.

An *individual with regular income* is an individual, other than a stockbroker or a commodity broker, whose income is sufficiently stable and regular to enable him or her to make payments on a plan under Chapter 13 of the bankruptcy code.

Insolvency is an inability to meet debts, or an excess of debts over assets.

Judicial lien refers to a lien obtained by judgment, levy, sequestration, or other legal or equitable process or proceeding.

A *lien* is the charge against or interest in property to secure either payment of a debt or performance of an obligation.

Perfection is the protection of a security interest against the claims of third parties other than the debtor. Frequently it is accomplished by complying with state recording acts, but it can also be created in other ways under the Uniform Commercial Code. For example, under the Uniform Commercial Code, a purchase money security interest in consumer goods perfects automatically.

A *person* includes individuals, partnerships, and corporations.

A *petition* commences a case by or against a debtor.

A *proceeding* is any controversy or other matter requiring judicial action within a case.

Purchase money security interest is created when a seller takes a security interest in goods sold on credit, or when a creditor lends money used to buy the collateral that secures the loan.

Referees in bankruptcy are U.S. bankruptcy judges.

Secured and unsecured creditors are holders of secured and unsecured claims (*provable claims* are, simply, claims).

A *security agreement* is an agreement that creates or provides for a security interest.

A *security interest* is a lien created by an agreement.

A *statutory lien* is either a lien arising solely by force of a statute on specified circumstances or conditions or a lien of distress for rent, whether or not statutory.

A *stockbroker* is a person engaged in the business of effecting transactions in securities for the account of others or with members of the general public, from or for such person's own account.

A *transfer* refers to every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest and foreclosure of the debtor's equity of redemption.

8. CHAPTER 7: LIQUIDATION

8.1 Introduction

The vast majority of bankruptcy cases are Chapter 7 cases. The terms *straight bankruptcy* and *bankruptcy* usually refer to a liquidation under Chapter 7.

The purpose of liquidation under Chapter 7 is to satisfy as many creditor claims as possible while providing a fresh start for the debtor by preserving exempt property. The debtor forfeits all nonexempt property in exchange for a complete discharge of debts.

Because the debtor has the ability in bankruptcy to exempt certain assets, most Chapter 7 cases are no-asset cases; that is, no assets are available for distribution to unsecured creditors. To the extent nonexempt assets are available, the code provides various payment priorities and the order of distribution between classes of claimants.

In a Chapter 7 asset case, a trustee collects and sells all nonexempt property and, with the sale proceeds, makes payment to claimants in the order provided by the code.

A Chapter 7 liquidation case has five basic stages:

1. Commencement
2. Collection of all debtor assets
3. Liquidation of assets through sale
4. Distribution of sale proceeds
5. Discharge of debtor's debts

8.2 Commencement

8.2.1 How to file

A Chapter 7 liquidation is begun by the filing of a petition. Usually the debtor files the petition, making it a voluntary case (see section 16.7 of this chapter). In addition to the petition, the debtor must file a schedule of debts and assets and a statement of financial affairs containing income and expense information. The petition may be filed with the bankruptcy court where the debtor's residence, principal place of business, or principal assets have been located for most of the 180 days prior to filing.

8.2.2 Who may file

To be eligible to file a petition, the debtor must be a *person*, defined to include partnerships and corporations as well as individuals. A husband

and wife may file a single joint petition. A sole proprietor would file as an individual, and the proprietorship assets would then be included in the individual's bankruptcy estate. The Chapter 7 debtor may not be a railroad, insurance company, or banking institution. Railroads are eligible for relief under Chapter 11; financial institutions and insurance companies may liquidate under various other regulatory laws. A Chapter 7 debtor need not be insolvent to file a petition. The debtor must pay a filing fee (a petition may be dismissed for nonpayment of the fee).

8.2.3 Effects of filing

The filing of a Chapter 7 petition operates as an order for relief and requires no formal adjudication. Filing institutes an automatic stay of all debt enforcement and collection by creditors. The stay is very broad and applies not only to judicial proceedings but also to phone calls and letters from creditors. Exceptions to the stay include criminal actions against the debtor, maintenance and child-support decrees, and several other narrow circumstances (Section 362).

8.3 Collection of All Debtor Assets

8.3.1 Appointment of a trustee

A trustee is appointed to oversee every Chapter 7 case. To a large extent, the trustee is vested with the debtor's rights in property. The trustee's role is to collect and sell the assets of the debtor's estate and make payments to claimants against the estate. Under the Bankruptcy Code, trustees generally are required to file a bond in a case. Pursuant to Section 326, they are paid a certain percentage of the value of the debtor's estate as compensation for their services. Usually, an interim trustee is appointed by the court immediately after the petition is filed. The interim trustee administers the case until a permanent trustee is selected, generally at the creditor's meeting provided under Section 341.

8.3.2 Creditors' Section 341 meeting

As a practical matter, the interim trustee becomes the permanent trustee at the Section 341 meeting, except in the unusual event that the creditors elect a different trustee. The debtor is also examined under oath at the Section 341 meeting to allow the trustee and creditors to locate and evaluate the debtor's assets and to determine whether the debtor has made any conveyances or transfers of property that are avoidable. The scope of the examination is limited to actions and property that might affect the administration of the debtor's estate.

8.3.3 The debtor's estate

Filing a petition automatically creates an estate in the debtor's assets. The estate consists of all the debtor's nonexempt property at the commencement of the case. In general, the debtor's estate consists of "all legal and equitable interest of the debtor at the start of the case." The estate therefore includes all real and personal property, intangible assets, property of the debtor possessed by a third party, equitable and legal interests, and causes of action (Section 541).

Property acquired by the debtor *after* filing the petition that becomes part of the estate includes

- Property the debtor acquires or becomes entitled to within 180 days after filing the petition by
 - Bequest, devise, or inheritance.
 - Property settlement or divorce decree.
- Life insurance proceeds as policy beneficiary.
- Earnings from the estate property, such as rents.
- Property received from the conversion of estate property, such as an insurance payment for destroyed property.

Any other property acquired after filing is excluded from the debtor's estate. The trustee has the power and duty to investigate all property transfers, liens, and improper conveyances to determine if they could be avoided and included in the estate. The trustee must also distinguish between valid and invalid liens under the code. Valid lien holders are paid, under the code, to the full extent of the lien's value.

8.4 Liquidation of Assets Through Sale

With some exceptions where property is subject to a lien, the trustee is empowered to sell all the assets of the debtor's estate under procedures provided in the Bankruptcy Code and rules of procedure. The trustee files with the court an accounting of the completed liquidation of the bankruptcy estate. From this accounting the court orders the distribution of the funds collected according to the schedule of priorities and distribution provided by the code.

8.5 Distribution of Sale Proceeds

Chapter 7 provides its own rules for the distribution of property in liquidation cases (of pertinence is Section 726). Sections 507 and 726

should always be considered together when determining priorities in a liquidation case.

Section 726(a) of the Bankruptcy Code provides for distribution or payment to claimants from property recovered in a Chapter 7 case in the following order:

1. Priority claims in the order provided by Section 507 (see section 16.5 of this chapter)
2. Unsecured claims filed in a timely manner or, if certain conditions are met, tardily filed
3. Unsecured claims that are tardily filed and that do not fall within second-priority treatment
4. Secured and unsecured claims for fines, penalties, forfeitures, or punitive damages arising before the earlier of the orders for relief or appointment of trustee, to the extent that they are not compensation for actual pecuniary loss
5. Interest from the date of the petition on the preceding four classes of claims
6. Any balance to debtor

Claims are generally paid pro rata to all claimants within a class in the descending order provided by statute.

8.6 Discharge of Debtor's Debts

An individual Chapter 7 debtor is ordinarily entitled to a discharge or release of liability for dischargeable debts under Section 727 of the Bankruptcy Code. The discharge is granted by a written document issued by the bankruptcy court within several months after the debtor's petition was filed. Unless there is some problem with discharge, it is normally granted without regard to whether the trustee has completed the liquidation of the debtor's Chapter 7 estate. A corporation or partnership cannot receive a discharge under Chapter 7 and is liquidated only to provide for the equitable distribution of assets to all creditors. Corporations or partnerships may dissolve after liquidation, but such dissolution would be carried out under state law because there are no such dissolution provisions under the Bankruptcy Code.

8.6.1 Nondischargeable debts

Section 523(a) of the Bankruptcy Code provides that the following types of debts are not discharged in a Chapter 7 case:

- Certain taxes or customs duties
- Debts incurred through false pretenses, false representations, or actual fraud

- Debts not listed or scheduled in time to be allowed
- Debts arising from fraud or embezzlement while the debtor was acting as a fiduciary
- Maintenance and child-support obligations
- Debts based on willful or malicious injury
- Debts for certain government fines, penalties, or forfeitures
- Student loans (in certain circumstances)
- Debts based on a liability incurred as a result of the debtor's operating a motor vehicle while legally intoxicated
- Debts from a prior bankruptcy where the debtor waived or was denied discharge

8.6.2 Effects of discharge

The discharge in bankruptcy not only releases the debtor's liability for dischargeable debts but also voids the debtor's personal liability for judgments of discharged debts and operates as an injunction against creditor collection action against the debtor personally (Section 524). A Chapter 7 debtor can receive no more than one discharge every six years; the fact that a debtor has been granted a Chapter 7 discharge will therefore not preclude the debtor from filing again within six years of a prior filing, but no discharge can be granted in the second case (Section 727(a)(8)).

9. CHAPTER 13: ADJUSTMENT OF DEBTS OF AN INDIVIDUAL WITH REGULAR INCOME

9.1 Introduction

Under the earlier bankruptcy act, a Chapter 13 case was referred to as a wage-earner bankruptcy. The code has broadened the former provisions to include people with regular income. The goal of Chapter 13 is debtor rehabilitation. The Chapter 13 debtor must submit a plan that generally provides for payment, over an extended time period, of the debtor's priority and secured claims, and all or a portion of unsecured claims. To the extent that a completed Chapter 13 plan does not pay the debtor's unsecured debt, the debtor receives a Chapter 13 discharge.

9.2 Limitations

9.2.1 Eligibility for relief

To be eligible for Chapter 13 relief, the debtor must be an individual with regular income (Section 101(27)). This requirement has been interpreted to mean an individual (including sole proprietors) who has income that is sufficiently stable and regular to provide payments under a Chapter 13 plan. In practice, therefore, the requirement allows for a plan tailored to the debtor's income flow whether the debtor receives income weekly, monthly, quarterly, or seasonally. Of course, the debtor's income must be sufficient to make the payments provided under the plan, or the plan cannot be confirmed.

9.2.2 Monetary limitations

A second limitation under Chapter 13 is monetary. To be eligible under Chapter 13, a debtor must have unsecured debts of less than \$250,000 and secured debts of less than \$750,000. Aggregate debts of a husband and wife must be within these limits (Section 109(e)).

9.2.3 Prior bankruptcies of the debtor

A third limitation concerns prior bankruptcy filings. A debtor will not be eligible for bankruptcy relief if, at any time within the preceding 180 days, the case was dismissed for willful failure of the debtor to follow court orders or to appear in court to follow through on the case, or if the debtor filed a request for relief from the automatic stay and thus obtained a voluntary dismissal of the case.

A Chapter 13 proceeding will generally proceed by these steps:

1. Commencement
2. Appointment of a trustee
3. Statement and plan
4. Confirmation
5. Discharge

9.3 Commencement

A Chapter 13 case is commenced by the debtor's filing with the bankruptcy court the original and a copy of a petition. The petition is filed with the bankruptcy court located where the debtor has resided or had a principal place of business or assets for the 180 days prior to filing. A filing fee must be paid, but the debtor may apply to pay the fee in installments. A creditor may not file an involuntary petition (see section 16.7 of this chapter) against a debtor under Chapter 13. The filing of

a petition operates as an order for relief and institutes a stay against all debt collection efforts.

9.4 Appointment of a Trustee

The principal administrator of the Chapter 13 case is the trustee. Section 1302 provides for the appointment of a Chapter 13 trustee unless the court has already appointed a standing trustee. A standing trustee is ordinarily appointed when the number of Chapter 13 cases in the district warrants the appointment. Standing trustees are chosen from a panel of private trustees under the United States trustee program. Creditors may not elect the Chapter 13 trustee.

Chapter 13 trustee duties include attending meetings and hearings, investigating the debtor's finances and creditor claims, determining the feasibility or modification of the Chapter 13 plan, filing reports, and being accountable for all of the debtor's property. The trustee also advises the debtor on the plan, assists the debtor with performance under the plan, and ensures that the debtor makes timely payments under the plan. Chapter 13 trustees are required to file a performance bond before beginning their duties.

9.5 Statement and Plan

The debtor is required to file, in addition to the petition, a Chapter 13 statement and plan. The Chapter 13 statement contains the debtor's budget list of assets and liabilities and property claimed as exempt. In nonbusiness cases, this statement is filed in lieu of schedules and a statement of financial affairs in Chapter 7 cases. In business cases, the debtor must file a Chapter 13 statement and a statement of financial affairs. If the statements and plan are not filed with the petition itself, they must be filed within fifteen days after filing the petition. Further extensions of time may be granted only by the court and for cause.

The Chapter 13 plan, which is the heart of a Chapter 13 case, provides a schedule for payment of creditor claims against the debtor. The form of a Chapter 13 plan will vary for every case, since a plan must be tailored to each debtor's own situation.

9.5.1 Required provisions

Section 1322 of the Bankruptcy Code requires that the plan must contain these three provisions:

1. The debtor's payment of future income to the trustee
2. The payment of priority claims as provided in Section 507 (see section 16.5 of this chapter)
3. Equal treatment of all claims within a class of claims

9.5.2 Permissive provisions

Some of the more important permissive plan provisions allowed under Section 1322 include higher-percentage payment of consumer debts for which another person may be liable with the debtor, modification of rights of secured creditors (other than mortgages on the debtor's principal residence), and cure of defaults in secured claims during the pendency of the plan.

9.5.3 Payment period

A Chapter 13 plan may not provide for a payment period in excess of three years unless the court approves a longer period for cause. In no event may the court approve a plan that is longer than five years. Unless the court orders otherwise, the debtor must start making payments within thirty days after the proposed plan is filed. These payments are retained by the trustee until the plan is confirmed and are then applied by the trustee toward the plan.

9.6 Confirmation

9.6.1 Creditors' Section 341 meeting

As in Chapter 7, creditors are entitled to a Section 341 meeting whereby the financial affairs of the debtor are examined and a determination made as to whether the plan complies with code requirements. A Section 341 meeting, however, may not always be necessary, particularly if the trustee has already met with the debtor on filing.

9.6.2 The confirmation hearing

A confirmation hearing before the bankruptcy court is held after the creditors' meeting. The court will determine whether the plan should be confirmed. Section 1325(a) provides that the court shall confirm the plan if the following conditions are met:

- The plan complies with applicable bankruptcy code provisions.
- All required fees and charges have been paid.
- The plan is proposed in good faith.
- Unsecured creditors will receive at least as much in payments under the plan as they would have received in a Chapter 7 liquidation case.
- Each secured creditor has accepted the plan or under the plan retains its lien, and will receive payment under the plan in the value of its claim; alternatively, the plan may provide for the debtor to surrender the security collateral to the secured creditor. Secured creditors have

- limited veto power over the plan. If either of these two conditions is met, a secured creditor cannot veto the plan. Acceptance by unsecured creditors is not necessary.
- The plan is feasible, that is, the debtor will be able to make all payments and otherwise comply with the plan.

9.6.3 Objections to confirmation

Section 1325(b) of the Bankruptcy Code, which amended the code in 1984 (the Bankruptcy Amendments and Federal Judgeship Act of 1984), imposes a new confirmation standard on Chapter 13 cases filed on or after October 10, 1984. Under this provision, the trustee or an unsecured creditor may object to confirmation. In that event, the court may not confirm the plan unless the plan proposes to pay the objecting creditor in full *or* unless the plan provides that all of the debtor's projected disposable income to be received during the first three years of the plan will be applied to payments under the plan. The code defines *disposable income* as income received by the individual debtor that exceeds the reasonable expenses needed to support the debtor and the debtor's dependents, and income received by the business debtor that exceeds expenses needed to continue to operate the business.

9.7 Discharge

A Chapter 13 debtor may receive one of two types of discharge under Section 1328.

9.7.1 Full or expanded discharge

A full discharge is granted under Section 1328(a) to the debtor who fully performs and completes a confirmed Chapter 13 plan. When the plan is completed, all creditors have been fully paid pursuant to the plan. A Section 1328(a) discharge, broader than that under Chapter 7, discharges all but two types of debts. These are (1) long-term debts, such as mortgages, and (2) alimony and support payments. A third exception is post-petition consumer debts for property or services needed for the debtor's performance under the plan, which also are not dischargeable unless prior approval of the trustee was obtained.

9.7.2 Hardship or partial discharge

Under Section 1328(b), a hardship or partial Chapter 13 discharge may be granted to the debtor by the court even if the debtor does not com-

plete payments under the plan. The hardship discharge is granted if three conditions are met:

1. The debtor's failure to complete the plan is due to circumstances not within the debtor's control.
2. The distribution made to each creditor under the plan is at least equal in value to the amount that would have been paid to the creditors under a Chapter 7 proceeding.
3. Modification of the plan is not practical.

The hardship discharge is not as broad as the full discharge and is comparable to a Chapter 7 discharge. In fact, a Chapter 13 debtor unable to complete the plan who is also not eligible for a hardship discharge can usually convert the Chapter 13 case to a Chapter 7 case and receive a discharge under Section 727.

9.7.3 Nondischargeable debts

Long-term debts, spousal debts, debts arising from willful and malicious injury, and fraud and misrepresentation are not dischargeable. Post-petition claims are also not dischargeable unless prior approval of the trustee was obtained.

9.7.4 Effect of discharge

The discharge serves as a total prohibition on any further debt-collection efforts. It also voids any judgment obtained on pre-petition debts and any allowed post-petition claims.

A debtor granted a Chapter 13 discharge is not eligible for a Chapter 7 discharge within six years after the Chapter 13 discharge, unless payments under the Chapter 13 plan totaled at least 100 percent of unsecured claims, or unless they totaled 70 percent of such claims and the plan was made in good faith, representing the debtor's best effort.

9.7.5 Revocation of discharge

A court may revoke the discharge on request of a party in interest and after notice and hearing only if the discharge was obtained through fraud and knowledge of the fraud came to the requesting party after the discharge was granted. The request for revocation must be made within one year after the discharge is granted.

10. CHAPTER 11: REORGANIZATION

10.1 Introduction

The typical Chapter 11 case involves a business, since the goal of Chapter 11 is business rehabilitation. A Chapter 11 case is based on the idea that

a financially troubled business is in a much better position to pay off debts if it continues to operate while reorganizing its financial affairs than if it liquidates its assets and ceases operation. Chapter 11 allows the business to continue and devises a plan for payment or partial payment of its debts. A Chapter 11 case generally involves these five steps:

1. Commencement
2. Operating the business
3. Formulating a plan
4. Creditor acceptance of the plan
5. Confirmation

10.2 Commencement

A Chapter 11 case, which may be involuntary (see section 16.7 of this chapter), is commenced by filing a petition with the bankruptcy court in the district where the debtor has been domiciled, resides, or has had his or her principal place of business or assets for most of the 180 days prior to filing (28 USC Section 1408). As in Chapters 7 and 13, debtors must pay a filing fee. Individuals filing under Chapter 11 may pay the fee in installments. Individuals, partnerships, and corporations may file under Chapter 11, but governmental units, financial institutions, railroads, stockbrokers, and commodity brokers are prohibited from being Chapter 11 debtors (Section 109(d)). Stockbrokers and commodity brokers are provided with separate liquidation methods under Subchapters III and IV of Chapter 7. These subchapters are designed primarily to protect the clients of these debtors.

The filing of a petition under Chapter 11 operates as an order for relief and institutes an automatic stay of all debt-collection efforts. As in Chapters 7 and 13, the stay is very broad and covers not only judicial proceedings but also phone calls and letters from creditors (Section 362).

10.3 Operating the Business

10.3.1 Debtor in possession

In most Chapter 11 cases, the debtor will remain in control of its business operations as a “debtor in possession.”

The debtor in possession has all the rights, duties, and powers of a bankruptcy trustee except for the right to compensation. The debtor in possession is required to perform all functions specified for the trustee except the investigation of his or her own acts, conduct, and financial affairs. These duties include filing with the court periodic reports of business operations and tax reports, and being accountable for all prop-

erty. A debtor in possession retains the power to use, sell, or lease property; to obtain unsecured credit; to contract; to exercise the trustee's turnover and avoiding powers; to recover preferences and other property transfers; to file and object to creditor claims; and generally to exercise all powers of a trustee. The debtor may be required to lower the salaries of its corporate officers (Section 1107).

10.3.2 Appointment of a trustee

At the request of a party in interest, the court may appoint a trustee if there is or has been fraud, dishonesty, incompetence, and gross mismanagement on the part of the debtor or if it is in the best interest of creditors or security-holders. An example would be if the debtor continued to operate the business in a way that still damaged it financially. If a trustee is not appointed, the court may appoint an examiner to investigate any fraud, dishonesty, incompetence, or misrepresentation on the debtor's part.

10.4 Formulating a Plan

The term reorganization basically connotes an adjustment or reordering of the rights of parties having an interest in the business. The Bankruptcy Code allows the debtor great flexibility in designing a plan tailored to the needs and interests of each business.

10.4.1 Required provisions

Section 1123(a) lists the contents of the plan required under Chapter 11 for confirmation. In summary, a plan must

- Designate the classes of claims and interests.
- Specify which classes are not impaired by the plan.
- Specify the treatment of impaired classes.
- Provide the same treatment for each claim or interest within a particular class (unless a claimant agrees to less favorable treatment).
- Provide adequate means for implementation of the plan.
- Provide, in certain instances, for corporate charter amendments.
- Contain provisions for the selection of officers, directors, and trustees and their successors consistent with interests of creditors, equity-security holders, and public policy.

10.4.2 Impaired classes under the plan

The concept of impaired classes of claims or interests is vitally important in the Chapter 11 confirmation process.

Whether a class of claims or interests is impaired under a plan must be determined by tests prescribed by Section 1124. Basically, the claim- or interest-holder whose legal rights remain unaltered or who will be fully paid under the plan is not impaired. The claim- or interest-holder that accelerated its right to demand payment under the terms of its contract with the debtor is not impaired, provided the plan cures the default, reinstates the maturity of the claim or interest, compensates the holder for any damages, and does not otherwise alter the legal rights of the holder.

10.4.3 Who may file a plan

Unless a trustee has been appointed in the case, the debtor has an exclusive right to file a reorganization plan during the first 120 days of the case. If the debtor files a plan within the 120 days, another sixty days are added, allowing the debtor 180 days to have its plan accepted. If a trustee has been appointed, if the debtor fails to file a plan within 120 days, or if a plan the debtor has filed is not accepted after 180 days, any party in interest may file a proposed plan. These periods of exclusivity may be increased or reduced for cause by the court (Section 1121).

10.5 Creditor Acceptance of the Plan

Full disclosure is required of the debtor before a plan can be accepted. Creditors and shareholders must be furnished with a copy or summary of the plan and a written disclosure statement approved by the court as containing adequate information.

10.5.1 Acceptance by impaired classes

A plan is accepted by the vote of each class of creditors or claims. The debtor or proponent need not obtain acceptance from all creditors and shareholders within a class. An impaired class of claims accepts the plan when a majority of the impaired class and two-thirds of the dollar amount represented by the claims of the impaired class vote to accept the plan (Section 1126).

10.5.2 Acceptance by unimpaired classes

Each class of claims or interests not impaired by the plan is deemed to have accepted the plan. Thus, it is not necessary to solicit acceptance from these classes, creditors, or interests.

10.6 Confirmation

The reorganization plan may be confirmed by the bankruptcy court only after notice and hearing. Any party in interest may object to con-

firmation. The Securities and Exchange Commission also has a right to object and to appear and be heard in Chapter 11 cases that involve SEC matters.

10.6.1 Requirements for confirmation

Under Section 1129(a), the plan must meet all of the following requirements for confirmation:

1. The plan and its proponent must comply with the applicable Bankruptcy Code provisions (Sections 1122, 1129(a)(1)(2)).
2. The plan must be proposed in good faith and not be forbidden by law in any way (Section 1129(a)(4)).
3. Payments for the administration of the case must be approved and disclosed (Section 1129(a)(3)).
4. Directors, officers, and the voting trustee who will be appointed to serve after the reorganization must be disclosed, and their appointment must be consistent with the interests of creditors, equity security holders, and public policy. The identity and compensation of any insider to be employed must be disclosed (Section 1129(a)(5)).
5. Any rate changes in the plan must be approved by the government regulatory commission having jurisdiction over such rates (Section 1129(a)(6)).
6. The plan must satisfy the best-interest-of-creditors' test (described below) (Section 1129(a)(7)).
7. The plan must be accepted by each class of impaired claims and interests (except for cramdown provisions) (Section 1129(a)(8)).
8. The plan must provide for the payment of priority claims, administrative expenses, involuntary gap claims, employee wages, and taxes (Section 1129(a)(9)).
9. The plan must be accepted by at least one impaired class (Section 1129(a)(10)).
10. The plan must be feasible (Section 1129(a)(11)).
11. The plan must not discriminate unfairly and must be fair and equitable with respect to each class (Section 1129(b)).

10.6.2 Cramdown

When unanimous approval is not obtained, the court may confirm the plan if one class of claims or interests accepts the plan and if the best-interest and absolute-priority tests are met. To meet the best-interest test, each holder of a claim or interest must receive at least what would have been received under a Chapter 7 liquidation. Secured creditors must receive at least the value of the property that secures the claim.

The absolute-priority test requires that no class of claims or interests junior to a nonaccepting impaired class may receive anything until the nonaccepting class has been fully compensated. Once these requirements are met, the court may confirm the plan over the dissent of one or more classes. Confirmation under these circumstances is known as *cramdown* and must be requested by the proponent of the plan.

10.6.3 Effect of confirmation

Confirmation discharges the debtor from all pre-petition debts except as provided in the plan, the confirmation order, and under Section 1141(d), nondischargeable debts. Confirmation is binding on the debtor, stockholders, and all creditors. Confirmation vests all the property of the estate in the debtor unless the plan or order provides otherwise.

11. CHAPTER 12: ADJUSTMENT OF DEBTS OF A FAMILY FARMER WITH REGULAR ANNUAL INCOME

11.1 Introduction

Chapter 12 was enacted by the Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986. It is modeled after the Chapter 13 plan of reorganization but makes it easier for a family farmer to confirm a plan of reorganization.

Typically, family farmers in need of financial reorganization have too much debt to qualify as debtors under Chapter 13 and many find Chapter 11 complicated, time-consuming, expensive, and in many cases unworkable. Chapter 12 is designed to give family farmers facing bankruptcy a chance to reorganize their debts and keep their land. Under Chapter 12, secured creditors are prevented from lifting the stay (that is, foreclosing) due to lack of adequate protection, provided the debtor pays "reasonable rent customary in the community." Thus, a farmer whose land values have decreased will be able to shift much of the loss to secured lenders.

11.2 Eligibility

In addition to individuals, partnerships and corporations in which 50 percent or more of the equity is held by one family may qualify for

Chapter 12. To qualify for Chapter 12, all the following criteria must be met:

1. Aggregate debts do not exceed \$1,500,000.
2. At least 80 percent of the debt (excluding debt for the principal residence) arises out of a farming operation.
3. More than 50 percent of the gross income in the taxable year prior to filing was from farming.
4. Annual income is sufficiently stable and regular to permit payments under the plan.

11.3 Operation of the Farm; Appointment of a Trustee

Like Chapter 11, Chapter 12 allows the family farmer to maintain possession and operation of the farm. A trustee, however, is automatically appointed to oversee the operation, file reports and attend hearings, account for the debtor's property, examine creditor claims, investigate the debtor's conduct, and report any dishonesty, fraud, or misconduct. This dual system of control is unique to Chapter 12. As in Chapter 11, a debtor farmer in possession may be removed for cause.

11.4 Filing the Plan

Under Section 1222, the debtor must file a reorganization plan within ninety days of the order for relief. The plan must provide that the debtor turn over to the trustee all future income and earnings to the extent necessary to carry out the plan. Unless agreed otherwise, it must also provide that all Section 507 priorities (see section 16.5 of this chapter) are paid in deferred cash payments and it must treat each class of claims and interests equally. Although the payment period ordinarily may not extend over more than three years, the court may increase this to up to five years.

The Chapter 12 plan may provide for repayment of secured debts over a period that exceeds the length of the plan. In addition, payments in the plan only need to have a present value that is equal to the value of the secured creditor's collateral. Thus, for example, if a farmer bought property worth \$1 million with a secured loan of \$850,000, and the value of the land securing the loan decreased by 50 percent, the secured lender would have a secured claim of \$500,000 and an unsecured claim of \$350,000. Under Chapter 12, the farmer would be able to keep the farm by making payments only on the secured claim and could treat the balance as unsecured.

11.5 Creditor Protections

Chapter 12 creditors are afforded less “adequate protection” (see section 10.6.2 of this chapter) than are Chapter 11 creditors. Section 1205 requires that the debtor compensate a secured creditor seeking relief from the automatic stay (1) only for any decreases in the value of the collateral, either by making cash payments or by providing additional or replacement liens (for example, a lien on a crop), or (2) by paying the creditor for the continued use of the collateral with a “reasonable rent customary in the community,” based on the debtor’s annual income and earning ability. Thus, if a farmer’s income is low and the farmland has decreased substantially in value, Chapter 12 could substantially reduce the farmer’s interim obligation if the reasonable rent is less than the principal and interest in the mortgage.

It is also easier for Chapter 12 debtors to sell farmland and equipment outside the ordinary course of business, as long as the sale proceeds are subject to existing valid liens.

11.6 Approval of the Plan

The court is to hold a hearing on confirmation of the plan within forty-five days of filing. The court may approve a plan over the objections of unsecured creditors if it offers the unsecured creditors at least what they would have received under Chapter 7, or if all disposable income of the farmer in the plan period is applied to plan payments. *Disposable income* means income that is not reasonably needed for support of the debtor’s family or for expenditures necessary for the continued operation of the farming business.

11.7 Discharge

After all payments required under the plan are paid, Chapter 12 debtors can get a full discharge of their unsecured debts. The debtor can also get a hardship discharge if the debtor fails to make full payments under the plan and shows that (1) he or she is not responsible for the failure to make full payment, and (2) modification of the plan is not practical. This option is available only if unsecured creditors have received more than they would have received had the debtor liquidated under Chapter 7.

12. EXEMPTIONS

12.1 Introduction

Exemptions provide the main vehicle through which a debtor is given a fresh start after a bankruptcy. The exemption system protects certain property of the debtor both from inclusion in the debtor's estate for liquidation and from judicial liens and other security interests.

Although exemptions may apply to cases filed under Chapters 11 and 13, they are most significant in Chapter 7. Debtors in Chapters 11 and 13 usually propose their own debt adjustment and reorganization plans that control the disposition of their property. Further, exempt property under a Chapter 11 plan may not be disposed of without the debtor's permission.

12.2 Claiming Exemptions

A debtor must file a statement, specifying property claimed as exempt, on or before the creditors' meeting but in any case no later than thirty days after filing the petition. The statement is included on scheduled forms.

12.3 Federal vs. State Exemptions: Sometimes a Debtor's Choice

The individual debtor may choose either the federal exemptions provided in the Bankruptcy Code or the exemptions afforded in the debtor's state and under federal nonbankruptcy law. The choices are mutually exclusive.

If the debtor's state has "opted out" or prohibits debtors within that state from choosing the federal bankruptcy package, the debtor must claim the exemption provided by the state. To date, most states have opted out.* Section 522(b) requires a husband and wife to choose

*States that have opted out are Alabama, Arizona, Arkansas, California (with some exceptions), Colorado, Delaware, Florida, Georgia, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Mississippi, Montana, Nebraska, Nevada, New Hampshire, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, South Carolina, South Dakota, Tennessee, Utah, Virginia, West Virginia, and Wyoming.

the same exemption system. If they fail to do so, they will be given the federal exemptions, unless their state has opted out.

If the debtor chooses the federal exemptions, the debtor will waive all nonbankruptcy federal exemptions and state exemptions. In addition, the debtor will lose any state protections of joint tenancies and tenancies in the entirety, such as a law against creditors' reaching such interests. If the debtor chooses the noncode (state) exemptions, the debtor may use both state and local law and any federal nonbankruptcy statute. The state or local law that applies is that of the place where the debtor has been domiciled for most of the 180 days immediately preceding the bankruptcy filing.

12.4 Federal Bankruptcy Exemptions

The federal bankruptcy exemption system is found in code Section 522. All property claimed as exempt must be property of the debtor's estate. Since the debtor's estate is defined very broadly—that is, as “all legal and equitable interests of the debtor”—it is unlikely that any claimed property would be outside the bankruptcy estate. A debtor who has chosen the code exemptions has the following exemptions available under Section 522(d).

12.4.1 The homestead exemption

Probably the best known is the homestead exemption. Specifically, the exemption protects a maximum of \$15,000 in the homestead. *Homestead* is defined as real or personal property that the debtor or a dependent uses as a residence.

12.4.2 The grubstake exemption

If the debtor has no homestead or simply prefers to do so, the debtor may apply the homestead exemption to the only unrestricted exemption available in the code. This exemption allows the debtor to exempt any interest in the property to a maximum of \$800, plus up to half or \$7,500 of any unused portion of the homestead exemption. This unrestricted \$8,300 exemption is known as the *grubstake exemption*. This exemption allows the debtor greater flexibility in protecting his or her most cherished property because it covers any property without restriction.

12.4.3 Exemptions specific to specific property

All other exemptions under the code are restricted to particular property. Although a few are available without limitation, most are limited as to value, value and use, or need.

Properties exempt without limitation include

- Professionally prescribed health aids for the debtor or a dependent.
- The right to receive Social Security, unemployment compensation, local public assistance, veterans and certain employment benefits.
- The right to receive the proceeds from property traceable to crime-victim awards.
- Any unmatured life insurance policy.

Exemptions limited by value include

- Up to \$2,500 interest in a motor vehicle.
- Up to \$4,000 value in a life insurance policy.
- The right to receive up to \$7,500 in a personal injury award or the property traceable therefrom.

Exemptions limited by value and use include

- Personal, family, and household property up to \$400 in any single item or an aggregate of \$8,000.
- Tools of trade up to \$1,500 of the debtor or a dependent.

Exemptions limited by need or to the extent that they are “reasonably necessary for the support of the debtor and dependents” include

- The right to receive alimony or separate maintenance.
- The right to receive payment under certain stock bonus, pension, profit-sharing, and annuity plans.
- The right to receive pensions and other employment-related permanent benefits.
- The right to receive payment of or property traceable to wrongful death awards of a dependent.
- The right to receive payment of or property traceable to payment of life insurance proceeds.
- The right to receive payment of or property traceable to payment compensating for loss of future earnings.

12.4.4 The “right to receive” and “tracing property”

The “right to receive” language accompanying many exemptions is significant because the right to receive does not necessarily include the debtor’s right to exempt payment itself.

The right to preserve “property traceable” or “tracing” is restricted under the code—only the exemptions under Section 522(d)(11) can be traced. Section 522(d)(11) protects the exemption as it changes form from a right to receive, to payment in the form of a check, to a bank deposit and cash proceeds.

12.5 Avoiding Liens on Exempt Property

Section 522(f) of the Bankruptcy Code provides the debtor and the trustee with two powers to avoid certain liens on exempt property. A debtor’s exemption is thus protected notwithstanding a creditor’s lien on the exempt property.

The first power allows the debtor to avoid a judicial lien on the debtor’s interest in real and personal property to the extent that the lien impairs the exemption. The avoidance of the lien, however, does not extinguish a valid security interest or statutory lien upon which the judicial lien is based.

The second power permits the debtor to avoid certain security interests in consumer goods, health aids, and tools of trade to the extent that the lien interferes with the exemption. Possessory and purchase-money security interests are specifically excluded from the power to avoid. The consumer-goods provision is limited to household furniture and goods, clothing, books, animals (pets may be retained) and crops, musical instruments, and jewelry. Cars and other motor vehicles are notably absent, but a debtor may be able to protect them as a tool of the trade.

13. CONVERSION OF CASES

Conversion refers to the transfer of a case from one chapter of the code to another. A successful conversion creates an order for relief under the chapter to which the case is converted but otherwise does not usually change the commencement date of the case.

A debtor may convert an original Chapter 7 liquidation to Chapter 11, 12, or 13 at any time, as an absolute right. A creditor generally must establish cause to convert at a hearing. The rules are summarized below.

Conversion of Chapter 7 (Section 706)

- To Chapter 11: Debtor can so request without showing cause or a hearing.
- To Chapter 12: Only at the request of the debtor; debtor must meet Chapter 12 eligibility requirements.
- To Chapter 13: Only at the request of the debtor; debtor must meet Chapter 13 eligibility requirements.

Conversion of Chapter 11 (Section 1112)

- To Chapter 7: Debtor may transfer under certain circumstances; creditors must show cause.
- To Chapter 12: At the request of the debtor, if conversion is equitable and the debtor has not received a Chapter 11 discharge.
- To Chapter 13: Only at the debtor's request and only before discharge; debtor must meet Chapter 13 eligibility requirements.

Conversion of Chapter 12 (Section 1208)

- To Chapter 7: At any time at debtor's request, or by the court upon showing of fraud by the debtor.
- To Chapter 11 or 13: Code language provides that a case may be converted only if the debtor may be considered a debtor under those chapters. Recent case law indicates, however, that a Chapter 12 case may not be converted to Chapter 11 or 13 because there is no language under Chapter 12 that specifically allows for conversion to Chapter 11 or 13, or that a case may be converted only if done in good faith.

Conversion of Chapter 13 (Section 1307)

- To Chapter 7: At any time at debtor's request; creditors must show cause.
- To Chapter 11: At request of creditors, before confirmation of the plan and after a hearing for cause.
- To Chapter 12: At the request of the creditor or trustee before confirmation and after notice and hearing; if debtor is a farmer, only at debtor's request.

Double conversions—from an original chapter to another chapter and back again to the original—are allowed only under special circumstances.

14. DISMISSAL OF CASES**14.1 Chapter 7**

Section 707 of the Bankruptcy Code provides that the court may dismiss a case only for cause after notice and hearing. Cause to dismiss includes

- Unreasonable delay by the debtor that is prejudicial to creditors.
- Nonpayment of fees.

- A case involving primarily the consumer debts of an individual debtor when granting relief would be a substantial abuse of code provisions.

14.2 Chapter 13

Section 1307 of the code provides for dismissal for cause after notice and hearing when there is

- Unreasonable delay by the debtors to the prejudice of creditors.
- Nonpayment of fees.
- Failure to file a timely plan.
- Denial of confirmation and denial of request for additional time to file another plan.
- Failure to start timely payments or material default by the debtor on a plan.
- Denial of confirmation of a modified plan and revocation of a confirmation order.
- Termination of a confirmed plan by a contingency other than completion of the plan.
- A debtor's request for dismissal if request is prior to conversion to another chapter.

14.3 Chapter 11

Section 1112 of the code provides for dismissal of a Chapter 11 case for cause and after notice and hearing. The court may dismiss if

- The debtor's estate is of so little value that there is little likelihood of rehabilitation.
- Unreasonable delay by the debtor prejudices the creditors.
- There is a failure by the debtor or other parties to propose a timely plan.
- Confirmation of a proposed plan and request for additional time to present a modified or new plan are both denied.
- There is a revocation of a confirmation order or denial of a modified plan.
- There is an inability to carry out, or a material default on, a confirmation.
- There is inability to effect a plan.
- A plan is terminated by a condition specified in the plan.

14.4 Chapter 12

Section 1208 of the Bankruptcy Code provides for dismissal any time either at the request of the debtor (unless the case has been converted) or at the request of a party in interest for cause after notice and hearing when any of the following circumstances exist:

- Unreasonable delay, or gross mismanagement, by the debtor that is prejudicial to creditors
- Nonpayment of fees
- Failure to file in a timely manner a plan under Section 1221 of the Bankruptcy Code
- Failure to commence timely payments as required by a confirmed plan
- Denial of confirmation of a plan and denial of a request made for additional time in filing another plan or a modification of a plan
- Material default by the debtor with respect to a term of a confirmed plan
- Revocation of the order of confirmation of the plan and denial of confirmation of a modified plan
- Termination of a confirmed plan by reason of the occurrence of a condition specified in the plan
- Continuing loss to or diminution of the estate and absence of a reasonable likelihood of rehabilitation

15. TRANSFERS OF PROPERTY

15.1 Introduction

One goal of the Bankruptcy Code is to use the debtor's assets in a manner that treats creditors within a given class equally. Code provisions that allow a trustee to avoid certain transfers made before or after the petition is filed help to achieve this goal. The term *transfer* is used quite broadly. It includes giving a security interest, attaching a lien, bank deposits, an entry of judgment, sales, and gifts as well as monetary payments. When the trustee is able to avoid the transfer, the property returns to the debtor's estate. Transfers can be divided into two categories: pre-bankruptcy and post-bankruptcy.

15.2 Pre-bankruptcy Transfers

Pre-bankruptcy transfers are transfers of property made prior to petition filing. There are five basic types: preferences, fraudulent conveyances, secret transfers, transfers avoidable under state law, and statutory liens.

15.2.1 Preferences

A *preference* under Section 547 is a pre-petition transfer that favors an individual creditor or allows the creditor to get more than the creditor would otherwise get in a Chapter 7 liquidation case. The court may avoid the preference if, under Section 547(b), there is a transfer of the debtor's property

- To a creditor.
- For a prior debt.
- Made within ninety days prior to the petition.
- While the debtor is insolvent.
- That allows the creditor to receive more than the creditor would otherwise have received under a Chapter 7 case if the transfer had not been made and the creditor had been paid for the debt to the extent provided under the code.

The trustee has the burden of proving each element. Usually, the trustee will have little or no problem with the first four, because they are easily determined and objective.

The debtor's insolvency is a rebuttable presumption under Section 547(f) if the transfer was made within ninety days prior to the petition date. The transferee has the burden of rebutting this presumption. There is no requirement that the transfer be out of the ordinary or that the debt be past due. A regular payment on an installment loan may be a preference.

The last element is often difficult to determine. The question is whether the creditor received more by the transfer than the creditor would have received in a Chapter 7 liquidation.

If the trustee establishes all of the elements under Section 547(b), an avoidable preference has been established.

There are seven exceptions to the rule that avoids preferences:

- *Contemporaneous exchanges*. The key factor is that the parties *intended* the exchange to be simultaneous. A typical contemporaneous exchange occurs when a creditor extends new value to the debtor and the debtor for some reason cannot fully pay for the new value at the

time of the transaction. If the debtor returned later the same day, for example, to sign a note or make full payment, the exchange would be contemporaneous and not a preference. Payment by check, unless dishonored, for new value given in exchange is considered a contemporaneous exchange. At some point, the passage of time before payment or security by collateral will make the exchange no longer contemporaneous.

- *Payments in the ordinary course.* A payment made to the creditor within forty-five days of incurring the debt, if both debt and payment occurred in the ordinary course of the debtor's business or financial affairs, such as a regular monthly payment of a utility bill.
- *Consumer debts.* Transfer of consumer goods with a value of less than \$600.
- *Statutory liens.* Statutory liens that are valid under Section 545.
- *Inventory and receivables.* A continuing security interest in changing inventory or receivables is protected except when the creditor's position is improved to the prejudice of creditors holding unsecured claims during the ninety days before the petition. Any improvement in the value of inventory that occurs within ninety days of filing is suspect. For example, assume that ninety days before filing, inventory that is collateral for a debt of \$25,000 has a value of \$17,000. On the date of filing, the value of the inventory has increased to \$21,000. This \$4,000 increase in the inventory improves the position of the creditor whose claim it secures. To the extent that it reduces the value of the debtor's assets available to pay other unsecured creditor claims, it is a preference.
- *Purchase-money security interests.* Perfected security interest granted in exchange for loans when the proceeds are used to finance specific property.
- *New value.* Cash payments on a running account if the creditor extends new unsecured credit after the payments are made. Payments are protected to the extent that the new credit is extended. For example, if the debtor owes a creditor \$1,000 and pays \$600, and the creditor then extends another \$800, the \$600 payment is protected. Had the creditor extended only \$400 in new credit, only \$400 would be protected.

15.2.2 Fraudulent conveyances

Section 548 of the Bankruptcy Code allows the trustee to avoid transfers of the debtor's property or of obligations incurred by the debtor

- Made with the actual intent to hinder, delay, or defraud the creditors. The debtor's insolvency need not be proved to avoid this type of transfer.
- Made to a general partner while the debtor was insolvent or from which the debtor became insolvent.
- For which the debtor received less than the reasonably equivalent value for the property and
 - That was made while the debtor was insolvent or from which the debtor became insolvent; or
 - From which the debtor was left with an unreasonably small amount of capital with which to operate a business; or
 - When the debtor intended to incur debts that the debtor knew could not be paid when due.

Only transfers made within a year preceding the petition may be avoided. Except to the extent that a transfer or obligation voidable under this section is voidable under Section 544, 545, or 547, a transferee or obligee of the transfer or obligation who takes for value and in good faith has a lien and may retain the interest transferred, or may enforce the obligation to the extent of the value given. A fraudulent conveyance is governed both by the Uniform Fraudulent Conveyances Act, if adopted by the debtor's state, and by Section 548 of the Bankruptcy Code. There is no time limit on avoiding transfer under the UFCA.

15.2.3 Unrecorded transfers

An unrecorded transfer is a transfer of property that has not been made a matter of public record. The code requires parties to comply with the recording acts of their states. There are two situations in which the code requires compliance with the state recording acts:

1. Section 547(e) provides that an unrecorded or untimely recorded security interest may become a preference. The security interest, if it is not recorded within ten days of the transfer, is deemed transferred when it is actually filed. Therefore, if a transfer protected by a security interest is made prior to the ninety-day prefiling preference period but is recorded within ninety days (unless recorded within ten days of the transfer) prior to the petition, it becomes a preference if the other requirements for a preference are met. The security interest is avoidable and the creditor is unsecured.
2. Section 548(d) of the Bankruptcy Code concerns the time when a transfer is made for the purpose of invalidating a fraudulent conveyance. Its purpose is to prevent a fraudulent conveyance from becoming good by reason of being kept secret for longer than the

one-year time limit. Thus, a fraudulent conveyance (see section 15.2.2 of this chapter for transfers considered by the code to be fraudulent conveyances) made more than one year before filing, but not recorded until within one year of filing, is deemed transferred as of the date of recording and thus falls within the avoiding time limit under Section 548. Section 548 makes the date of recording or perfection the crucial factor, rather than the date of the actual transfer. If, on the date of recording or perfection, the financial condition of the debtor or the debtor's actions would have made an *actual transfer* of the property on that date a fraudulent conveyance, the transfer becomes a fraudulent conveyance, regardless of whether it was so at the time of transfer. If recorded within a year prior to filing, the trustee can avoid it.

15.2.4 Transfers avoidable under state law

Section 544(a) grants the trustee the status and thus the avoiding power of a lien holder as of the commencement of the case. The trustee's powers are derivative and hypothetical, not requiring the existence of an actual creditor. The lien creditor's status in all but one state (Louisiana) derives from Article 9 of the Uniform Commercial Code. The hypothesized lien extends to any property that could be subject to a lien under the applicable state law.

Article 9 of the Uniform Commercial Code grants the lien creditor priority over unperfected security interests; any power of the lien holder to avoid transfers of property under this provision is thus granted to the trustee. The primary impact of this power is to allow the trustee to avoid the transfer of unperfected security interests in personal property. In addition, Section 544 allows the trustee to avoid a variety of unfiled, imperfectly filed, and incomplete transfers of interest.

A second provision under Section 544(a) grants the trustee the status of a bona fide purchaser of real estate. Thus, where a recording act exists and a grace period is inapplicable, the trustee may avoid transfers that are not recorded or perfected prior to the bankruptcy petition.

Section 544(b) allows a trustee to stand in the shoes of actual, as opposed to hypothetical, unsecured creditors who exist at the date of the petition and to avoid any transfers that are avoidable by them. This provision does not strip creditors of this state-created power but rather shifts it to the creditor's representative. The importance of this power, however, is severely limited because of the restricted rights of the unsecured creditor. These avoidance powers will thus have no impact on security interests perfected prior to the petition filing.

15.2.5 Statutory liens

A *statutory lien* is one that arises automatically by virtue of statute and is not based on contract or judicial action. Section 545 of the Bankruptcy

Code allows the trustee to avoid certain statutory liens. In general, Section 545 provides that the trustee may avoid a statutory lien that (1) first becomes effective upon the insolvency or bankruptcy of the debtor, (2) is not perfected or unenforceable against an existing or hypothetical bona fide purchaser at the time of the commencement of the case, or (3) is for rent or for the seizure of property for nonpayment of rent.

15.3 Postpetition Transfers

The commencement of a case creates an estate in the debtor's property. Property acquired before the day of filing becomes part of the estate, while property acquired after commencement generally belongs to the debtor. During the tenure of an interim trustee, after commencement but before a permanent trustee is selected, the debtor usually has control of and possession of the estate assets. Any transfer made by the debtor during this period is subject to Section 549.

Section 549 protects certain transferees. The consideration received by the debtor from the transfer becomes part of the estate. A transfer is protected if the postpetition transfer was authorized by the court. Transfers after commencement of an involuntary case, but before the order for relief is entered, are valid to the extent of the value given to the debtor. Transfers of realty by the debtor after filing of a voluntary case and after an order for relief in involuntary cases are valid against a good-faith purchaser at a judicial sale in a county other than that in which the petition is filed. To be protected, the purchaser must also have properly recorded the transfer before a copy of the petition is filed in the county where the land is located.

Section 542(c) protects a third party, such as a bank, that transfers property after the petition is filed if the third party transferred in good faith without knowledge of the petition. In these cases, only the third party or transferor is protected, not the transferee.

15.4 Limitations on the Trustee's Avoiding Powers

Section 546 of the Bankruptcy Code places limitations on the trustee's avoiding powers under certain circumstances. The trustee must bring any action to avoid a transfer within two years after the trustee's appointment to the case or before the case is closed or dismissed, whichever is earlier.

The trustee must also recover the transferred property within one year after the avoidance or before the case is closed or dismissed, which-

ever is earlier. Moreover, the trustee may not recover more than the property itself or the value of such property, and he or she cannot get anything further from a transferee who may be jointly liable.

Secured parties who perfect under state or other applicable law that allows the perfection to relate back to an earlier date are protected from the trustee's avoiding powers granted under Sections 544, 545, and 549. For example, a creditor with a mechanic's lien covering materials sold to the debtor that relates back to the time when the materials were first provided to the debtor would be good against the trustee.

A seller who has sold goods in the ordinary course of business to the debtor while the debtor was insolvent may retain those goods, if the seller makes a written demand for such goods within ten days of the debtor's receipt of the goods. The court, however, may deny reclamation to the seller if it grants the seller's claim priority status as an administrative expense under Section 503(b) of the code, or if it gives the seller a lien to secure the claim. Grain producers and U.S. fishermen are specifically given similar reclamation protections under Section 546(d).

Section 546(e) bars the trustee from avoiding certain margin and settlement payments made in good faith and, before the commencement of the case, by or to a stock or commodity broker, a securities clearing agency, a financial institution, or a forward-contract merchant. Subsection (f) protects margin and settlement payments made by or to a repo participant in connection with a repurchase agreement in a similar manner.

16. CREDITORS' RIGHTS AND PROTECTIONS

16.1 Proof of Claims and Interests

A creditor may file a proof of claim and an equity security holder may file a proof of interest in a bankruptcy case under Chapters 7, 11, and 13 (Section 501). A claim generally refers to a creditor's right to receive a payment of money. The interest of an equity security holder is based on ownership of corporate stock or on a limited partnership.

In a Chapter 7 or 13 case, a creditor must file a proof of claim to receive a distribution from the estate. Filing of a claim in a Chapter 11 case may be optional, since the proof is deemed to be filed for any claim or interest that appears on the debtor's schedules and is not designated as disputed, contingent, or unliquidated; otherwise, a timely proof of claim or interest must be filed in a Chapter 11 case (Section 1111(a)). Of course, the better practice is for a creditor to file a claim whether or not the creditor is listed in the schedules.

If a creditor fails to file a timely claim, a co-obligor, debtor, or trustee may file a claim for the creditor. This right may be useful for the debtor if the creditor's claim is not dischargeable.

16.2 Requirements for Filing

A proof of claim (the requirements for filing a proof of claim are set out in Bankruptcy Rules 3001–3008) in a Chapter 7 or 13 case must be filed within ninety days of the first date set for the creditor's Section 341 meeting. The United States, a state or subdivision, and an infant or incompetent may be granted additional time by the court. Unsecured claims arising from a judgment may be filed within thirty days after a final judgment. Chapter 11 creditors, if they are required to file a claim, must file at a time set by the court.

A proof of claim must be in writing and in the required form. Supporting documents must also be filed if the claim is based on a writing (e.g., contract, promissory note, or letter agreement) or security interest. A trustee is likely to object to a claim filed without supporting documents. The claim should indicate principal, interest, and service charges.

16.3 Objections to a Claim

A proof of claim comprises prima facie evidence of the amount and validity of the claim, which is deemed to be allowed unless another party in interest objects to the claim. To overcome the prima facie case, the objecting party must offer specific evidence establishing the basis of the objection. If the court determines that the evidence overcomes the prima facie case, the claimant must prove the validity of the claim by a preponderance of evidence.

An objection to a claim must be in writing and filed with the court. Upon receiving the objection, the court will ordinarily schedule a hearing on the objection. A copy of the objection and a notice of the hearing must be mailed or delivered to the claimant, debtor, and trustee at least thirty days prior to the date of the hearing. The objection hearing requires judicial resolution by the court.

16.4 Disallowance of Claims

Under Section 502(b) the following claims are disallowed:

- A claim that is unenforceable against the debtor by reason of an agreement or applicable law
- A claim for unmatured interest

- An unsecured property-tax claim that exceeds the value of the property
- A claim for pre-petition services of an insider or attorney for the debtor that exceeds the reasonable value of the services
- A claim for postpetition alimony, maintenance, and support
- A claim for damage resulting from termination of a lease to the extent that the claim exceeds a formula provided in the code
- A claim for damages resulting from termination of an employment contract to the extent that the claim exceeds a formula provided in the code
- A claim that resulted from the reduction, due to late payment, of a credit available to the debtor in connection with an employment tax

Other restrictions on the allowance of claims concern claims by parties that hold assets of the estate or are transferees of avoidable transfers (Section 502(d) and claims of parties that are co-obligors on debts of the debtor (Section 502(e)).

16.4.1 Reconsideration of disallowed claims

A disallowed claim may be reconsidered for cause and allowed according to the equity of the case. If a previously disallowed claim is later allowed, claimants in the same class who have been paid need not return the payments but will not be entitled to further payments until the holder of the newly allowed claim has received equivalent payment (Section 502(j)).

16.4.2 Estimating contingent and unliquidated claims

Contingent and unliquidated claims may be estimated and allowed if the fixing and liquidation of the claims would not delay unduly the administration of the case. Generally, the bankruptcy judge will estimate the value of the claim, and the court's estimation will not be overturned unless there is a clear abuse of discretion (Section 502(c)).

16.5 Priorities

Priorities are designed to assure payment of certain classes of claim before other classes are paid. Priorities are set by Congress, and the courts are not free to fashion priorities within any given class. Debts falling within each priority must be fully satisfied before debts in the next priority can begin to receive payment. Priorities are established in Section 507.

16.5.1 First priority

Administrative expenses and fees are given first priority by Section 507(a)(1). Generally, administrative expenses include all the expenses necessary to administer the estate or conduct business incurred after the order for relief is granted. Salary and reimbursement for necessary expenses are allowed under this priority to an accountant who renders services after the commencement of the case to preserve the debtor's estate. Other expenses and fees include court fees and taxes incurred during the administration of the estate.

16.5.2 Second priority

Involuntary "gap" creditors with unsecured claims receive second priority under Section 507(a)(2). An involuntary gap creditor is one who has extended credit or sold goods or services to the debtor after the filing of an involuntary bankruptcy petition but before an order for relief is entered and a trustee is appointed. Creditors in this category include government units that have claims for tax liabilities incurred during the gap period. These gap claims must be unsecured.

16.5.3 Third priority

Third priority under Section 507(a)(3) is granted to individuals who have allowed unsecured claims for wages, salaries, and commissions earned within ninety days before the date of petition filing or as of the date the debtor ceased business, whichever is earlier. The maximum allowed on such a claim is \$4,000 per individual. The term *wage* is quite broad and includes withheld income and Social Security taxes as well as vacation, severance, and sick-leave pay. Holders of wage claims who live in states that allow unavoidable liens on the debtor's assets for wages due may be granted super-priority status.

16.5.4 Fourth priority

Claims for contributions to employee benefit plans such as pensions or life and health insurance plans, arising from services rendered within 180 days before the date of petition filing or as of the date the debtor ceased business, whichever is earlier, are accorded fourth priority under Section 507(a)(4)). The value of these claims must not exceed \$2,000 times the number of employees covered, minus the amount paid in wages. Amounts that exceed this limit must be pro-rated between employees.

16.5.5 Fifth priority

Fifth priority under Section 507(a)(5) is granted to certain persons who produce and raise grain and who have allowed unsecured claims

against a debtor who owns or operates a grain-storage facility. Commercial fishermen with claims against a debtor who is operating a fish-produce storage or processing facility are also included in the fifth priority. Claims in these two categories are limited to \$4,000 per individual.

16.5.6 Sixth priority

An individual consumer who has made deposits for undelivered goods or services from the debtor is entitled to sixth priority under Section 507(a)(6). Claims in this category must have arisen in a consumer transaction and may not exceed \$1,800 per person.

16.5.7 Seventh priority

Taxes are afforded seventh priority. The types of taxes due include income and gross receipts taxes; property taxes; employment and Social Security taxes; federal, state, and local excise taxes; and customs duties. Penalties related to tax claims are given priority only to the extent that the penalty is compensation for actual pecuniary loss. Priority taxes are covered under Section 507(a)(7) and are quite specific. That section should be examined for additional details.

16.6 Super-Priorities

Under certain circumstances the code provides “super-priority” status to some creditors. Claims that have super-priority status have priority over all the Section 507 priorities.

16.6.1 Super-priority to secured creditors

Under Section 507(b), a secured creditor has super-priority in a case in which the trustee (or the debtor in possession in a Chapter 11 case) has given the creditor inadequate protection of the creditor’s interest. The creditor is given an administrative expense claim under Section 503(b)(1)(A) that is superior to other claims in this class. Inadequate protection would result from a limitation in the value of the secured creditor’s collateral because of an automatic stay under Section 362; from the use, sale, or lease of the collateral under Section 363; or from the granting of a lien under Section 364.

A trustee can provide adequate protection by

- Making one or more cash payments to the creditor to the extent that the value of the creditor’s collateral is diminished.
- Providing the creditor with an additional or replacement lien to the extent of the decrease in value of the creditor’s collateral.

— Granting some other relief that serves to give the creditor the value of the diminution in value.

Super-priority status is given to the creditor to the extent that the three preceding provisions are inadequate. To be eligible for Section 507(b) benefits, the creditor must have made a timely request for adequate protection.

16.6.2 Super-priority when there is conversion

A second super-priority arises when a case is converted from Chapter 11 or 13 to Chapter 7. In this circumstance, the administrative expenses incurred in the Chapter 7 case have priority over the expenses incurred prior to conversion (Section 726(b)).

16.6.3 Debts incurred by a trustee

A third super-priority arises from debts incurred by a trustee as authorized by the court when the trustee has failed in all other efforts to obtain unsecured credit (Section 364(c)(1)).

16.7 Involuntary Petitions

Nearly all bankruptcy cases are begun by debtors, but creditors may commence an involuntary case under Chapters 7 and 11. Involuntary petitions under Chapter 13 and against farmers and nonprofit corporations are prohibited. The governing code section is Section 303.

16.7.1 Filing an involuntary case

An involuntary case is commenced by filing a Chapter 7 or a Chapter 11 petition with the bankruptcy court. The petition must include all required supporting documents. Upon filing, a summons will be sent to the debtor. A hearing is then set to establish the propriety of the petition or the presence of both the requisite number and value of claims and the grounds for relief. A debtor must answer the petition, and there may be discovery and other prehearing activity. The time period between initial filing and resolution of the petition is referred to as the *involuntary gap period*.

16.7.2 Prerequisites of filing

The petition must be filed by at least three creditors if there are twelve or more creditors, and by at least one if there are fewer than twelve. Petitioners must also show that the debtor owes an aggregate of at least \$10,000 in unsecured claims to be eligible to file an involuntary petition.

Creditors who do not, by themselves, meet these requirements may also establish their claims after the petition has been filed. Holders of contingent claims—claims that will require payment only upon the occurrence of certain extrinsic events—are ineligible.

A claim may be eligible for relief under an involuntary petition but may not be included in the count of the requisite number of creditors. These claimants are the debtor's employees, insiders of the debtor, and recipients of avoidable transfers. A holder of more than one claim is counted only once.

16.7.3 Grounds for relief in an involuntary petition

Creditors must show one of two grounds for relief. The first is that the debtor is generally not paying debts as they become due. There is no precise number or value established to prove that a debtor is not paying debts. This determination is made on the facts of each case.

The second ground for relief is the fact that a custodian has been appointed or has already taken substantial control of the debtor's property within 120 days of the petition. Petitioning creditors may also be required by the court to post bond for expenses to the debtor if the petition is dismissed for cause. Cause usually requires evidence of bad faith, improper motive, or little chance of success on the petition.

16.7.4 Involuntary gap period

During the involuntary gap period the debtor is generally free to conduct his or her business or financial affairs. The court may, however, impose restrictions or limitations on the debtor if there is a fear that the debtor may fail to preserve estate assets. Debtors may also transfer property during the gap period for a debt, but the trustee may be able to avoid such transfers on pre-petition debts.

16.7.5 Appointment of an interim trustee

An interim trustee may be appointed under Section 303 in Chapter 7 cases. To appoint an interim trustee in Chapter 11 cases, the requirements of Chapter 11 must be met (Section 1104). The interim trustee may be appointed only after notice to all parties in interest, and creditors requesting an interim trustee must post a bond to indemnify the debtor. Similarly, if the debtor wishes to remove an interim trustee, the debtor must post a bond sufficient to indemnify the state against waste and/or mismanagement during the gap period.

16.7.6 Resolving the involuntary petition

The involuntary petition will result in either an order for relief or dismissal. If an order for relief is granted, the case will proceed in the same manner as a voluntary case. If the case is dismissed, the court may award the debtor costs, attorneys' fees, and proximate and punitive damages when applicable. An involuntary petition may also be dismissed prior to a hearing determination in certain circumstances. These are usually the consent of all petitioning creditors or a sudden improvement in the financial condition of the debtor, making the petition pointless. A dismissal under these circumstances must be preceded by a notice to all creditors and a hearing.

17. INCOME TAX IMPLICATIONS

Transfers of property generally have certain income tax consequences. Taxable gains or losses are normally determined by computing the difference between the sale proceeds and the taxpayer's basis in the property conveyed.

Discharge or cancellation of indebtedness is also normally included in taxable gross income under Internal Revenue Code Section 108. This income is reported in the taxable year in which the debtor's obligation is canceled or discharged. Taxable income is not realized to the extent that payment of the debt would have given rise to a deduction (such as forgiveness of accrued interest in the case of a cash-basis taxpayer). The amount of debt discharge income is simply the difference between the debt reduction and the consideration paid to obtain that amount of reduction.

The Internal Revenue Code provides a number of special provisions applicable to transfers of property and cancellation of indebtedness activity conducted by insolvent and bankrupt taxpayers.

17.1 Bankruptcy

The Bankruptcy Tax Act of 1980 added Internal Revenue Code Section 1398, which states that, for individuals, a bankruptcy petition creates a new taxable entity. This separate taxable entity for federal income tax purposes is created in bankruptcy filings under Chapters 7 and 11 but not under Chapter 13. A separate tax entity is *not* created when a corporation or a partnership files for bankruptcy (IRC Section 1399).

These rules have the following consequences:

- In the case of a corporation under bankruptcy, any income or loss from transfers of property or debt discharge income should be reported on its regular income tax return.
- In the case of an individual, any income or loss from pre-petition property transfers or pre-petition debt writedowns should be reported on the debtor's individual income tax return. Any tax liability on this individual return cannot be eliminated by a bankruptcy filing at a later date.
- The filing of a Chapter 7 or 11 bankruptcy creates a separate taxable entity, and the estate consists of the property (except exempt property) belonging to the debtor before bankruptcy. Any transactions involving this estate property or debt while the bankruptcy is open should be reported on the bankrupt estate's fiduciary income tax return.
- Any tax liability created in the bankruptcy estate is an administrative expense of the estate. The tax obligation is not a debt of the debtor, but of the estate. Upon termination of the estate, any remaining tax liability that is unpaid because of insufficient assets does not revert to the debtor.
- Special tax provisions permit the debtor to elect to close the tax year upon commencement of the bankruptcy. This would necessitate filing two short-year returns during the calendar year in which the petition begins. The major advantage of this election is that it allows a debtor to use individual tax attributes on the initial short-year return. Without the election, any individual tax attributes (such as net operating loss carryovers) would flow to the fiduciary income tax return of the estate and would not be available to offset any of the debtor's taxable income during the year the debtor files bankruptcy. An exception would occur if a debtor's tax attributes exceeded the reportable income (including debt discharge income) in the tax return of the bankruptcy estate, in which case remaining unused attributes would be passed from the estate back to the debtor.

17.2 Insolvency

Income or loss on the transfer of property by an insolvent taxpayer outside of bankruptcy is reported on the taxpayer's income tax return just as a solvent taxpayer would report the income or loss. However,

income from the discharge or cancellation of debt is treated differently depending upon whether a taxpayer is solvent or insolvent.

Internal Revenue Code Section 108 provides the general rule that income from the discharge or cancellation of indebtedness is included in taxable gross income. If any one of the following situations exists, income from the discharge or cancellation of indebtedness can be excluded from income:

- The debtor is in bankruptcy under Title 11 of the United States Code.
- The debtor is insolvent. *Insolvency* is defined as the excess of liabilities over the fair market value of assets. To exclude income, the taxpayer must be insolvent before and after the discharge of indebtedness. To the extent that the taxpayer becomes solvent because of the discharge, the taxpayer will need to report the debt cancellation as taxable income. Exempt property can be excluded in determining the fair value of the assets. The exclusion of cancellation of indebtedness income causes certain tax attributes to be reduced. The tax attributes that need to be reduced include:

Net operating loss carryovers.

Credit carryovers.

Capital-loss carryovers.

Basis in the taxpayer's remaining assets (both depreciable and non-depreciable). However, the aggregate basis of the debtor's remaining assets cannot be reduced below the total amount of the taxpayer's remaining undischarged liabilities.

REFERENCES

Aaron, Richard E. *Bankruptcy Law Handbook*. New York: Clark Boardman Callaghan, 1990.

AICPA. *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code*. (Statement of Position 90-7.) New York: American Institute of Certified Public Accountants, Inc., 1990.

Altman, Edward I. *Corporate Financial Distress: A Complete Guide to Predicting, Avoiding, and Dealing with Bankruptcy*. 2d ed. New York: John Wiley & Sons, Inc., 1993.

———, ed. *Bankruptcy and Distressed Restructurings: Analytical Issues and Investment Opportunities*. Burr Ridge, Ill.: Irwin Professional Publishing, 1992.

- Anzivino, Ralph C. *Partner and Partnership Bankruptcy*. (Business Practice Library Series.) New York: John Wiley & Sons, Inc., 1987.
- Bankruptcy Law Reporter*. Chicago: Commerce Clearing House. Loose-leaf service.
- Bienenstock, Martin J. *Bankruptcy Reorganization*. New York: Practising Law Institute, 1987.
- Buzzell, Allyn, ed. *Consumer Bankruptcy*. Washington, D.C.: American Bankers Association, 1991.
- Cohen, Arnold B., and Mitchell W. Miller. *Consumer Bankruptcy Manual*. 2d ed. Boston: Warren, Gorham & Lamont, 1991.
- Collier Bankruptcy Manual*, 3d ed. 3 vols. New York: Matthew Bender, 1979. Loose-leaf service.
- Ginsberg, Robert E., and Robert E. Martin. *Bankruptcy*. 4th ed. New York: Prentice Hall, 1995.
- Lebowitz, Harvey M. *Bankruptcy Deskbook*, 2d ed. New York: Practising Law Institute, 1990.
- Lee, Joe. *Bankruptcy Practice Systems PSL*. New York: Clark Boardman Callaghan, 1993.
- Murphy, Patrick A. *Creditors' Rights in Bankruptcy*, 2d ed. Colorado Springs, Colo.: Shepard's McGraw-Hill, Inc., 1988.
- Newton, Grant W. *Bankruptcy and Insolvency Accounting*, 5th ed. New York: John Wiley & Sons, Inc., 1994.
- _____ and Gilbert D. Bloom. *Bankruptcy Taxation*. 2d ed. New York: John Wiley & Sons, Inc., 1993.
- Norton, William, Jr. *Norton Bankruptcy Law and Practice*. 2d ed. 11 vols. New York: Clark Boardman Callaghan, 1993.
- Rome, Donald L., et al. *Business Workouts Manual*. 2nd ed. (Bankruptcy Law Service.) Boston: Warren, Gorham & Lamont, 1992.
- Rosenberg, Robert. *Doing Business With Troubled Companies*. (Commercial Law Service.) New York: Practising Law Institute, 1991.
- Sulmeyer, Irving, et al. *Collier Handbook for Trustees and Debtors in Possession*, rev. ed. New York: Matthew Bender, 1985. Loose-leaf service.
- Treister, George M., Ronald Trost, Leon S. Forman, Kenneth N. Klee, and Richard B. Levin. *Fundamentals of Bankruptcy Law*. 3d ed. Philadelphia: American Law Institute—American Bar Association, 1993.
- Walsh, S. Suzanne. *Bankruptcy Basics for Small Business*. (Paralegal Practice Series) New York: Clark Boardman Callaghan, 1994. Looseleaf.

- _____. *Bankruptcy: Maneuvering Through the Maze*. (Paralegal Practice Series) New York: Clark Boardman Callaghan, 1994. Looseleaf.
- Weintraub, Benjamin, and Alan N. Resnick. *Bankruptcy Law Manual*, 1992. 3d ed. (Bankruptcy Law Series) Boston: Warren, Gorham & Lamont, 1992.

EMPLOYEE RETIREMENT & DEFERRED COMPENSATION PLANS

1. OVERVIEW OF RETIREMENT PLANNING

1.1 Qualified Versus Nonqualified Plans

2. CHOOSING A PLAN: KINDS OF QUALIFIED PLANS

2.1 Defined-Contribution Plans

2.1.1 Profit-sharing plans

2.1.2 Pension plans

2.2 Defined-Benefit Plans

3. STATUTORY REQUIREMENTS FOR QUALIFIED PLANS

3.1 Qualification Requirements

3.1.1 General rules

3.1.2 Operational rules

3.2 Eligibility to Participate

3.2.1 Age and service requirements

3.2.2 Workforce requirements

3.2.3 Entry dates

3.2.4 Minimum participation—IRC Sec. 401(a)(26)

3.2.5 Minimum coverage

3.2.5.1 Safe-harbor formulas

3.2.5.2 Ratio percentage test (general test)

3.2.5.3 Average benefit percentage test (general test)

3.2.6 Highly compensated

3.2.6.1 Pre-1997 law

3.2.6.2 Post-1996 law

3.2.7 Compensation limits

3.3 Discriminatory Contributions or Benefits—Special Rules

3.3.1 Special allocation formulas

3.3.2 Employee or matching contributions

3.3.2.1 Determining the deferral ratio

3.3.2.2 Family aggregation (only for plans beginning before January 1, 1997)

3.3.3 Defined benefit—nondiscrimination

3.3.4 Testing under benefit and contribution rules

3.3.5 Defined benefit—accruals

3.4 Permitted Disparity (Integration With Social Security)

3.4.1 Integration of defined-contribution plans

3.4.2 Integration of defined-benefit plans

- 3.5 Vesting
 - 3.5.1 Vesting—years of service
- 3.6 Funding Obligations
 - 3.6.1 Funding defined-benefit pension plans
- 3.7 Limitations on Contributions and Benefits
 - 3.7.1 Defined-benefit plan limits
 - 3.7.2 Defined-contribution plan limits
 - 3.7.3 Combined plan limits
- 3.8 Top-Heavy Plans
- 3.9 Section 401(k) Cash or Deferred Arrangements
 - 3.9.1 Hardship distributions
 - 3.9.1.1 Facts and circumstances
 - 3.9.1.2 Safe harbor
- 3.10 Employee Stock Ownership Plans
 - 3.10.1 Employee incentives
 - 3.10.2 Diversification and distributions (ESOPs)
 - 3.10.3 Seller incentives
 - 3.10.4 Estate tax considerations
- 4. DEDUCTION LIMITS**
 - 4.1 Pension Plans
 - 4.1.1 Deductions: Contributions to defined-benefit plans
 - 4.1.2 Deductions: Contributions to defined-contribution plans
 - 4.2 Deductions: Profit-Sharing or Stock Bonus Plans
 - 4.3 Combined Plan Deduction Limits
 - 4.4 Deductions: Plans for Self-Employed Persons and Other Owner Employees
 - 4.5 Deductions: Employee Stock Ownership Plans
 - 4.6 Deductions: Timing and Form
 - 4.7 Contribution Withdrawals
- 5. TAXATION OF DISTRIBUTIONS**
 - 5.1 Lump-Sum Distributions: What Are They?
 - 5.1.1 Lump-sum distributions: How are they taxed?
 - 5.1.2 Lump-sum distributions at death: How are they taxed?
 - 5.2 Direct Rollovers
 - 5.3 Distributions of Employee Contributions
 - 5.4 Additional Tax on Premature Distributions
 - 5.5 Additional Tax on Large Distributions
 - 5.6 Required Distributions
 - 5.6.1 Lifetime distributions
 - 5.6.1.1 Individual account plans
 - 5.6.1.2 Defined-benefit plans
 - 5.6.2 Required distributions at death

- 5.7 Taxation of IRA Distributions
 - 5.7.1 Penalties related to premature distributions
 - 5.7.2 Penalties related to excess distributions
 - 5.7.3 Penalties related to insufficient distributions
 - 5.7.4 Determining required minimum distributions
 - 5.7.5 Inheritance of an IRA by a spouse
 - 5.7.6 Distributions from a Roth IRA
- 5.8 Loans Treated as Distributions

6. FIDUCIARY RESPONSIBILITIES

- 6.1 Obligations
- 6.2 Prohibited Transactions
 - 6.2.1 Parties-in-interest
 - 6.2.2 Exemptions for participant loans
- 6.3 Plan Investments
 - 6.3.1 Valuation of nonliquid assets
 - 6.3.2 Unrelated business taxable income
 - 6.3.3 Plan investments—overview

7. PLAN ADOPTION AND REPORTING

- 7.1 Adoption of Plan—Overview of Approval
 - 7.1.1 Advantages of master, prototype, or uniform plans
 - 7.1.2 Determination letters
 - 7.1.2.1 Terminating plans
 - 7.1.3 Procedures for filing and appeal
 - 7.1.4 Locations of key district offices
- 7.2 Reporting
 - 7.2.1 Participant notification
 - 7.2.2 Annual filing forms
- 7.3 Audit Guidelines

8. SIMPLIFIED EMPLOYEE PENSION PLANS AND SIMPLE PLANS

- 8.1 Qualification Requirements
- 8.2 Deduction Limits
- 8.3 Taxation of Distributions
- 8.4 Elective Contributions to an SEP (Pre-1997 Law)
- 8.5 SIMPLE Plans
 - 8.5.1 SIMPLE plan contributions
 - 8.5.2 Compensation for SIMPLE purposes
 - 8.5.3 Other SIMPLE requirements

9. OTHER KINDS OF PLANS

- 9.1 Thrift or Savings Plans
- 9.2 Stock Bonus Plans
- 9.3 Money-Purchase Pension Plans
- 9.4 Target Benefit Plans (Hybrid Plans)

10. ACCOUNTING FOR PENSION PLANS

- 10.1 Calculation of Pension Expense—Defined-Benefit Pension Plans
- 10.2 Minimum Liability
- 10.3 Required Financial Statement Presentation and Disclosures
- 10.4 Amortization of Transition Amounts and Prior Service Costs
- 10.5 Accumulated Versus Projected Benefit Obligation

11. NONQUALIFIED PLANS

- 11.1 Deferral of Compensation
- 11.2 Department of Labor Considerations
- 11.3 Securing Deferred Compensation
- 11.4 Taxation of Nonqualified Arrangements

REFERENCES

APPENDIX 1: Selected ERISA Pension Plan Reporting and Disclosure Requirements

APPENDIX 2: Limitations Affected by Cost-of-Living Adjustments

1. OVERVIEW OF RETIREMENT PLANNING

This chapter provides an overview of qualified and nonqualified retirement plans that are typically implemented by small and medium-sized employers. Sections 1 to 6 are written to help the accountant review the steps taken to evaluate a client's need, implement a plan, and handle the normal year-end administration. Section 7 reviews the requirements for tax qualification of a plan and the basic Internal Revenue Service (IRS) and Department of Labor (DOL) annual reporting requirements. In section 11, the material reviews the general rules applicable to executive-only, nonqualified deferred compensation plans. That material is intended to provide an overview by comparing the rigid structure required for qualified plans to the less structured requirements of a nonqualified plan.

The reader should note that this material is designed to serve as a practical guide on deferred compensation for use by accountants for dealing with a client's plan. As a result, defined-contribution plans are described in greater detail than defined-benefit plans. Special attention is given to the design and administrative considerations of the most popular defined-contribution plans (for example, profit-sharing, money-purchase pension, and employee stock ownership plans, and 401(k) cash or deferred arrangements). This material has been updated to include the latest nondiscrimination requirements and 401(k) regulations. Unless otherwise noted, all references are to the Internal Revenue Code (IRC).

Qualified plans existed before the Employee Retirement Income Security Act (ERISA) of 1974, but the Act altered the ways that plans are administered. ERISA required, for the first time, that plans be subject to minimum participation, vesting, and funding of any promised retirement benefits. The Act required that plan assets be placed in a formal tax-qualified trust, and also established new fiduciary standards for the management of the trust. ERISA and the IRC have been amended more than two dozen times since then to create the regulatory scheme currently controlling qualified pension and profit-sharing plans. These requirements are monitored by three governmental agencies: the IRS, the DOL, and the Pension Benefit Guarantee Corporation (PBGC). In addition, the Pension and Welfare Benefit Administration (PWBA), a division of the DOL, oversees the annual 5500 filing requirements for pension and welfare plans.

1.1 Qualified Versus Nonqualified Plans

The key difference between qualified and nonqualified plans, in terms of ERISA, is that qualified plans are funded (meaning that assets are

deposited into an independent trust) and nonqualified plans generally are not. That distinction causes nonqualified plans to generally be limited to a “select group of management,” while qualified plans must cover a broad group of employees. (Note that some nonqualified plans use a rabbi trust, which is not separate and apart from other corporate assets.)

Qualified pension and profit-sharing plans must adhere to the provisions of IRC Sec. 401(a) and must be funded through a trust operated in compliance with IRC Sec. 501. (Note that a few qualified plans use a custodial arrangement or are funded solely through annuities.) In general, a qualified plan must be established and maintained for the exclusive benefit of participants and must not discriminate in favor of highly compensated employees (HCEs). (See section 3.2.6 of this chapter.) If plans follow the rules of this IRC section, they are deemed to be *qualified* and entitled to the following tax benefits:

- Plan participants are not taxed on contributions accumulating for their benefit until these benefits are received as distributions.
- Investment earnings on the funds accumulated are also not taxed until distributed as benefits.
- Certain distributions are permitted unique rollover or favorable income tax treatment.
- Employer contributions are currently deductible, while not being taxable to participants.
- Employee contributions under a 401(k) program are currently deductible to the employee.

By contrast, nonqualified plans are not subject to any nondiscrimination rules; in fact, a *nonqualified plan* must be discriminatory. Nonqualified plans have different tax benefits. The first is that employer deductions are only permitted when the employee is taxed. Generally, employee benefits are not subject to income taxes until they are paid. Vested benefits are subject to Federal Insurance Contribution Act (FICA) and a number of payroll taxes. The accumulations are typically held by the employer and only deductible when (a) paid out, (b) subject to constructive receipt, or (c) they bestow an economic benefit on the participant.

Since nonqualified plans cannot be funded without becoming currently taxable to the employee, the accumulations are subject to risk of forfeiture, if the employer goes bankrupt. As a result, they are reserved for a selected group of management employees. Nonqualified plans can be less expensive to adopt and operate, and because they are intended to meet a growing need to provide special incentives to management, employers have wide latitudes in their design. Nonqualified

plans typically involve a delay in the vesting of benefits until some future date, and are often seen as golden handcuffs. A number of plans are drafted to meet the requirements of Rev. Procs. 92-64 and 92-65; however, a number actually deviate from those safe-harbor guidelines.

2. CHOOSING A PLAN: KINDS OF QUALIFIED PLANS

Just where do you start in helping a client choose the best retirement plan? Probably the first step is to match your client's needs and objectives to the unique features of specific plan designs. This section compares and contrasts the most common kinds of qualified plans permitted under IRC Sec. 401(a) in an attempt to distinguish between plans and plan structures.

Basically, there are two distinct classes of qualified plans: *individual account plans (defined-contribution plans)* and *defined-benefit pension plans*. Defined-benefit plans are always pension plans—a kind of guaranteed benefits—and, as a result, require minimum funding. The required minimum annual contribution for a defined-benefit plan is determined by an actuary based upon the plan's benefit formula and reasonable actuarial assumptions. Defined-contribution plans can be either pensions (with required funding) or discretionary funded plans (*profit-sharing plans*). Under a defined-contribution plan, the annual contribution formula is defined in the plan document; hence its name. Typically, the annual contribution is a percentage of eligible pay (say, 10 percent of each participant's pay). Profit-sharing plans do not have contribution formulas, but instead have allocation formulas defined in the plan document (for example, the contribution is allocated pro-rata, based on the employees' pay).

2.1 Defined-Contribution Plans

A defined-contribution plan is another name for an individual account plan. These plans measure retirement benefits in terms of each participant's account balance. A participant's benefit, under a defined-contribution plan, is the vested value (meaning, the percentage that is nonforfeitable) of his or her separate account. These accounts reflect annual changes from employer and/or employee contributions, net investment income, benefit payments, and any transfers in or out during the year. If the plan permits, the accounts may also receive reallocations of forfeited account balances of terminated participants.

Generally, the assets of all participant accounts are commingled within a single trust fund, rather than invested in separate accounts. However, a number of plans, such as 401(k) plans, let employees select the investment mix of the assets in their separate accounts; these are referred to as *earmarked* or *self-directed* accounts.

Note that although defined-contribution plans provide each participant with an annual statement of the lump-sum value of his or her account, these plans may require that participants or their beneficiaries first be offered a monthly annuity if benefits are paid. The amount of the annuity is equal to the value of their account balance. If they waive that right to an annuity, the lump sum or another option can be paid. Because the annuity is based upon the benefit that the money in their account will purchase, another common name for defined-contribution plans are *money-purchase plans*.

These annuity provisions are part of the Retirement Equity Act that created special benefits for the spouses of married participants and that is applicable to all pension plans and many profit-sharing plans. In general, all pension plans (and some profit-sharing plans) require the participant and spouse to waive a right to a joint and survivor annuity before any other payment can be made. The requirements for distribution and any optional forms of benefits are specified in the plan document. Most benefit professions recommend showing the participant and spouse the actual amount of monthly annuity that could be paid when they permit such a waiver.

Following are common kinds of defined-contribution plans:

2.1.1 Profit-sharing plans

- Profit-sharing plans, including age-weighted allocation and cross-tested plans
- Stock bonus plans, including employee stock ownership plans
- 401(k) cash or deferred plans (before-tax employee contributions)
- Thrift or savings plans (after-tax employee contributions), few are being implemented today

2.1.2 Pension plans

- Money-purchase pension plans, generally providing for a level percentage of pay as a contribution
- Target benefit plans, which provide greater contributions for older participants

Retirement benefits available to be paid from an individual account plan depend upon the successful investment of the employer's and

employee's contributions, with the participant bearing the risk of poor investment returns.

Employers have a great deal of flexibility in designing a defined contribution plan: The funding can be made mandatory or discretionary, the contribution can be based on pay, tenure, or the participant's age; benefits can be paid as a lump sum (if profit sharing) or as an annuity; and the employees can direct the investment of the plan's assets. However, for 1998, contributions per participant are generally limited to the lesser of 25 percent of pay or \$30,000 (see appendix 2).

2.2 Defined-Benefit Plans

A defined-benefit pension plan is any plan that is not a defined-contribution plan (IRC Sec. 414(j)). Defined-benefit plans promise a defined level of monthly benefits for participants when they reach their normal retirement age under the plan. Funding is based upon the amount needed at retirement to pay for their promised benefit, as opposed to the defined annual contribution requirement of a money purchase pension plan. An enrolled actuary must determine and certify the funding of a defined-benefit pension plan.

Each participant in a defined-benefit pension plan will generally receive a benefit at retirement that is a percentage of pay multiplied by some years-of-service factor. A typical plan could provide a monthly benefit at retirement age equal to 2 percent of pay for each year of participation. Since benefits are defined as monthly benefits, distributions are normally paid as monthly annuities for the life of a participant. In the case of married participants, benefits are payable for the joint life expectancy of the participant and his or her spouse. Some defined-benefit pension plans permit a lump-sum payment as an optional form of benefit, if participants (and their spouses) waive in writing the right to an annuity. Commercial annuities are generally purchased and distributed, but some plans covering five hundred or more employees may make the payments directly from the trust.

The plan's actuary identifies the minimum and maximum levels of annual funding by using one of the actuarial methods approved by the IRS. Funding varies, depending on the method used. However, all methods are intended to provide for level funding over the working lifetime of the participants. Since most benefits under defined-benefit pension plans are guaranteed by a governmental agency, the PBGC, minimum funding is required regardless of the employer's financial condition. Certain waivers are permitted if the employer can show that they can be made up in the future. The PBGC provides insurance for employers that go bankrupt before funding all promised benefits. This protection is provided by PBGC premiums paid by the employer, but

ultimately the unfunded liability may fall on the federal government. (Note that this insurance is not available to the plans of small professional service corporations and plans covering only the owners of the business.)

Because of the desire to provide guaranteed benefits at retirement, defined-benefit pension plans have been the traditional medium for retirement planning. However, with the mandate for annual contributions and the increasing complexity of the rules governing these plans, small and medium-sized employers have all but abandoned them in favor of the less complex defined-contribution plans.

Defined-benefit pension plans for small professional service employers—those with less than twenty-five participants—and plans covering only family members are not covered by PBGC insurance. These plans do not pay the annual insurance fee and are not subject to the normal procedures for terminating a defined-benefit pension plan.

In contrast to defined-contribution plans, the risk of poor investment performance under a defined-benefit plan ultimately lies with the employer, who must provide sufficient funding to pay accrued benefits. If investment returns are poor, employers contribute more. The annual accrual of benefits in a defined benefit plan tends to favor older employees. Defined-benefit plans provide less valuable benefits for younger employees. The resulting skewing of benefits to the older employee is one reason why many professionals adopted defined-benefit pension plans in the past. However, beginning with the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982, legislative changes have significantly limited the ability of an older professional to accumulate large benefits without equally providing for the other participants.

Many defined benefit pension plans provide benefits based upon service before the adoption of the plan. These benefits, which favor the tenured employee, are called *past service credits*, and are normally funded over the remaining employment of the participant.

Defined-benefit plans are often said to not fit with our mobile society, because few employees remain with an employer long enough to accrue any valuable benefits. For large employers, these plans frequently provide the least amount of employer funding as a percentage of participants' pay compared with the funding in other plans.

3. STATUTORY REQUIREMENTS FOR QUALIFIED PLANS

3.1 Qualification Requirements

To be qualified, a plan and trust must satisfy, in form and operation, the following requirements identified under IRC Sec. 401(a), a section that links into the other tax code sections.

3.1.1 General rules

- The plan must be funded through a trust or equivalent entity created or organized in the United States. However, certain custodial arrangements are permitted as well as certain insurance/annuity only plans (IRC Sec. 401(a)).
- The plan must be in writing and communicated to employees (Regs. Sec. 1.401-1(a)(2)). This requires that the plan be amended to reflect changes in tax law to maintain that qualification.
- The plan must be intended as a permanent program (Regs. Sec. 1.301-1(b)(2)). A rule of thumb is that a plan is considered permanent once it has been in existence for at least three years. The IRS generally disregards sudden terminations caused by the employer's financial problems.
- The plan and trust must be adopted in writing before the end of the first plan year (Regs. Sec. 1.401-1(a)(2) and ERISA Secs. 402 and 403). Note that only simplified employer pension (SEP) plans may be adopted after the end of the tax year.
- The plan must be a stock bonus, pension, or profit-sharing plan established and maintained by an employer for the exclusive benefit of its employees or their beneficiaries. Frozen plans (plans that have been terminated, but still hold plan assets) generally are permitted under certain limited conditions (IRC Sec. 401(a)).
- Plan assets must not be used for or diverted to purposes other than the exclusive benefit of employees and their beneficiaries prior to the satisfaction of all liabilities with respect to employees and their beneficiaries. Reversions of any part of the trust assets to the employer are severely limited (IRC Sec. 401(a)(2) and ERISA Sec. 401(a)).
- Contributions, benefits, or any rights under the plan must not discriminate in favor of officers, shareholders, or HCEs (IRC Secs. 401(a)(4) and (5) and 414(q)).
- In the case of a plan's merger, consolidation with, or transfer of assets or liabilities to another plan, each participant must be entitled to receive, immediately after the transaction, no less than he or she would have received immediately before the transaction if the plan had then terminated (IRC Sec. 401(a)(12)).
- Death benefits payable to a participant's beneficiary, which are in addition to the vested benefits and from insurance benefits, must be incidental to the primary purpose of providing retirement benefits. Generally, not more than 50 percent of a participant's contribution

can be used to purchase whole life insurance, nor more than 25 percent for term insurance or other forms of insurance.

- Plan benefits cannot be assigned or alienated, with certain minor exceptions. For example, benefits payable pursuant to a qualified domestic relations order (QDRO) that is part of a marital separation are permissible assignments (IRC Secs. 401(a)(13) and 414(p)).
- A defined-benefit pension plan document must specify the actuarial assumptions used for determining alternate forms of benefits in a way that precludes employer discretion (IRC Sec. 401(a)(25)).

3.1.2 Operational rules

- The participants must satisfy certain minimum participation requirements for entry into the plan. Generally, the limits cannot exceed one year of service and cannot specify a minimum age of more than twenty-one (IRC Secs. 401(a)(3) and 410).
- The plan must satisfy certain minimum vesting requirements. Full vesting is required after seven years if vesting starts at 20 percent in year three (IRC Secs. 401(a)(7) and 411).
- If the plan is top-heavy, it must provide minimum benefits or contributions and have full vesting by six years (IRC Secs. 401(a)(10) and 416).
- If the plan is a defined-benefit pension plan, forfeitures cannot be used to increase benefits and must instead be used to reduce future employer contributions or plan administrative expenses (IRC Sec. 401(a)(8)).
- The plan must satisfy certain minimum distribution requirements. This generally requires that payments begin by April 1, following the year when a participant turns age 70½ and within five years after the date of death (IRC Sec. 401(a)(9)). Individuals who are not 5-percent owners can delay the commencement of plan benefits until they cease to be employed by the company providing the benefits if the plan is drafted to provide that option.
- Defined-benefit pension plans, defined-contribution pension plans, and certain profit-sharing plans (those that elect) must distribute benefits in the form of an annuity. For married participants, the annuity must be paid as a joint and survivor annuity based upon the lives of the participant and spouse.

A plan may permit the married participant to elect an optional form of benefit and an alternate beneficiary with the written consent of the spouse. Profit-sharing plans may pay benefits in a nonannuity form (for example, lump sum or periodic), however, death benefits

must be paid to the surviving spouse (IRC Secs. 401(a)(11) and 417). (Note that many profit-sharing plans are drafted with the joint-and-survivor annuity requirement.)

- Benefits must commence, unless the participant elects otherwise, within sixty days after the *later of*
 - The earlier of the participant's sixty-fifth birthday or the normal retirement age under the plan
 - Ten years of participation
 - The participant's termination of employment (IRC Sec. 401(a)(14))
- Benefits must not be reduced because of changes in Social Security benefits or the Social Security wage base after a participant starts receiving benefits or has separated from service (IRC Sec. 401(l)).
- The plan may not provide benefits or contributions that exceed the following annual limits:
 - For defined-contribution plans, annual contributions (and other annual additions) to all employees cannot exceed the lesser of the IRC Sec. 415(c) or 25 percent of pay (IRC Sec. 415(c)) (see appendix 2).
 - For defined-benefit pension plans, annual benefits at Social Security retirement age cannot exceed the IRC Sec. 415(b) limit. (IRC Sec. 415(b)(1)(A)) (see appendix 2).
- The plan may not provide for forfeitures of benefits that have already accrued (IRC Secs. 401(a)(19) and 411).
- The plan cannot force an employee to take a lump-sum distribution before retirement age unless the value of the benefit is \$5,000 or less (IRC Sec. 411(a)(11)).
- A fiduciary must discharge his or her duties with respect to the plan solely in the interest of the participants and beneficiaries (ERISA Sec. 401).
- An annual report must be filed (5500 Series) and participants must be provided with information disclosing the plan's financial transactions and their account balances (ERISA Sec. 101). The participant disclosure requirement is met by the annual distribution of a participant statement and a Summary Annual Report.

The preceding rules generally apply to business and professional entities of all sizes. Plans covering collective bargaining units and governmental units may have special rules or exemptions that will not be covered in this material, except where noted.

3.2 Eligibility to Participate

Plans for small and medium-sized employers generally cover all full-time employees. Nevertheless, a plan may exclude certain employees as long as the plan's coverage can satisfy certain nondiscrimination rules. The coverage provisions are identified in the plan document and must adhere to the statutory requirements for minimum participation. In the past, few, if any, participants of small plans have been excluded from participation. However, because of the rising cost of plans, some small employers are now excluding groups of employees. To be nondiscriminatory, the covered group must meet three separate tests, as discussed later. Larger entities may also choose to maintain separate plans for separate lines of business under the separate lines of business (SLOB) rules (IRC Sec. 414(r)). A plan document may permit a covered employee to begin participation on his or her date of hire; however, most plans restrict an employee's eligibility to enter the plan until completion of a period of service and attainment of a minimum age. Eligibility restrictions generally fall into two general categories: statutory exclusions, which refer to age and service, and certain nonstatutory workforce exclusions. The latter generally require testing to demonstrate nondiscrimination in favor of the HCEs.

3.2.1 Age and service requirements

As a general rule, a plan must permit employees meeting its age and service requirements to enter the plan within six months of meeting that requirement. (IRC Sec. 410(a)(4)). The minimum age and service limits under the code are as follows.

- An employee under age twenty-one can be excluded.
- An employee who has completed less than one year of service can be excluded; see exception below. Service is generally based on a twelve-month period in which the participant is credited with at least one thousand hours of service.

Entry into the plan may be delayed until the entry date (see section 3.2.3) stated in the plan document following the completion of the age and service requirement. (IRC Sec. 410(a)).

If the plan provides employees with full vesting after entering the plan, the service requirement may be extended to two years. (This is not permitted for 401(k) plans.) A plan may no longer exclude participants hired after a specific age (IRC Sec. 401(a)(1)). As a general rule, all service with the employer is counted when determining plan eligibility. Some plans shift the twelve-month period to credit eligibility to the first plan year beginning after the employee's date of hire. But, plans with

a two-year service requirement generally would not shift the eligibility computation period to the next plan year.

In measuring the eligibility service period, a plan document may be written to exclude the following:

- A twelve-month period commencing with the date of hire in which an employee works less than one thousand hours.
- Certain years prior to a break in service in the case of employees rehired after the break. Breaks in service are generally defined in a plan as twelve-month periods in which a participant is credited with five hundred hours or fewer hours (IRC Sec. 401(a)(5)). This exclusion is only permitted if the employee was never vested in the plan.

Large plans may utilize an elapsed time method of determining eligibility service. Under the elapsed time method, an employee is not required to work any minimum hours of service, but merely to be employed over a specified period of time. Under an elapsed time counting method, employees are credited with a year of service if they only work one hour a week for twelve months (DOL Regulation 2530.200(b)).

Years of service for other purposes, vesting, and determining eligibility to receive contributions are frequently based on the plan year. However, some plans are drafted with different twelve-month periods and different hour requirements. These will tend to make administration more difficult and probably more costly. There are special rules under DOL Regulation 2530.200(b) that specify how to count hours of service for employees for whom hours of employment are not maintained (for example, full- or part-time salaried employees). These regulations are generally cited in the plan document, giving employees who do not report on the number of hours worked each day, a standard number of hours, for example, 190 hours of service for any month in which they work one hour.

3.2.2 Workforce requirements

IRC Sec. 410(b) provides the general rules for accruing a benefit or receiving an allocation in the plan year. In general, a plan must cover (provide benefits for) a nondiscriminatory grouping of participants. For purposes of determining whether a plan meets this rule, employees not meeting the statutory service and age requirements (one year and age twenty-one, respectively) or other statutory exclusions may be omitted in this discrimination testing. These rules are discussed in section 3.2.4 of this chapter. Restrictions other than those on age and service

may be permitted if the general nondiscrimination rules are not violated. Typical workforce restrictions may include the following:

- *Job classification*—However, a plan cannot exclude part-time employees as a class. Certain union groups may be excluded.
- *Required contributions*—A pension plan may exclude from participation anyone not making a required after-tax contribution.
- *Location of employment*—One group of employees at a specific location could be excluded.

For example, an employer may choose to cover only salaried employees, or only employees classified as salespeople. These and other classifications can be acceptable if they have a business purpose and do not operate so as to discriminate in favor of individuals determined to be highly compensated employees under IRC Sec. 414(q) (see section 3.2.5).

3.2.3 Entry dates

Employees satisfying a plan's age and service requirements must enter the plan no later than six months after satisfying these requirements, but in no event later than the first day of the next plan year (IRC Sec. 410(a)(4)). Although entry can be deferred for as long as six months after satisfying the requirements for one year of service and age twenty-one, participation can occur at the date of hire. Any date between the date of hire and the last day permitted by law is acceptable. However, for ease of administration, most small plans generally provide for entry on semiannual dates based on the first day of the plan and the first day of the seventh month following the completion of one year of service (with one thousand hours) and attaining age twenty-one.

The following are three basic minimum requirements for plan coverage:

1. The age and service request, previously discussed, IRC Sec. 410
2. The 40 percent, two-employee test (only for defined benefit plans) of IRC Sec. 401(a)(26)
3. The nondiscriminatory coverage—who gets a contribution allocation or accrues a benefit after entering the plan of IRC Sec. 401(a)(4)

3.2.4 Minimum participation—IRC Sec. 401(a)(26)

The Tax Reform Act of 1986 (TRA 1986) revised the way discrimination is measured, but it also created the opportunity for planning. That legislation and the subsequent regulations have severely influenced the way plans are designed for most small and medium-sized employers. That law required each of the employer's plans to meet the provision

of IRC Sec. 401(a)26. The 1996 legislation revisited this section by exempting defined contribution plans and limiting the application to certain defined benefit pension plans.

That section requires that each defined benefit pension plan of an aggregated employer group (for example, a controlled group) must cover the lesser of fifty employees or 40 percent of all employees. This requirement can not be met by considering two plans as one. Employees not meeting the statutory age and service requirements that are excluded from participation can be excluded from this test. Beginning with plan years beginning after December 31, 1988, all related employers must be aggregated when determining minimum participation. This aggregation includes affiliated service groups (IRC Secs. 414(m), (n), (o), and (p)), and controlled groups (Sec. 414(b)). Note that plans not benefiting any HCEs are exempt from this requirement.

The rules affect any business with two separate operating units under common control (for example, IBM could not set up a plan covering forty-five employees if one was an HCE). Violations of this rule will result in the taxation of the HCE for all vested and funded benefits. If this is the only requirement that cannot be met, the plan generally will not be considered disqualified, however, all vested benefits of the HCEs will be immediately taxed.

3.2.5 Minimum coverage

Probably one of the most significant changes after TRA 1986 was the rewriting of the nondiscrimination requirements. The prohibited group was defined in a new IRC Sec. 414(q) as HCEs. Other employees are *nonhighly compensated employees* (NHCEs). (See section 3.2.6 for a definition of the highly compensated.) Prior to the legislation, two separate sets of nondiscrimination rules applied, one for minimum participation (under IRC Sec. 410(b)) and a second for minimum coverage of benefits and contributions (under IRC Sec. 401(a)(4)). TRA 1986 formulated a new participation requirement that, in part, was determined on the basis of the amount of contributions made or benefits accrued. Thus, the requirements for eligibility and benefit coverage were linked in a single, uniform set of rules. TRA 1986 also identified for the first time who made up the prohibited group (the HCEs).

Employee coverage and benefits are linked under IRC Secs. 401(a)(4) and 410(b). This linkage is accomplished by requiring that a plan *not discriminate in favor of HC employees* (see section 3.2.6, herein) *in either coverage eligibility or the amount of benefits or contributions (or both) that are provided*. To demonstrate that a plan does not discriminate, in either form or operation, the following three general nondiscrimination requirements must be satisfied:

1. The plan does not discriminate in favor of the HCEs in the amount of contribution or benefits, and any plan can be tested under a benefits test or a contribution test.
2. Every option, subsidy, or other right or feature under the plan is available on a nondiscriminatory basis.
3. Plan amendments or terminations do not significantly discriminate in favor of the HCEs.

3.2.5.1 Safe-harbor formulas

The new rules are somewhat difficult to apply but here is an overview.

- *Ratio Percentage Test.* If plans have a contribution formula that is a *safe harbor* defined in the regulations, the plan is nondiscriminatory if it covers a nondiscriminatory group of employees. That is, the percentage of NHCEs participating in the plan is 70 percent of the percentage of HCEs participating in the plan (IRC Sec. 410(b)).
- *Testing Under the General Trusts.* In order to demonstrate that benefits or contributions do not discriminate in favor of the HC employees, a plan must satisfy the two following requirements.
 1. It must meet one of two minimum coverage tests: the *ratio percentage* test or the *average benefit percentage* (ABP) test.
 2. It must show that benefits, rights, and features under the plan do not discriminate in favor of the HC employees.

3.2.5.2 Ratio percentage test (general test)

The ratio percentage test is sometimes called the 70-percent test. If the plan's coverage passes this test and the plan document incorporates a safe-harbor formula, no further testing is required and the plan will be deemed to be not discriminatory. If the plan does not meet this test or does not use a safe harbor, it requires more elaborate testing under the average benefits test (also called the general test).

The ratio percentage test compares the percentage of NHCEs eligible for and receiving benefits to the percentage of HCEs eligible for and receiving benefits. If this ratio is 70 percent or more, the plan passes the 70-percent benefit coverage test. (Prop. Regs. 1.410(b)-2 and 4).

In the following example, the plan document provides that certain employees do not participate because they work for an excluded division of the company and all employees receive the same percentage of pay as a contribution (a safe-harbor formula):

| | <u>Eligible for plan*</u> | <u>Participating†</u> | <u>Percentage</u> |
|---------------|--|-----------------------|-------------------|
| HC employees | 10 | 5 | 50% |
| NHC employees | 100 | 36 | 36 |
| | <u>Percentage of NHCEs participating</u> | = <u>36</u> | = <u>72%</u> |
| | <u>Percentage of HCEs participating</u> | <u>50</u> | |

This coverage is nondiscriminatory because it meets the 70-percent test. If one more NHCE were excluded, it would not pass.

*Employees meeting the age, service, and other statutory provisions of the code are included in this testing even if not eligible for plan benefits.

†Some employees do not participate because they work for a division or employer group that the plan document excludes.

-
- *Other Limitations.* Certain employees are excluded from these percentage calculations. Statutory exclusions include employees not meeting the plan's minimum age or service requirement, nonresident aliens, and certain employees covered under a collective bargaining agreement. Special, but limited, rules are available for testing employers operating with distinct and separate lines of business (Reg. Secs. 1.410(b)-6(g)).
 - *Terminated Employees.* Terminated participants with more than five hundred hours of credited service are not excluded from ratio percentage testing for years after 1989. Thus, a plan covering only one HCE and three NHCEs, one of whom was excluded under the terms of the document solely due to the fact that he or she did not work the required one thousand hours of service (assuming that the employee worked over five hundred hours), would not pass the 70-percent benefit test. The percentage of NHCEs participating would be 66.6 percent. Note that IRS Announcement 92-81 permits an employer to test for nondiscrimination on any day of the year. Under this "snapshot testing," the test is made on the basis of employees actually working on that day. Some practitioners hold that this snapshot testing on the last day of the year does not apply to small plans. In fact, the IRS holds that the selected day must represent typical plan coverage during the entire year. If the test is made on the last day of the plan year, the 70-percent requirement is increased to 77 percent (Regs. Secs. 1.410(b)-6(f)).

3.2.5.3 Average benefit percentage test (general test)

Plans failing the ratio percentage test or passing that test but not providing benefits under a design-based safe harbor must meet the average

benefit percentage (ABP) test. In general, the ABP tests the amount of benefits or contributions that are “earned annually” by each eligible participant. It requires that—

1. The plan meet a *nondiscriminatory classifications* test as to plan coverage (Regs. Sec. 1.410(b)-4).
2. The plan pass certain rate grouping tests utilizing the tables found in the regulations and that the average benefit for the NHCEs be 70 percent of the average benefit for the HCEs and the ABP test (Regs. Sec. 1.401(a)(4)-2,3).

The nondiscriminatory classification component requires that the eligibility criteria be both reasonable and nondiscriminatory. Any classification must be based upon objective business criteria that identify the category of employees who benefit under the plan (Regs. Sec. 1.410(b)-4). The percentage of NHCEs divided by the percentage of HCEs must be at least equal to the safe harbor percentage of Regs. Sec. 1.410(b)-4.

The techniques for testing under the ABP requirements are described under Regs. Sec. 1.410(b)-5. It is complicated and lengthy, and only a general review will be provided here. In general, a plan satisfies the ABP test for a plan year if and only if each rate group meets certain minimum percentage ratios (IRC Sec. 410(b)).

The ABP test requires three general steps. First, each participant is assigned an accrual rate, based upon contribution allocations or benefit accruals, as a percentage of current-year pay. Next, the employee groups are restructured to identify varying levels of participation at each rate group. Then, the percentage of HCEs and NHCEs in each rate group are compared. In general, the percentage of NHCEs participating divided by the percentage of HCEs participating at each rate group level must meet the midpoint of the safe-harbor/unsafe-harbor percentage found in the regulations (Prop. Reg. 1.410 (b)-4(c)). The midpoint of safe-harbor/unsafe-harbor percentages is determined based on the concentration percentage (percent of NHCEs who satisfy the plan’s age and service request). Finally, the 70-percent average benefit test is applied. The regulations greatly expand the application of these basic steps, but that will not be covered in this material.

The mechanics of the ABP test can be demonstrated by the following example of a defined-contribution plan covering two groups of employees who received differing-contribution levels—for example, a plan covering employees in two states. This example shows all eligible participants.

Allocation in Current Year

| | | <u>Employees Receiving 5 Percent of Pay</u> | <u>Employees Receiving 2 Percent of Pay</u> |
|---------|-------|---|---|
| Group A | HCEs | 1 | |
| | NHCEs | 5 | |
| Group B | HCEs | | 2 |
| | NHCEs | | 20 |

The ABP allows the two groups to be restructured as follows:

| | <u>Employees Receiving at Least 2 Percent of Pay Rate Group 1</u> | <u>Employees Receiving at Least 5 Percent of Pay Rate Group 2</u> |
|---------------------------------|---|---|
| HCEs | 1 + 2 = 3 (3/3 = 100%) | 1 (1/3 = 33.3%) |
| NHCEs | 5 + 20 = 25 (25/25 = 100%) | 5 (5/25 = 20%) |
| Total eligible in all plans: 28 | | |

Testing Rate Group 1 (2 Percent of Pay)

$$\frac{\text{Percentage of NHCEs}}{\text{Percentage of HCEs}} = \frac{100}{100} = 1, \text{ pass}$$

Testing Rate Group 2 (5 Percent of Pay)

$$\frac{\text{Percentage of NHCEs}}{\text{Percentage of HCEs}} = \frac{20}{33.3} = .60, \text{ pass}$$

Note: The concentration percentage is 25/28 or 89 percent (the number of NHCEs divided by the total number of those receiving a contribution). According to a table found in Treas. Reg. 1.410(b)-4(e)(4), the midpoint of the safe-harbor/unsafe-harbor levels is 24.12 percent. The plan in our example passes because each of the contribution levels (2 percent of pay and 5 percent of pay) produced testing rates that are above the 24.12 percent associated, in the table, with a concentration percentage of 89 percent.

The regulations provide specific rules for aggregating plans, excluding certain categories of employees and adjusting for Social Security integration. Specific exclusions are provided for certain types of plans that are tested under separate and distinct tests—disaggregation.

3.2.6 Highly compensated

3.2.6.1 Pre-1997 law

For plan years beginning after December 31, 1986, and continuing through 1996, an employee is considered to be highly compensated if, at any time during the current or preceding year, he or she—

- Was a more-than-5-percent owner (determined after applying the family attribution rules).
- Earned more than \$100,000 from the employer in 1996.
- Earned more than \$66,000 in 1996 and was also in the top 20 percent of all employees ranked on the basis of compensation paid during the year.
- Was an officer receiving compensation exceeding \$60,000, for 1996, that is 50 percent of the limit provided in IRC Sec. 415(b)(1)(A) (IRC Sec. 414(q)).

Refer to appendix 2 for cost-of-living adjustments for prior years.

To provide stability to this highly compensated group, an individual other than a more-than-5-percent owner will not be included in the group unless one of the following applies.

- He or she was included in the group for the preceding year.
- He or she is one of the 100 most highly paid employees of the employer.

Although the single most highly paid officer will always be considered highly compensated, no more than fifty employees will be considered officers (or, if fewer, the greater of three employees or 10 percent of the employees). This provision does not apply for years after December 31, 1996 (IRC Sec. 414(q)(5)).

3.2.6.2 Post-1996 law

In plan years beginning after December 31, 1996, a highly compensated employee is any 5-percent owner or an individual who earned more than \$80,000 in the prior year (after adding back 401(k), 125, and other nontaxable elective contributions in determining the \$80,000 threshold). Employers are permitted to apply the \$80,000 threshold to only the top 20 percent of employees under an election permitted by the regulations.

3.2.7 Compensation limits

The maximum compensation for any employee used to calculate benefits in a test for nondiscrimination is the IRC Sec. 401(a) limit (see appendix 2). A plan utilizes the calendar limit applicable on the first day of the plan year (IRC Sec. 401(a)(17)).

3.3 Discriminatory Contributions or Benefits—Special Rules

In general, a plan cannot provide benefits or contributions that discriminate in favor of the prohibited group. All plans of an employer and all

employees are, generally, aggregated for testing. However, certain special rules apply. They include those for the following.

- 401(k) and 401(m) plans; the portion of a plan that comprises elective contributions and qualified nonelective contributions (QNECs) are tested under the ADP test. After-tax employee voluntary contributions and matching employer contributions are tested separately under the ACP rules (see section 3.3.2 of this chapter).
- Employee stock ownership plan (ESOP) and non-ESOP portions of a plan, which are tested as two separate plans (see section 3.10 of this chapter).
- Participants in a defined-benefit plan who fail to accrue a benefit after attainment of normal retirement age solely because of actuarial adjustments, who are deemed to be benefiting.
- Employers meeting specific SLOB criteria, who may test plans separately (Reg. Sec. 1.414(r)-1).
- Coordination of coverage under Social Security; an employer is permitted to coordinate retirement coverage under Social Security with a qualified plan. TRA 1986 rewrote the traditional approach to using Social Security integration, using a new set of permitted disparity rules (Reg. Sec. 1.401(1)) (see section 3.4 of this chapter).

TRA 1986 extended nondiscriminatory rules to those 403(b) plans in which employer and employee contributions are nonelective. Safe-harbor rules are provided in IRS Notice 89-23.

3.3.1 Special allocation formulas

Each defined-contribution plan must contain a formula for allocating employer contributions (Regs. Sec. 1.401-1(b)(1)(ii)). The general nondiscrimination rules applicable to defined-contribution plans are under Regs. Sec. 1.401(a)(4)-2.

The following two design-based safe harbors exist for defined-contribution plans:

- The uniform formula
- Formulas weighted for age or service (point allocations)

To satisfy either of these safe harbors, the retirement age, allocation formula, vesting provisions of the plan, and definition of compensation must be uniform. Under the uniform safe harbor, contributions must be allocated to all participants as the same percentage of plan year compensation, or each participant must receive the same dollar amount. A more limited safe harbor is permitted under a point formula that weights allocations on age and service. For example, points may be

created for up to each \$200 of compensation, and one point for each year of service. A participant would receive an allocation based on the points credited to his or her account compared to the total points credited for all participants that year. This safe harbor, however, requires that the average rates for the HCEs must not exceed the average rates for the NHCEs. The age and service safe harbor of Regs. Sec. 1.401(a)(4)-2 is not to be confused with the currently popular age-weighted allocations permitted under Regs. Sec. 1.401(a)(4)-8.

Under the uniform point formula safe harbor, a plan is not permitted to use integration under IRC Sec. 401(l). See section 3.4 of this chapter for additional information on permitted disparity (integration). A document is also permitted to exclude compensation before entry into the plan (IRC Sec. 414(s)).

Exhibit 3.1: Point Allocation Formula

A plan grants 200 points for each year of service and 1 point for each \$200 of compensation. (No points are awarded in this plan for a participant's age.) The employer contributes \$20,000, to be divided among the participants based on each employee's share of the credited points.

The following table shows the total points and contribution allocation granted for each employee.

| | <i>Pay</i> | <i>Age</i> | <i>Years of Service</i> | <i>Points Credited</i> | <i>Allocation of Contribution</i> | <i>Contribution as Percentage of Pay</i> |
|---|------------|------------|-------------------------|------------------------|-----------------------------------|--|
| A | 100,000 | 51 | 5 | 1,500 | 2,817 | 2.8% |
| B | 50,000 | 42 | 20 | 4,250 | 7,981 | 15.9 |
| C | 50,000 | 35 | 2 | 650 | 1,221 | 4.1 |
| D | 30,000 | 35 | 10 | 2,150 | 4,038 | 13.5 |
| E | 20,000 | 35 | 10 | 2,100 | 3,943 | 19.7 |
| | 230,000 | | | 10,650 | 20,000 | |

The point allocations for Employee A and Employee D are shown below:

| <i>Employee</i> | <i>Compensation</i> | <i>Service</i> | <i>Total</i> |
|-----------------|---------------------|----------------|--------------|
| A | 500 | 1,000 | 1,500 |
| D | 150 | 2,000 | 2,150 |

3.3.2 Employee or matching contributions

Defined-contribution plans permitting employee salary deferrals are tested solely under a separate set of discrimination rules of IRC Sec. 401(k), while IRC Sec. 401(m) applies to matching employer contributions and voluntary after-tax employee contributions. The maximum

salary deferral for 1998 is \$10,000 (see appendix 2 for prior year’s cost-of-living adjustments). Employee electives (*salary deferrals*) must satisfy the actual deferred percentage (ADP) test. The actual contribution percentage (ACP) test is required for any after-tax voluntary contributions or matching contributions. Under the ADP test, the deferral percentage of each participant is determined by dividing the amount deferred by the participant’s eligible compensation. A deferral percentage (deferral divided by compensation) is developed for the HCE participants and compared to the average for the NHCEs. The plan is not discriminatory if the average for the HCE does not exceed the average for the NHCE by the greater of the following:

1. 125 percent of such NHCE percentage
2. The lesser of the following:
 - 200 percent of such NHCE percentage
 - Two percentage points more than the NHCE percentage

The following chart will demonstrate the permissible percentages.

**Exhibit 3.2: Nondiscrimination Table IRC Section 401(k)
Elective Deferrals**

| <u>Average-Deferral Percentage of Nonhighly Compensated Employees</u> | <u>Maximum Permissible Average-Deferral Percentage for Highly Compensated Employees</u> |
|---|---|
| 1% | 2% |
| 2 | 4 |
| 3 | 5 |
| 4 | 6 |
| 5 | 7 |
| 6 | 8 |
| 7 | 9 |
| 8 | 10 |
| 9 | 11.25 |
| 10 | 12.5 |

Thus, if the ADP for the NHCEs is at 3.5 percent, the ADP for the HCEs must not exceed 5.5 percent. For purposes of calculating the average percentages, eligible participants not making deferrals are included in the test at zero percent.

An employer may calculate this test using either current-year compensation and deferral for the NHCEs and HCEs, or the current-year compensation for the HCE and the NHCE ADP percentage for the prior year. An employer may assume the NHCE ADP was 3 percent for the prior year.

3.3.2.1 Determining the deferral ratio

Deferral ratios are determined by dividing the elective deferrals by the participant's compensation. Compensation for purposes of this test must not discriminate in favor of the highly compensated. Typically, it will be compensation used to test for annual additions under IRC Sec. 415(c) (for example, taxable compensation or compensation subject to withholding). Employers may elect to include the participant's tax-exempt salary deferrals in compensation when calculating the deferral percentages permitted in the plan document (IRC Sec. 401(k)(9)).

IRS Notice 97-2 updates the procedures for annual testing of 401(k) plans.

The IRS opted to implement a common-sense and simple method for utilizing prior-year test results in the current-year 401(k) and 401(m) tests. The notice did not address how matching contributions and QNECs (fully-vested employer contributions that are treated as employee salary deferrals) play into the testing. This release did indicate that a further notice would address how these contributions apply in current-year and prior-year testing. These rules apply to plan years that *begin* in 1997; thus, plans with a calendar-year end will follow these steps for the December 31, 1996, plan-year testing.

The Small Business Job Protection Act of 1996 (SBJPA) rewrote the steps for testing 401(k) plans for prohibited discrimination in favor of the HCEs—the so-called ADP and ACP tests.

Beginning in 1997, an employer may test the plan using either current-year salary deferrals and compensation for all employees, or the results of the prior-year testing for the NHCEs. The 1996 legislation also changes the definition of when an employee becomes an HCE. Some IRS representatives had suggested that when prior-year results were used, there would be a recalculation based on each participant's current status (for example, as to whether they were HCEs or NHCEs, or had terminated and could be ignored).

Utilizing prior-year results. The IRS release avoided requiring any of the prior-year NHCE results. That is, if the 1996 average deferral ratio for the NHCEs was 3 percent, that ratio is used to test for the maximum ADP of the HCEs, regardless of whether the employee's status has changed or if the individual is no longer a participant for 1997. For new 401(k) plans or profit sharing plans that implement a salary deferral option in 1997, another helpful rule applies. These plans may test on current-year deferrals and compensation, or assume that the average deferral ratio for the NHCEs is 3 percent.

Here's the good news. All 401(k) sponsors will know the maximum average deferrals for the HCEs early in the current year. If that limit is exceeded, these employers will still have the option of testing on current-year results.

Testing elections. For the 1997 plan year, employers may elect to test on either a current-year or prior-year basis, without setting that election in concrete. Thus, you'll be able to test the 1997 test year on a current-year basis, and then switch to prior-year testing in 1998. However, for the 1998 year the election choices are somewhat limited. Employers may always elect to go from prior-year testing to current-year testing, but going back to prior-year testing will require a formal election under procedures that are to be released.

The notice also states that the plan administrator of a 401(k) plan need not amend the plan or file a formal election to make either testing choice for 1997.

The 1997 ADP and ACP tests. The IRS has not attempted to simplify the clash between Tax Code sections that were amended by the SBJPA and prior law (for example, IRC Sec. 401(k)(8)(C) and IRC Sec. 401(k)(8)(B)). The latter section is old law and dictates how to test salary deferrals for nondiscrimination and how much to distribute if the test fails; the former dictates how to apply those distributions to the HCEs. Basically, you'll apply existing law to the way you test salary deferrals for prohibited discrimination. When the ADP test fails, salary deferrals for the HCEs are reduced through either distribution or reclassification, starting with the HCE who has the highest deferral percentage. (IRC Sec. 401(k)(8)(B))

This testing is shown for the 1997 year.

Step 1: Preparing the ADP test and determining the amount of salary deferrals to be distributed to the HCEs for the 1997 plan year. This example assumes that prior-year testing will be used and that ADP for the NHCEs in the 1996 year was 4.33 percent.

Highly compensated employees

| <i>Employees</i> | <i>Before Deferral Pay</i> | <i>Initial Deferral</i> | <i>Ratio</i> | <i>Theoretical Distributed Amount</i> | <i>Final Deferral</i> | <i>Deferral Ratio</i> | <i>Average for Group</i> |
|---------------------------------|----------------------------|-------------------------|--------------|---------------------------------------|-----------------------|-----------------------|--------------------------|
| A | \$150,000 | \$9,000 | 6.00% | <0> | 9,000 | 6.00% | |
| B | 100,000 | \$8,250 | 8.25% | <1,750> | 6,500 | 6.50% | 6.33% |
| C | 80,000 | \$7,000 | 8.75% | <1,800> | 5,200 | 6.50% | |
| Total to be distributed \$3,550 | | | | | | | |

Nonhighly compensated employees

For the NHCEs, assume that average deferral ratio for the 1996 plan year was 4.33 percent.

This plan initially fails the ADP test, and the plan administrator elects to distribute a portion of the salary deferrals to the HCEs. The amount of the deferrals to be distributed is determined by lowering the deferral

percentages of the HCEs until they average 6.33 percent (two percentage points higher than the ADP for the NHCEs).

The total amount of the deferrals to be distributed from the HCEs' accounts is \$3,550.

After the testing is completed and the total amount of the deferrals is determined, IRC Sec. 401(k)(8)(C) takes over. The notice confirms that this amount of deferrals is withdrawn from the HCEs with the highest dollar amount of deferrals. There is a leveling process—that is, the highest deferral amount is reduced to the next highest and these are reduced to the next highest, and so on until the total amount determined in the first step is exhausted.

The prior example demonstrates how deferrals are distributed.

Step 2: Distributing excess contributions under IRC Sec. 401(k)(8)(C). The amount to be distributed, \$3,550, was determined in Step 1. The amounts are distributed in a leveling method described below.

Highly compensated employees

| Employees | Before Deferral Pay | Initial Deferral | Ratio | Actual Amount to | | Deferral Ratio | Average for Group |
|----------------------------------|------------------------|---------------------|-------|---------------------|-------------------|-------------------|----------------------|
| | | | | Be Distributed | Final Deferral | | |
| A | \$150,000 | \$9,000 | 6.00% | <2,100> | 6,900 | 4.60% | 6.71% |
| B | 100,000 | \$8,250 | 8.25% | <1,350> | 6,900 | 6.90% | |
| C | 80,000 | \$7,000 | 8.75% | < 100> | 6,900 | 8.63% | |
| Total amount distributed \$3,550 | | | | | | | |

The \$3,500 is distributed by first lowering the deferral for Employee A until the remaining equals the next highest deferral for an HCE (\$8,250 for Employee B); then the deferrals of both A and B are reduced until they equal the amount for the next highest HCE (\$7,000 for Employee C) and then all three HCEs have their deferrals reduced until the entire \$3,550 is exhausted.

Once this distribution method is applied, the average deferral ratio of the remaining deferrals in the HCEs' accounts is 6.71 percent—an amount that exceeds the average of the NHCEs by more than 2 percentage points. It might appear that another round of tests must be applied to bring the two percentages into the ranges required by IRC Sec. 401(k)(3). This is not the case. The notice states that no further testing is required; the plan will be deemed to have passed the ADP test.

This notice provides relief as far as it goes, but it hardly scratches the surface of how to address the inconsistencies brought about by the SBJPA. For example, the notice provides no real guidance for the ACP testing beyond saying that parallel rules apply to the ACP testing. No

guidance is given on whether matching contributions are based on the theoretical final deferral for the HCEs, or the actual deferrals. Nor is there any guidance on how to make corrections under the multiple use test.

3.3.2.2 Family aggregation (only for plans beginning before January 1, 1997)

As part of the nondiscrimination requirements of 401(k) plans, special aggregation rules apply. The effect of these rules is to aggregate all

(Text continued on page 29)

family members and treat the family group as one employee. Aggregation is only required for family members of highly compensated employees that are 5-percent owners or one of the top ten highest paid [IRC Sec. 401(k)(5), Reg. Sec. 1.401(k)-1(g)(1)(ii)(C) and Reg. Sec. 1.401(m)-1(e)(2)(iii)].

For purposes of calculating the ADP deferral percentages, elective contributions and QNECs that satisfy the vesting (100 percent) and distribution restrictions (see section 3.9 of this chapter) may be treated as salary deferrals. The test may be determined using either gross compensation (including the salary deferral) or compensation after salary deferral.

If the plan fails to meet the nondiscrimination test, excess elective deferrals for the HCEs, and the income attributable to such amounts, are distributed. If the amounts are withdrawn within 2-1/2 months of the plan year, the amounts are reflected on an employee's W-2 as of the first day of the plan year. If distributed after that date, they are taxable in the next year and the employer pays a 10-percent excise tax (IRC Sec. 4979). The plan will be disqualified if these amounts are not distributed before the end of the subsequent plan year (IRC Sec. 401(k)(8)).

In lieu of distributing excess deferrals from a plan, an employer may make nonelective contributions to a plan for the NHCEs. These contributions are 100 percent vested and are treated as deferrals in the ADP tests.

Similar testing rules apply to after-tax voluntary employee contributions and matching employer contributions, under IRC Sec. 401(m). The percentage limits are the same as those under the ADP tests; however, the rules prohibit the multiple use of the 2 percent or double-multiple of the ADP and ACP test in the same plan year, unless the plan also passes a special combined multiple-use test.

3.3.3 Defined benefit—nondiscrimination

Five design-based safe harbors are provided for defined-benefit plans under the final IRC Sec. 401(a)4 regulations. Plans not meeting one of these safe harbors must meet the general test annually (see section 3.2.5.3). In general, an employer must show that employer-provided benefits under the plan are not discriminatory. A defined-benefit plan may also show that the equivalent contributions under the plan are nondiscriminatory.

Various methods are permitted to satisfy these tests. An employer is permitted to establish rate groups under the plan, and then test each rate group under the ratio percentage test of IRC Sec. 410(b). Rate

groups are determined by grouping HC and NHC employees with the same or equivalent accrual rates (Regs. Sec. 1.401(a)(4)-3).

A plan with a safe-harbor formula may be tested under the ratio percentage test. The first safe harbor covers unit credit plans, which contain a benefit formula that accrues annually, for all participants with the same number of years, the same dollar amount of benefit, or the same percentage of compensation.

The second safe harbor applies to plans using the fractional accrual method, and, in general, must convert to an equivalent of the first safe harbor. A typical formula would provide for 2 percent of pay for each year of participation, or \$18 for each year of participation.

The third safe harbor is for flat benefit plans, which provide a flat percentage of pay benefit at retirement age. These plans accrue benefits under the fractional method, over the service of the participant. In general, these plans are required to have a design that equates to unit credit type accruals. Such a formula could be: 50 percent of pay at normal retirement, reduced 1/25 for each year of participation less than 25. (This is similar to a 2-percent per year of participation formula.) A minimum number of years is required to avoid acceleration of benefits for the older participant. These design-based safe harbors cover both the ultimate benefit and the annual accrual.

The fourth safe harbor is for flat benefit plans, and requires that the average accrual of NHC employees as a group must be at least 70 percent of the average rate of the highly compensated employees as a group (Regs. Sec. 1.401(a)4-3).

Under these rules, compensation must be determined on a uniform basis. Compensation is averaged over at least three years, and is tied to the definition of compensation under IRC Sec. 414(s). Special safe harbors are also permitted for certain insurance plans described in IRC Sec. 412(i).

3.3.4 Testing under benefit and contribution rules

TRA 1986 eliminated techniques of demonstrating comparability between two different plans permitted under Rev. Rul. 81-202. However, it introduced a means to test defined-contribution plans and defined-benefit plans for discrimination under either a benefit or contribution basis. The final regulations provide techniques for cross-testing of plans (see Section 3.2.5.3).

In a similar manner, certain defined-benefit plans with the individual account characteristics of defined-contribution plans, *cash balance plans*, can be tested on a basis of contribution credits (Regs. Sec. 1.401(a)(4)-8(c)(3)). *Floor offset* plans are arrangements in which the benefits under a defined-benefit plan are offset by the benefits under

the same employer's defined-contribution plan. These plans may satisfy special tests under Regs. Sec. 1.401(a)(4)-8(d)(1).

3.3.5 Defined benefit—accruals

The final regulations under Regs. Sec. 1.401(a)(4) generally prescribe rules for benefit accruals in a defined-benefit pension plan. Additional minimum accrual rules are provided under IRC Sec. 411(b)(1).

Participants accrue benefits under a defined-benefit plan in accordance with the benefit formula in the plan and one of the following benefit accrual standards (IRC Sec. 411(b)(1)):

- *3-Percent Method.* Each participant's accrued benefit upon termination of employment must be at least 3 percent of the normal retirement benefit that the employee would have received if participation commenced at the earliest age and continued until age sixty-five or the normal retirement age in the plan, if earlier, multiplied by the employee's years of participation (maximum: $33\frac{1}{3}$).
- *133-1/3-Percent Rule.* The accrual rate for any year must not exceed $133\frac{1}{3}$ percent of the accrual rate for any prior year.
- *Fractional Rule.* Each participant's accrued benefit upon termination must be at least equal to a fraction of the participant's actual years of participation to potential years of participation if he or she had served until normal retirement age, multiplied by the normal retirement benefit.

For purposes of determining the benefit accruals for these tests, years of participation may be used. Accordingly, years of service prior to entry into the plan as a participant can be ignored. A year of service is a twelve-month period in which the participant is required to be credited with not more than one thousand hours of service. Years in which less than one thousand hours are completed can be ignored for benefit accrual purposes. Unlike a defined-contribution plan, a defined-benefit plan must provide accrued benefits if a participant works one thousand hours during the year, even if he or she is not employed at year end.

3.4 Permitted Disparity (Integration With Social Security)

Although contributions and benefits under a plan cannot discriminate in favor of HC employees, a plan may provide certain additional benefits to the HC employees if the plan meets the permitted disparity rules

under IRC Sec. 401(l). The concept behind permitted disparity, traditionally called Social Security integration, is that it is a means to achieve equalized retirement benefits under an employer's plan and under Social Security.

As a part of the Social Security system, employers are required to make contributions that ultimately provide retirement benefits. However, retirement benefits under Social Security are limited based upon the taxable wage base set each year as the base for FICA taxes. As a result, HC employees receive a smaller percentage of their compensation as a retirement benefit from Social Security than do lower paid employees. Under integration, an employer's plan can make up for this disparity by providing for additional benefits to the HC employees.

Two separate sets of rules apply to permitted disparity, one for defined-contribution plans and one for defined-benefit plans. In the following two subsections, permitted disparity is referred to by its more common name, integration.

3.4.1 Integration of defined-contribution plans

Defined-contribution plans can be integrated relatively easily. The following table was provided for integrating for plan years beginning in 1989.

Exhibit 3.3: Integration Percentages and Levels for Defined-Contribution Plans

| <u>Integration Level</u> | <u>Maximum Percentage of Excess Benefit</u> |
|--|---|
| If the integration level used is less than 20 percent of the Social Security wage base (see appendix 2), the maximum integration percentage rate is | 5.7% |
| If the integration level is at least 20 percent of the maximum allowable level but less than 80 percent of the Social Security wage base (see appendix 2), the maximum integration percentage is | 4.3% |
| If the integration level is at least 80 percent of the maximum allowable level but less than 100 percent of the Social Security wage base (see appendix 2), the percentage rate is | 5.4% |
| If the integration level is at the maximum allowable Social Security wage base (see appendix 2), the maximum allowable percentage is | 5.7% |

A defined-contribution plan is integrated under the following format: X percent of total pay plus Y percent of pay above a dollar amount.

X is the total percent and Y is the excess percent. The *dollar amount* is the integration level of the plan. The integration level (maximum allowable level) and the excess percentage are determined in exhibit 3.3 shown above. The dollar amount of the integration level can be any amount up to the Social Security taxable wage base in effect at the beginning of the plan year. In addition, the excess percentage may not exceed the lesser of the base percentage or the amount under the chart above.

(Text continued on page 35)

3.4.2 Integration of defined-benefit plans

The integration rules applicable to defined benefit plans were revised under TRA 1986. Final regulations under Regs. Secs. 1.401(l) and 1.401(a)(4)-7, released in the fall of 1991, control the requirements for integrating a defined-benefit pension plan.

In general, a plan using a nondiscriminatory definition of compensation that satisfies the 401(l) integration regulations must satisfy one of the nondiscrimination safe harbors. Integration for defined-benefit pension plans is defined under both a unit credit benefit formula and flat benefit formula. The maximum integration formulas are reduced for the following:

- Retirement prior to an individual's Social Security age
- Normal form of benefit other than a life annuity
- Ancillary death or disability benefits
- Averaging compensation over less than five years

3.5 Vesting

When employer-funded benefits cannot be forfeited by the employee, that employee is then said to be vested. Employer-funded contributions or benefits funded can be vested under a schedule in the plan document, based upon the participant's years of credited service. Full vesting is required after seven years of service. All plans must satisfy the following four basic vesting rules:

- Participants must be fully vested at the normal retirement age (IRC Sec. 411(a)).
- Participants must always be vested in their own contributions (IRC Sec. 411(a)(1)).
- To the extent that benefits have been funded, employees must be vested if the plan terminates, or on complete discontinuance of contributions to a profit-sharing or stock bonus plan (IRC Sec. 411(d)(3)).
- Partial terminations occur when a large portion of the workforce is terminated. Under a partial termination, terminated participants are deemed fully vested.

A participant must be fully vested as to an employer's contributions after completing service required under one of three statutorily permissible vesting schedules. The three permitted vesting schedules are the following.

- *Five-year cliff vesting.* Under this schedule a participant is fully vested only after completing five years of service.
- *Three- to seven-year vesting.* Vesting begins upon being credited with three years of service (20 percent) and increases at 20 percent per year to 100 percent at seven years.

| <u>Years of Service</u> | <u>Vested Percentage</u> |
|-------------------------|--------------------------|
| 3 | 20% |
| 4 | 40 |
| 5 | 60 |
| 6 | 80 |
| 7 | 100 |

- *Special schedule for multiple employer plans.* Multiemployer plans must provide 100-percent vesting after ten years of service (IRC Sec. 411(a)(2)(C)).

In most cases, when an employer changes a vesting schedule, employees credited with at least one hour of service in the plan year of the vesting change will be subject to the more favorable vesting schedules. In addition, plans requiring two years of service for participation must provide 100-percent vesting after entry into the plan (IRC Secs. 411(a)(10) and 410(a)(1)(B)).

Note that small employer plans that become top heavy are subject to shortened vesting schedules (see section 3.8).

3.5.1 Vesting—years of service

As a general rule, all service beginning with the employee’s date of hire is included in determining the vested percentage. If the plan so provides, the following years may be excluded:

- Any twelve-month period provided in the plan in which the participant works fewer than 1,000 hours
- Years worked prior to age eighteen
- Years when the employee does not make a *required* contribution to the plan
- Years worked prior to adoption of the plan or a predecessor plan
- Certain years worked prior to a break-in-service in the case of employees rehired after the break who were never vested in any benefits.

3.6 Funding Obligations

Pension plans, whether defined benefit or defined contribution, are subject to mandatory funding obligations not imposed on profit-sharing

and stock bonus plans. Contributions are due not later than 8¹/₂ months after the end of the plan year. Failure to satisfy the pension funding obligations will subject an employer to a nondeductible 10-percent excise tax for each year the deficiency continues. An employer liable for the 10-percent excise tax is required to file IRS Form 5330 and pay the tax within seven months after the end of its plan year. Under certain temporary conditions, an employer may request a waiver of the current year funding from the IRS. Waived amounts are required to be amortized under a fixed schedule. The annual funding requirement of a defined-contribution pension is equal to the amount determined under the contribution formula in the plan document.

Employers maintaining a defined-benefit plan are required to make equal quarterly contributions during the plan year if the plans do not meet mandatory funding requirements. The required amount of the contribution is the lesser of 100 percent of the amount required in the prior year or 90 percent of the current-year funding requirement. Failure to make these contributions will subject the employer to a penalty that is paid to the plan and, if the participants are not notified, a plan disqualification. The penalty is contributed to the plan and is based on interest at 175 percent of the federal midterm rate, or the rate in the plan, if higher.

3.6.1 Funding defined-benefit pension plans

Funding of a defined-benefit pension plan is determined by an actuary under IRC Sec. 412. This funding has developed into an elaborate and technical process that attempts to preclude small employers from accumulating too much too rapidly and larger employers from not contributing enough to meet emerging liabilities. Thus, an actuary must calculate liabilities under various approaches under the plan's assumptions and government-proscribed rates. These liabilities are compared to the plan assets to determine if a plan is underfunded or at a funding limitation. Under these rules, it is possible to have an underfunded plan based upon the plan's actuarial factors, with the employer unable to make a deductible contribution.

Subject to certain limitations, an employer may make deductible contributions up to a plan's full funding limitation. The full funding limitation is the excess, if any, over the plan's assets, or the lesser of 150 percent of current liability—increased in increments of 5 percent every two years beginning in 1999 until reaching a cap of 170 percent for plan years beginning in 2005—or the accrued liability (including normal cost) under the plan. If the plan's liabilities cannot be directly determined under its funding method, they must be determined under the entry age normal funding method. The value of the plan's assets

is the lesser of the assets' fair market value or the assets' value determined under the rules in IRC Sec. 412(c)(2). Current liability is defined under IRC Sec. 412(1)(7) to mean all liabilities to employees and their beneficiaries under the plan as determined under IRC Sec. 401(a)(2) as if the plan had terminated. The Secretary of the Treasury is empowered to prescribe full funding limitations based on factors other than current liability.

In the operation of a defined-benefit pension plan, a funding standard account is established, and certain charges and credits are made to determine whether there is an accumulated funding deficiency (IRC Sec. 412(b)(1)). The funding standard account is reflected on Schedule B of the Form 5500 annual filing. In the case of single-employer plans, the funding standard account is charged with the following:

- The normal cost for the plan year
- The amount necessary to amortize in equal annual installments
 - The unfunded past service liability over thirty years (forty in the case of plans in existence on January 1, 1976)
 - Any increase in unfunded past service liability arising from plan amendments over thirty years
 - Any net experience loss (that is, adverse actual experience in relation to the actuarial assumptions) over fifteen years; any net loss arising from changes in the actuarial assumptions over thirty years
- The amount necessary to amortize any waived funding deficiency over fifteen years

The funding standard account is credited with the following:

- The contributions, including forfeitures, for the year
- The amount necessary to amortize in equal annual installments
 - The net decrease in unfunded past service liability arising from plan amendments over thirty years
 - The net experience gain over fifteen years
 - The net gain resulting from changes in actuarial assumptions over thirty years
- The amount of any waived funding deficiency for the year

The Omnibus Budget Reconciliation Act of 1987 modified the IRC Sec. 412 minimum funding requirements by increasing the amount that is charged to the funding standard account of any underfunded plan. The increase is not to exceed the amount necessary to increase the funded current liability to 100 percent. The increase is (1) the

unpredictable contingent-event amount for the plan year plus (2) the excess of the deficit reduction contribution over the amount necessary to amortize past service liability, each waived funding deficiency, certain amounts credited in the case of an employer's previously using the alternative minimum funding standard account, reduced by the amounts necessary to amortize decreases in past service liability. Unpredictable contingent events include, but are not limited to, facility shut-downs and reductions in workforce. The increase charged to the standard account is not to exceed the amount necessary to increase the funded current liability percentage to 100 percent. These funding rules do not apply to plans that had 100 or fewer participants on each day during the preceding plan year.

In a number of cases, if the fair market value of plan assets exceeds the total accrued liabilities under the plan because of, for example, a substantial increase in the value of its investment portfolio, no contribution is due. This occurs when the full funding limitation is reached, even if there would otherwise be an accumulated funding deficiency.

3.7 Limitations on Contributions and Benefits

Limitations are imposed on the amounts of benefits that can be provided from defined-benefit plans and the amounts of annual contributions that can be made to defined-contribution plans (IRC Sec. 415). These limitations are determined on a participant basis. That is, for 1998, the maximum annual benefit that a participant can receive at normal retirement age is limited to \$130,000. This limitation is adjusted based on cost-of-living increases published by the IRS (see appendix 2). Additional limitations are imposed for employers that have maintained both a defined-benefit and a defined-contribution plan. The IRC Sec. 415 limitations are described below.

Profit-sharing plans are also subject to deduction limits. This limit is based on total eligible pay and is currently at 15 percent. Employers maintaining both a pension and profit-sharing plan are subject to an overall 25 percent of eligible pay limit (IRC Secs. 404(a)(3) and 404(a)(7)).

3.7.1 Defined-benefit plan limits

A defined-benefit plan may not provide a participant an annual benefit in excess of the lesser of \$125,000 for 1997 or 100 percent of the participant's average compensation for his or her high three consecutive years (see appendix 2). The maximum limit is available if the plan's

normal retirement age is at the individual's Social Security retirement age.

This primary limitation requires that the plan's normal form of benefit be in the form of a level monthly annuity payable over the life of the participant. Other forms of benefits can be paid if they are the actuarial equivalent of the life annuity. However, this maximum limitation is adjusted if any of the following occur.

- The normal form of benefit is in any other form. A 100-percent joint and survivor annuity can be provided without a reduction in the IRC Sec. 415 amount.
- The employee is required to contribute to the plan.
- The benefit begins at an age other than the Social Security retirement age.
- The participant has less than ten years of participation. The maximum annual accrual of a participant's benefit is 1/10 of the \$125,000 limit (IRC Sec. 415(b)).

Because of the changes in the tax laws since TEFRA that have systematically eliminated the amount of benefits that an individual could receive as a retirement benefit, transition rules are available to allow participants to keep amounts accrued at the date of change. These participants cannot, however, continue to accrue additional benefits.

3.7.2 Defined-contribution plan limits

While the benefit limit on defined-benefit plans is based on the annual benefits provided at retirement to a participant, defined-contribution plans are limited to the total annual additions allocated to each participant's account. A participant's annual additions cannot exceed the lesser of \$30,000 for 1998 or 25 percent of compensation (see appendix 2 for cost-of-living adjustment). Annual additions include a participant's share of the current employer and employee contributions (before and after-tax) and forfeiture reallocation. An account's share of investment earnings and rollover contributions or the direct transfer of assets between plans is not included (Regs. Sec. 1.415-6(b)(3) and IRC Sec. 415(c)).

3.7.3 Combined plan limits

Individuals participating in both a defined-contribution plan and a defined-benefit plan of the same employer are subject to a combined limit. In general, they are permitted to have a percentage of the maximum limit available under each kind of plan. The maximum percentage is between 125 percent and 140 percent, depending on the level of the

participant's average annual pay and how top-heavy the plan is. Thus, as a representative example, a participant could receive a 20-percent of pay contribution in a defined-contribution plan (80 percent of the maximum percentage limit), if the participant had earned an annual benefit of only \$54,000 (45 percent of the maximum annual limit) under the employer's defined-benefit plan. ($1.25 - .80 = .45$.) For top-heavy plans, the 1.25 percent is reduced to 1.00 (IRC Sec. 415(e)).

The Small Business Job Protection Act of 1996 repealed the IRC Sec. 415(e) combined limit between defined-contribution and defined-benefit plans. This limit has been removed for limitation years beginning after 1999.

3.8 Top-Heavy Plans

Plans are subject to additional limitations if the employer's plans, when considered together, are top-heavy. A top-heavy plan is one in which more than 60 percent of the present value of current benefits or account balances are attributable to the key employees. The plan's distribution to the key and non-key employees for the previous five years is added back in the 60-percent determination. This test is based on the present value of accrued benefits for defined-benefit plans and the account balances for defined-contribution plans. Testing is based upon the values of the participants on the last day of the prior plan year (IRC Sec. 416(g)).

A key employee is an individual who at any time in the current year or the previous four years has been one of the following.

- An officer earning more than 50 percent of the limit contained in IRC Sec. 415(b) (see appendix 2 for cost-of-living adjustments)
- A more-than-5-percent owner
- A more-than-1-percent owner whose annual compensation exceeds the IRC 401(a) threshold (see appendix 2 for cost-of-living adjustments)
- One of the ten employees earning more than the IRC Sec. 415(c) limit and owning the largest interests in the employer (IRC Sec. 416(i)) (refer to appendix 2 for cost-of-living adjustments)

Compensation includes all pretax elective contributions to plans qualified under IRC Secs. 401, 403(b), 125, and so on.

Top-heavy plans must satisfy two additional requirements:

1. Vesting is accelerated.
2. Minimum benefits or contributions must be provided.

A top-heavy plan must provide full vesting under one of two schedules: either full vesting after completion of three years of service or graduated vesting in accordance with the schedule that follows. The years of service that are to be included are those that are under the general vesting rules. See section 3.5 of this chapter (IRC Sec. 416(b)).

| <u>Years of Service Vested</u> | <u>Percentage</u> |
|--------------------------------|-------------------|
| 2 | 20% |
| 3 | 40 |
| 4 | 60 |
| 5 | 80 |
| 6 | 100 |

A top-heavy defined-benefit plan must provide a minimum benefit for each nonkey participant equal to the lesser of (1) the maximum total benefit provided to any key employee or (2) 2 percent of the participant's average compensation, up to 20 percent (ten years). Average compensation is based on a five-year average. The minimum benefit is offset by any employer-provided benefits accrued to date. The minimum required benefit is paid in the form of a single-life annuity commencing at the plan's normal retirement age (IRC Sec. 416(c)(1)).

A top-heavy defined-contribution plan must provide a minimum contribution for each nonkey participant equal to the lesser of (1) the greatest percentage of allocation to any key employee or (2) 3 percent of compensation (IRC Sec. 416(c)(2)). For purposes of determining whether these minimum benefits or contributions have been provided, neither salary reduction amounts, matching contributions used to meet the ACP test under IRC Sec. 401(m), nor employer-paid employment taxes may be taken into account. In some cases, if the employer maintains both a defined benefit and defined contribution plan, the minimum contribution may be increased above the 2 and 3 percent limits mentioned above.

Employees covered under both a defined-contribution and a defined-benefit plan, which are together top heavy, must be provided with an alternate amount that is the lower of the combined minimums. For example, if a defined-contribution plan provides for a minimum contribution of at least 5 percent of the annual compensation, the test is met (Regs. Sec. 1.416-1, m-13).

3.9 Section 401(k) Cash or Deferred Arrangements

A cash or deferred arrangement (CODA) is a 401(k) plan under which an employee can elect to receive an employer contribution as cash or

have it deposited to a qualified plan. These contributions are discussed under section 3.3.2 of this chapter. Only the portion actually received in cash is considered taxable income. IRC Sec. 402(a)(8) provides a special exemption from taxation to the participant with elective contributions.

The maximum calendar-year deferral or elective contribution is the lesser of (1) the 401(k) and SEP salary or (2) 20 percent of predeferral compensation (IRC Sec. 402(g)) (refer to appendix 2 for cost-of-living adjustments). Plans are subject to the following additional requirements:

- No more than one year of service may be required for participation.
- Amounts deferred from taxation by payment into the qualified trust may not be paid out, without penalty prior to the employee's termination of employment, retirement or death, except in the case of disability, hardship, attainment of age 59-1/2, or termination of the plan without establishment of a successor plan (IRC Sec. 401(k)(2)(B)).
- Elective contributions are fully vested (IRC Sec. 401(k)(2)(C)).

A CODA arrangement must be part of a profit-sharing or stock bonus plan. However, employers are no longer required to have current or accumulated profits to make contributions to any profit-sharing plan (IRC Sec. 401(a)(27)). Tax-exempt or government employers may adopt a CODA (IRC Sec. 401(k)(4)(B)) after December 31, 1996. CODAs that are part of a money-purchase plan in existence on June 27, 1974, that included a salary reduction agreement, are grandfathered under prior law.

An employer may not condition contributions or plan benefits, except for matching contributions, upon participants' making elective deferrals. Loans to participants must bear either the prevailing national rate on similarly secured loans or a reasonable rate of interest exceeding the prime rate charged by banks in their region.

3.9.1 Hardship distributions

Because of the restrictions on in-service distributions of elective contributions employers are required to monitor any hardship distributions to assure continued qualification of the plan. A distribution of elective contributions qualifies as a hardship distribution only if—

1. It is made on account of an immediate and heavy financial need of the employee.
2. It is necessary to satisfy such financial need.

There are two methods to determine whether a distribution qualifies as a hardship distribution. The first is known as the facts and circumstances method, and the second method is under a safe harbor. For most employers, the safe harbor will permit a more uniform administration of distributions, even if those rules are more limiting.

3.9.1.1 Facts and circumstances

In using the facts and circumstances method, an employer will have to develop uniform rules to apply in the determination of hardship distributions and maintain records to support each decision. The regulations permit the employer to identify reasonable criteria when evaluating whether a request meets the definition of “an immediate and heavy financial need” of the participant.

In order to satisfy the second criterion of a hardship distribution under facts and circumstances, regulations provide that certain steps be followed before completing the distribution. These requirements provide assurance that the distribution is not in excess of the amount required to satisfy the financial need. In general, an employer can rely on the participant’s representation that other financial sources are not available from any one of the following sources:

- Through reimbursement of compensation of insurance or otherwise
- By reasonable liquidation of the participant’s assets
- By ceasing the participant’s elective or voluntary contributions under the plan
- By making all available withdrawals or nontaxable loans from any qualified plan
- By borrowing from commercial sources on reasonable terms (Regs. Sec. 1.401(k)-1(d)(2)(iii)(A))

3.9.1.2 Safe harbor

There are two steps in determining if a distribution qualifies as a safe-harbor hardship distribution. In addressing the first criterion, “an

(Text continued on page 45)

immediate and heavy financial need” of the participant, the regulations cite the following financial needs as meeting the definition:

- Payment of medical expenses of the employee, spouse, or dependents
- Purchase of a participant’s principal residence, but not including mortgage payments
- Payment of annual tuition of postsecondary education for the participant, spouse, children, or dependents
- Expenditures to stave off eviction or foreclosure of a mortgage on the employee’s principal residence
- Any additional events that may be prescribed by the IRS (Regs. Sec. 1.401(k)-1(d)(2))

In applying the safe-harbor rules to the second criterion (that the amount does not exceed the amount necessary to satisfy the financial need), all of the following requirements must be satisfied:

1. The participant has made all available withdrawals (other than hardship withdrawals) and all nontaxable loans currently available under any plan maintained by an employer.
2. All elective deferrals under any plan maintained by the employer must be suspended for at least twelve months after the hardship distribution.
3. The maximum elective contribution that the participant may make in the next year of participation (currently \$9,240—see appendix 2 for cost-of-living adjustments) is reduced by the amount of the portion of the current-year deferral that is part of the hardship distribution.

3.10 Employee Stock Ownership Plans

In recent years, particular attention has been given to ESOP plans. An ESOP is a defined-contribution plan that is qualified as a stock bonus plan or a combination of a stock bonus and money-purchase plan. The plan(s) must be designed to invest primarily in qualifying employer securities (IRC Sec. 4975(e)(7)). Qualifying employer securities can be common stock readily tradeable on an established securities market or common stock not readily tradeable. Special rules apply to stock not meeting the readily tradeable definition. Such stock is required to have the highest voting power and the greatest dividend rights (IRC Sec. 409(l)). Annual valuation is required by an independent appraiser (IRC Sec. 401(c)(28)(C)).

3.10.1 Employee incentives

ESOPs are designed to place the employer's stock ownership in the hands of a qualified trust for the benefit of the employees and their beneficiaries, thereby presumably creating an incentive for better job performance. In addition to their use as employee incentives, ESOPs can—

- Broaden the base of stock ownership.
- Help resist unfriendly takeover attempts.
- Implement spin-offs of divisions.
- Assist the employer corporation in raising capital and can provide a tax deduction without any immediate cash outlay.

On the other hand, potential problems with ESOPs include the following:

- Dilution of the present owners' control
- Difficulty in valuing stock (if closely held)
- Employee resentment if good earnings are not achieved

Voting rights of the employer's stock are passed through to the participants in the plan, depending on the kind of stock and issue to be voted. A distinction is made between registration type securities and other securities. Registration-type securities are generally required to be registered under Section 12 of the Securities Exchange Act of 1934. For registration-type securities, each participant must be allowed to direct how his or her allocated securities will be voted (IRC Sec. 409(e)(2)). If the employer has no such securities, each participant must be allowed to direct the vote on corporate matters with respect to approval or disapproval of merger, consolidation, recapitalization, reclassification, liquidation, dissolution, sale of substantially all assets, or similar transactions (IRC Sec. 409(e)(3)).

3.10.2 Diversification and distributions (ESOPs)

TRA 1986 added a diversification requirement to these plans for participants age fifty-five or older and with at least ten years of participation. They must be allowed to direct the investment of at least 25 percent of their account balances during the five-year period beginning with the plan year after the participant attains age fifty-five. This amount is later increased to 50 percent (IRC Sec. 401(a)(28)(B)).

Unless elected otherwise by the participant, distributions from the plan must begin not later than one year after the close of whichever plan year is one of the following:

- The year in which the participant separates from service because he or she has attained normal retirement age, or because of disability or death.
- The year that is the fifth year following the separation, if for other reasons.

Securities in the participant's account which were part of a qualified loan under IRC Sec. 404(a)(9) are exempt from this requirement until the loan is repaid (IRC Sec. 409(o)(1)(A)).

Unless the participant elects otherwise, distribution of ESOP benefits must be made in substantially equal payments over a period not longer than the greater of one of the following:

- Five years
- Five years plus one additional year (but not more than five additional years) for each \$135,000 by which the participant's account balance exceeds \$690,000 (IRC Sec. 409(o)(1)(C)) (see appendix 2)

Participants entitled to a distribution from the plan have a right to demand that benefits be distributed in the form of employer securities (IRC Sec. 409(h)(1)). If the securities are not readily tradeable, the employer must be ready to repurchase them or provide a sixty-day put option (IRC Secs. 409(h)(1)(B) and 409(h)(4)). In certain cases, however, cash may be an acceptable medium for distribution (IRC Sec. 409(h)(2)).

3.10.3 Seller incentives

In addition to the employee incentive, tax incentives are also available to the seller. Persons selling qualified securities to the plan may elect nonrecognition of long-term capital gain if, immediately after the sale, at least 30 percent of each class or of the total value of the corporation's stock is held by the plan (IRC Secs. 1042(a) and (b)). For this purpose, qualified securities are employer securities issued by a domestic corporation that have no readily tradeable stock outstanding (IRC Sec. 1042(c)(1)). In order to obtain these tax benefits, certain written statements must be provided to the IRS, and the seller of the securities must then purchase qualified replacement property. Currently, sellers of S Corporation stock are not eligible for the special Sec. 1042 rollover treatment.

ESOPs have become an attractive financing instrument; due to several tax-favored features that existed prior to June 10, 1996, banks and certain similar commercial lenders may exclude from gross income 50 percent of the interest received with respect to loans that an ESOP uses to acquire employer securities. This exclusion is permitted only if, immediately after the acquisition, the ESOP owns 50 percent of each

class of outstanding stock of the employer or of the total value of all outstanding stock (IRC Sec. 133). The 50-percent exclusion is lost for any year in which the percentage of ownership of the employer by the ESOP falls below 50 percent. Employers are also subject to a 10-percent excise tax for certain changes in stock ownership made within three years of the sale to the ESOP. An ESOP may sell bonds to finance stock purchases with 50 percent of the interest on these bonds tax exempt (1989-1 CB24).

Dividends of C Corporations are deductible by the paying corporation maintaining the ESOP if paid in cash on stock held in the ESOP to the following:

- Plan participants or their beneficiaries
- The plan and then distributed to the participants or their beneficiaries
- The plan to make payments on a loan incurred to purchase employer securities to the extent the dividends are paid on employer stock acquired with the loan

One of the most significant features of using an ESOP loan to purchase employer stock is that contributions made to a plan to pay the principal of the loan become deductible to the corporation.

3.10.4 Estate tax considerations

Before December 19, 1989, an estate could deduct 50 percent of the proceeds of the sale from the value of the gross estate for purposes of determining estate tax (IRC Sec. 2057(a)), as long as no portion of the assets of the plan accrued to the benefit of that decedent or the estate for a ten-year period, nor to the benefit of anyone owning 25 percent or more of the corporation that issued the employer securities (IRC Secs. 409(n)(1)(A) and (B)).

There is no deduction to the extent that employer securities are acquired with transferred assets held by another qualified employer plan. An excise tax of 30 percent is imposed if securities are acquired with proceeds of a loan and transferred assets are used to make payment on the loan.

The deduction is not available unless—

- The decedent owned the employer securities immediately before death
- The securities are allocated to plan participants (or held for future allocation in connection with an exempt loan or a transfer of assets from a defined-benefit plan) (IRC Sec. 4980(c)(3)).

Failure to carry out this allocation results in an excise tax of 30 percent of the amount realized on disposition of the securities before

allocation. Even if the proceeds are allocated, an excise tax of 30 percent is imposed if disposition of the securities occurs within three years from the date of purchase.

4. DEDUCTION LIMITS

Employer contributions to a qualified plan must be ordinary and necessary business expenses. Contributions to a qualified plan that would otherwise be deductible pursuant to IRC Sec. 162 are not deductible unless specifically permitted under IRC Sec. 404. Contributions deposited to a plan prior to the end of the plan year and in an amount in excess of a deduction limitation are subject to a 10-percent excise tax. This is an annual penalty for each year that the amounts remain nondeductible (IRC Secs. 404 and 4972(c)). Nondeductible amounts may be carried over to a subsequent year and are deductible in that year if permitted. Employees should note that an excess deduction may not be withdrawn from the plan and redeposited in the employer's account, unless the plan document so permits, and most plans do not.

The Tax Code requires that the compensation of an individual must be reasonable to be deductible. This determination requires that plan contributions and compensation be considered together (IRC Sec. 162).

Pension and profit-sharing plans are subject to two separate limitations in determining the maximum annual contribution deduction.

4.1 Pension Plans

The maximum deductible contributions to a pension plan, whether defined benefit or defined contribution, is determined under any one of three alternative standards.

1. *Minimum funding.* The amount necessary to satisfy the minimum funding standard for the plan year ending within or with the employer's taxable year (or for any previous plan year).
2. *Level funding.* The amount necessary to provide all participants their remaining unfunded cost of past and current service credits distributed as a level amount or a level percentage of compensation over the remaining service of the employee. If more than 50 percent of the remaining unfunded costs is attributable to any three participants, the amounts attributable to such participants must be spread over at least five years.

3. *Past service funding.* The amount equal to the normal cost of the plan plus an amount necessary to amortize past service credits in equal annual installments over ten years.

The first applies to defined-contribution plans, while all three apply to defined-benefit plans.

The selection of the applicable standard is made on a year-by-year basis; that is, the employer can use whichever standard results in the largest deduction (IRC Sec. 404(a)(1)). A separate deduction limit applies when an employer maintains both a defined-benefit and defined-contribution plan. (See section 4.3, below.)

4.1.1 Deductions: Contributions to defined-benefit plans

The funding of a defined-benefit plan is determined under one of the IRS approved level cost methods. In general, an employer can deduct the amount that is necessary to fund the present and past service cost. This amount is generally spread over the working lives of the participants. However, an employer is permitted to accelerate deductions using the limits cited in section 4.1 of this chapter, as long as the contribution does not exceed limitations written into regulations.

These limits are referred to as the *plan's full funding limits*, and only actuaries can really understand how they work. They necessitate several different calculations to determine whether one or more funding limits have been exceeded. This funding limitation is made annually and basically compares the value of the accrued liabilities (how much is to be paid currently) to the plan's assets. Notwithstanding the deduction limits discussed in section 4.1 of this chapter, an employer may not deduct amounts in excess of the full funding limitation for the year. That limit is briefly discussed in section 3.7.1 of this chapter (IRC Secs. 404 and 412).

For purposes of determining the funding and plan liabilities of a defined-benefit pension plan, the projected benefits cannot exceed the maximum permissible benefit limits. The maximum annual benefit at retirement is the lesser of \$125,000, for 1997, or 100 percent of the participant's average earned income (see appendix 2; IRC Sec. 415(b)).

4.1.2 Deductions: Contributions to defined-contribution plans

The annual deduction limit for a defined-contribution pension plan is equal to the sum of the required contributions for each participant. Each participant is limited to the lesser of \$30,000 or 25 percent of pay in, generally, the plan year. This limitation is applied to each individual's

total allocation of employer contributions, forfeitures and employee contributions (both before-tax and after-tax) in the plan year—the so-called annual additions limitation. For most defined-contribution pension plans, forfeitures of nonvested accounts are used to reduce the required employer contribution. A few plans permit or require after-tax employee contributions (now subject to the ACP tests of IRC Sec. 401(m), which are part of the annual addition limits but not the deduction limits), and before-tax employee contributions (which are included in both the annual addition limits and the deduction limits) (IRC Secs. 404(a) and 415(c); Regs. Sec. 1.404(j)(1)(B)).

Beginning in 1990, defined-contribution pension plans may reallocate forfeitures to participants, rather than offset the contribution under the formula in the plan, as long as the annual additions are not exceeded and the plan document permits the reallocation (IRC Sec. 401(a)(8)).

Compensation for deduction purposes is based on compensation paid or accrued within the employer's tax year. However, compensation for purposes of determining plan allocations may be determined on any twelve-month period ending, beginning, or coincident with the plan year; however, it must be used on a consistent basis and be stated in the document. Compensation for purposes of calculating the annual additions limit is based on compensation paid in the limitation year. The twelve-month period is defined in the document as the *limitation year* (IRC Sec. 414(q); Regs. Secs. 1.404(a)(4)-3(e) and 1.414(a)(14)).

4.2 Deductions: Profit-Sharing or Stock Bonus Plans

In addition, the annual deduction limitation described in section 4.1.2, the maximum annual deduction limit for contributions to profit-sharing or stock bonus plans, is 15 percent of the total eligible compensation paid or accrued in the employer's tax year. It may include compensation that is not used to determine the allocation of contributions. For example, if the plan allocates contributions only on compensation after entry into the plan, the employer may use the full compensation in determining the maximum deduction.

For purposes of determining the maximum deduction, employers may count only the compensation of participants who received a meaningful contribution. If a participant is excluded from receiving a contribution solely because he or she terminated employment or did not work one thousand hours, the pay of that excluded individual cannot be used to determine the maximum deduction. But, if a plan limits compensation to base pay, full-year compensation may be used in the deduction calculation (Regs. Sec. 1.404(a)-9(b)).

If an employer maintains more than one profit-sharing or stock bonus plan, or a profit-sharing plan and a stock bonus plan, the 15-percent limitation is applied to all such plans on a combined basis (IRC Sec. 404(a)(3)).

Profit-sharing plans generally provide for discretionary annual contributions and thus do not have a required funding formula. They must, however, have a specific formula for allocating the employer's annual contribution. For discretionary corporate plans (profit-sharing plans), the amount of contribution is determined by the board of directors. TRA 1986 removed the requirement that an employer's contributions be contingent upon the existence of current or accumulated profits (IRC Sec. 401(a)27). So now nonprofits or failing corporations may have a profit-sharing plan. For purposes of determining the maximum profit-sharing deduction, forfeitures do not affect the calculation, as they do in a money-purchase pension plan where a forfeiture reduces the maximum contribution.

Compensation for purposes of determining deductible contributions cannot exceed the annual IRC 401(a) cap. Refer to appendix 2 for the cost-of-living adjustments.

Profit-sharing plans receiving nondeductible contributions generally must allocate the entire contribution, up to the annual additions limitations, unless the document says otherwise. Thus, a profit-sharing plan may not carry any contributions or forfeitures in suspense unless each participant has received an allocation of the lesser of 25 percent of pay or \$30,000, unless the document so permits.

4.3 Combined Plan Deduction Limits

If an employer maintains both a defined-benefit and a defined-contribution plan, the deduction limits are modified. The maximum deductible contribution is the greater of the following: (1) the amount required to be funded for the defined-benefit plan or (2) 25 percent of eligible participant pay (IRC Sec. 404(a)7).

Any nondeductible amounts may be carried forward to a subsequent year when deductible. This limit only applies if at least one employee participates in both plans. Thus, if the employer maintains two plans for two distinct groups of employees, the rules do not apply.

Effective for tax years beginning after 1997, nondeductible contributions to a defined-contribution plan that are not deductible because they exceed the combined plan deduction limit are no longer subject to the excise tax, to the extent the contributions do not exceed the amount of the employer's matching contributions plus the elective deferral contributions to a section 401(k) plan (limited to no more

than 6 percent of compensation paid or accrued to beneficiaries under all plans).

However, any nondeductible contributions are generally subject to an annual 10-percent excise tax (IRC Sec. 404(a)(7)). Thus, an employer may be forced to make contributions to a money-purchase plan that are not deductible.

4.4 Deductions: Plans for Self-Employed Persons and Other Owner Employees

So far, this chapter has addressed the rules and limitations of qualified plans set up by corporate employers. Self-employed individuals and

(Text continued on page 53)

partnerships may also participate in a qualified retirement plan. The rules relating to the adoption and operation of a plan for a self-employed individual or partnership are generally the same as those for corporate employers. Certain restrictions apply to the self-employed's plan. A self-employed individual is one who has *earned income* for the taxable year and also is one of the following:

1. Would be self-employed except that the trade or business carried on by this individual had no net profits for the year
2. Has been a self-employed individual for any prior taxable year (IRC Sec. 401(c)(1)(A))

This definition also includes partners in partnership.

Earned income is the net earnings from self-employment in a trade or business in which the personal services of the taxpayer are a material income-producing factor (IRC Sec. 401(c)(2)(A)).

The contributions for the self-employed are more difficult to determine than for their common-law employees because contribution limits are based on earned income *after* subtracting all contributions and one-half of the individual's self-employment taxes. In concept, the maximum 25-percent defined contribution for a self-employed individual is 20 percent of gross earned income after subtracting one-half of the self-employment taxes. The same rules apply to contributions made for partners of partnerships.

Plans covering self-employed participants are subject to the same overall limits of IRC Sec. 415 (see section 3.7 of this chapter). Thus, the maximum annual addition under a defined-contribution plan is the lesser of \$30,000 or 25 percent of earned income after the contribution. The maximum annual benefit at retirement is the lesser of the IRC Sec. 415(b) limit, or the plan participant's average earned income (IRC Secs. 415(b) and (c)).

Contributions to profit-sharing plans on behalf of self-employed individuals are also subject to 15 percent of the earned-income deduction limit, after subtracting contributions and one-half of the self-employment taxes. Thus, the contribution for the self-employed individual may not create a loss unless the plan is a defined-benefit pension. However, the contribution for the common-law employees is greater than the earned income, and the expense is treated as any other expense and may result in a net loss for tax purposes.

In addition to the preceding requirements, owner-employees and self-employed individuals are prohibited from making participant loans (IRC Sec. 4975). The rules covering participant loans are discussed in section 5.8 of this chapter.

4.5 Deductions: Employee Stock Ownership Plans

Deductible employer contributions to ESOPs, whether pension or profit sharing, are subject to the general limits for all defined-contribution plans. However, for certain ESOPs (called leveraged ESOPs) that have purchased employer stock with a plan-held note, additional deductions are permitted. Employer contributions to a qualified ESOP that are applied to the repayment of such loans are deductible under the following two rules:

1. Principal payments are deductible up to 25 percent of the total eligible compensation (IRC Sec. 404(a)(9)(A)).
2. The full amount of the interest payment is deductible (IRC Sec. 404(a)(9)(B)).

See sections 3.10 and 9.2 of this chapter for additional information on ESOPs.

4.6 Deductions: Timing and Form

To be deductible, contributions must be made either during the employer's taxable year or up to the time for filing the employer's income tax return, including valid extensions. This payment rule applies to both cash- and accrual-basis taxpayers. It is no longer necessary, formally, to recognize the accrual prior to year end to support the deduction to pension or profit-sharing plans (IRC Sec. 404(a)(6)). The service deems that the filing of the tax return is sufficient to validate the accrual.

A special rule applies to the timing of pension contributions made after the due date of the employer's tax return but before the period for minimum funding. If the plan is a pension plan subject to minimum funding, the contribution is required within eight and one-half months after the plan year end. Such contributions are, for cash-basis taxpayers, deductible in the current year only if paid by the due date of the tax return. Contributions made after the due date of the employer's tax return, plus extensions, are deductible in the next tax year. At that time, the employer may deduct the remaining required contribution and the current-year contribution, even if the two amounts exceed the 25 percent of current-year pay limitation (IRC Secs. 404(a)(1)(A) and 412(c)(8)).

Payment of the employer contribution generally must be made in cash. Certain transfers of employer stock, third-party notes, or property (called in-kind contributions) of the employer *may be* eligible for a

deduction to a profit-sharing plan but only if the property is unencumbered. However, a contribution of the employer's promissory note does not entitle the employer to a deduction. Although such noncash contributions of property may be deductible, they will trigger taxable gain equal to the value of the appreciated property over its cost, and could be a party-in-interest prohibited transaction (IRC Sec. 267, ERISA Sec. 408(a), and DOL Opinions 81-69A and 90-05A). See DOL Interpretive Bulletin 94-3 and IRS Announcement 95-14 for rules on in-kind contributions (see section 6.2.1 of this chapter).

4.7 Contribution Withdrawals

In an effort to avoid the 10-percent nondeductible excise tax or to avoid an unintended allocation of contribution in a profit-sharing or stock bonus plan, an employer may be tempted to withdraw the excess contribution from the plan. Such a withdrawal would violate a requirement that plan benefits must be for the exclusive benefit of participants. Such a withdrawal and return to the employer is permitted for only a few limited exceptions. They are the following:

- Contributions made on account of a mistake of fact. Such withdrawals are restricted and must be within one year of the date that the deposit was made, and, generally, are only available for defined-benefit plans. The plan document must specify that such a withdrawal may be made (Rev. Proc. 89-35) (PLR 9436045).
- Reversions in a defined-benefit pension plan, which generally are subject to a 50-percent excise tax. If the reversion is contributed to a defined-contribution plan, the excise tax is reduced to 20 percent if either of the following requirements are met:
 1. At least 25 percent of the maximum reversion is transferred to the defined contribution plan
 2. Provides a *pro rata* increase in terminated participants in terminated plan of 20 percent
- Deposits that are made conditional on the deductibility of the contribution, the contribution is *not* deductible, and the plan permits a withdrawal. This is generally available for employers adopting a plan making its initial deposits, before the IRS has completed the determination letter process, that is denied and the deposits are returned.

Unauthorized withdrawals may subject the plan to penalties and disqualification (Rev. Rul. 83-52; Committee Reports ERISA, 1974, Section 403).

Certain employee withdrawals are permitted. See the discussion of hardship withdrawals in section 3.9.1 of this chapter.

5. TAXATION OF DISTRIBUTIONS

The following three basic rules govern the income taxation of distributions from a qualified plan.

1. If the participant realized no taxable income when the employer contributed to the plan, tax is incurred when a distribution is made.
2. If the participant incurred tax when the contribution was made to the plan, or if the participant contributed after-tax funds to the account, a portion or all of the distribution of these funds are tax free, based on an exclusion ratio.
3. For certain qualifying distributions, it is possible to defer the imposition of income tax at the time of distribution by transferring all or a part of the distribution to another eligible retirement plan or a rollover IRA.

Special rules apply to the income taxation of distributions and the availability of rollovers. The rules were greatly simplified, however, when the rollover rules were rewritten in 1992. A brief description of the distribution rules follow. The form of distributions is determined under the plan document and may differ from plan to plan. The basic forms of distribution from a deferred contribution plan are as follows:

- A single-sum payment of all of the participant's account balance
- A series of periodic payments based upon the participant's balance
- An annuity
- A combination of the preceding two

Each of these distribution methods is subject to a separate set of requirements that affect their taxability, as well as the notification requirements. Special rules apply to married participants.

(Text continued on page 57)

5.1 Lump-Sum Distributions: What Are They?

For the most part, participants include the taxable portion of any distribution with the participants' other income to determine the taxes due. However, certain distributions are afforded a lower-income tax rate, if they qualify as lump-sum distributions. A lump-sum distribution is that of the employee's entire balance after the participant attains age 59^{1/2} and if distribution also satisfies the following requirements.

- The distribution is made within a single tax year of the recipient.
- The participant must also receive a lump-sum distribution from all similar plans. Similar plans are divided into three groups: profit-sharing plans, stock bonus plans, and pension plans (both defined contribution and defined benefit).
- The distribution is made on account of one of the following triggering events:
 - The participant's death
 - The employee's attainment of age 59^{1/2}
 - The participant's termination of employment, an option that is not available to self-employed participants
 - A self-employed participant's becoming totally and permanently disabled (IRC Sec. 402(d)(4)(A))

In addition, the employee must have been a participant in the plan for five or more taxable years. This five-year restriction does not apply to lump sums paid as a death benefit (IRC Sec. 402(e)(4)(h)).

Distributions from an IRA are not eligible for lump-sum distribution treatment. Thus, any qualified plan distribution rolled over to an IRA loses this favorable tax treatment.

5.1.1 Lump-sum distributions: How are they taxed?

Single-sum distributions that qualify as lump-sum distributions permit the recipient to elect one of the following methods of taxation:

1. To have the entire distribution taxed as ordinary income in the year of receipt
2. To treat the distribution as ordinary income subject to a special five-year forward averaging under current rates (Five-year forward averaging is repealed for tax years beginning after December 31, 1999.)
3. For certain participants age fifty or over on January 1, 1986, to determine the income tax under a special ten-year forward averaging based upon 1986 income tax rates (If the individual also participated

in a plan prior to 1974, capital gain treatment of a portion of the distribution is available at a flat 20 percent.)

4. To defer the income tax by transferring all or a part of the distribution to another qualified plan or IRA through a direct rollover, if completed within sixty days of receipt

Employees electing special forward averaging must apply the averaging to all lump-sum distributions received in the same year. Thus, a portion of one distribution cannot be rolled over while another portion is treated to the special tax averaging (IRC Sec. 402(e)).

5.1.2 Lump-sum distributions at death: How are they taxed?

Spousal beneficiaries, generally, are permitted all the distribution options available to a deceased participant. A spouse may make the rollover of a lump-sum distribution, even if the participant had been receiving retirement distributions prior to death (IRC Secs. 402(c)(9) and 402(e)(4)). If the participant has an IRA with the spouse as sole beneficiary, the spouse may treat the IRA as his or her own.

Death benefits that are paid from a plan as proceeds of a life insurance policy are entitled to an exclusion from income tax if the equivalent insurance costs have been paid by the participant (called "PS 58" costs). This exclusion is equal to the excess of the face value of the policy over the policy's cash value. In order to receive the proceeds tax-free, the participant must include as taxable income the annual cost of the insurance. These costs (the PS 58 costs) are determined from the table of values; see Rev. Rul. 55-747 and 6-110 (IRC Sec. 101 and Regs. Sec. 1.72-16(b)).

Beneficiaries of a deceased employee who died prior to August 21, 1996, could exclude from taxable income up to \$5,000 of payments made from a plan. This exclusion applied to any lump-sum distributions or to any benefits that become vested at the date of death (IRC Sec. 101(b)(2)).

5.2 Direct Rollovers

Legislation in 1992 rewrote the way distributions could be made from a plan and when they could be rolled over. The net effect of the new law is to enable just about any kind of distribution, lump-sum or periodic, to be transferred directly to an eligible plan or IRA. The kinds of distributions that are not permitted to be direct rollovers are the following:

1. Minimum distributions at age 70^{1/2}
2. Periodic level distributions that are paid over the participant's life expectancy and for at least ten years

3. Distributions made because a 401(k) plan failed the ADP and ACP tests
4. Distribution of amounts that were previously taxed

The new law also imposed a new withholding requirement of 20 percent of all qualified plan distributions that are paid to the participant. No withholding is required of distributions from IRAs.

5.3 Distributions of Employee Contributions

Generally, all portions of a periodic distribution are subject to income tax when paid by a plan. However, distributions that include after-tax employee contributions are partially tax-free. Such distributions are taxed in accordance with the annuity payment provisions of IRC Sec. 72, which were revised under TRA 1986. An exclusion ratio is now applied to all distributions from qualified plans in which the participant has basis. The portion of any distribution that is not taxable is the product of the exclusion ratio and amount of the distribution. The exclusion ratio is determined by dividing the participant's total basis in the plan by the total value of the account. For example, if the participant in a defined-contribution plan had one thousand dollars of after-tax contributions in the plan, and the plan account was valued at ten thousand dollars, one-tenth of each distribution in the year would be tax-free. The items that make up basis in the plan include loans deemed taxable, after-tax employee contributions and, under certain conditions, the participant's PS 58 costs.

If distributions are made after the annuity starting date or from a defined-benefit plan, the nontaxable portion is determined by multiplying the distribution by a fraction, the numerator of which is the amount contributed by the employee on an after-tax basis, and the denominator of which is the total expected distribution calculated as of the annuity starting date (IRC Sec. 72(b)).

However, certain plans in effect on May 5, 1986, that permitted in-service withdrawal of after-tax employee contributions are permitted to continue that provision. For these plans, participants may make fully tax-free withdrawals of any after-tax contributions made before December 31, 1986. After that, the exclusion ratio applies. The plan document must provide for such a withdrawal of employee after-tax contributions (IRC Sec. 72(e)(8)(D)).

In no event can more than the recipient's after-tax contributions be excluded from taxation. If the participant dies before recovering his or her contributions tax-free, the remaining nontaxable amount is deductible on the decedent's final income tax return.

No portion of an employee's after-tax contribution may be rolled over to another plan or IRA as a direct transfer. It is permissible to make a formal trustee-to-trustee transfer of after-tax employee contributions from one plan to another if the plan is amended to reflect the transfer.

5.4 Additional Tax on Premature Distributions

Distributions made before a participant's attainment of the age of 59-1/2 are subject to an additional tax, the *premature distributions tax*. The additional tax is 10 percent of the taxable portion of a qualified plan or IRA distribution. The exemptions permitted for this additional tax under the different kinds of distributions are described in the following.

IRAs and Qualified Plans

For distributions under IRAs and qualified plans, exemptions are permitted—

- For payment over the participant's life.
- After the participant's death.
- As a result of disability.
- To the extent of deductible medical expenses.
- Distributions rolled over tax-free to an IRA or to another qualified plan.

There are additional requirements under the substantially equal payments exclusion identified above. Notice 89-25 provides a detailed description of three methods to calculate level payments. In addition, if the amount of the level payments is changed prior to the *later* of age 59-1/2 or five years, the previous payments will be subject to the additional tax (IRC Sec. 72(t)(4)).

Qualified Plans

For distributions under qualified plans, exemptions are permitted—

- As a payment to an alternate payee under a qualified domestic relations order (QDRO).
- For distributions made to participants that separate from service after age 55.

5.5 Additional Tax on Large Distributions

The previous tax on excess distributions from qualified retirement plans (IRC Sec. 4980A) is repealed by the 1997 tax act.

5.6 Required Distributions

All plans are required to make certain minimum distributions. Generally, distributions of benefits must commence in the calendar year in which a participant attains age 70¹/₂ unless the participant is not a 5-percent owner of the employer company, but is still employed by the employer. A participant is permitted to delay the first required distribution until the April 1 following attainment of age 70¹/₂, or until the April 1 following actual separation from service (after attaining age 70¹/₂). This date is referred to as the required beginning date (RBD). After the RBD, minimum distributions are required by each December 31 (IRC Sec. 401(a)(9)).

5.6.1 Lifetime distributions

5.6.1.1 Individual account plans

The amount of the minimum distribution required at age 70¹/₂ is based upon the joint life expectancy of the participant and any *designated beneficiary* named on the annuity starting date. The first-year minimum distribution for defined-contribution accounts is calculated by dividing the participant's balance by the life expectancy of the participant and the designated beneficiary, under Tables V or VI of Regulations 1.72-9. The balance for the first distribution used is the participant's account balance as of the plan's valuation date immediately preceding the calendar year when the participant attains age 70¹/₂. For each subsequent distribution, the next plan year valuation is used (Regs. Sec. 1.401(a)9-1(E)).

For purposes of utilizing the tables, married participants may either use the amount determined as of the first distribution date reduced by one for each year, or recalculate the remaining life expectancy for the participant and spouse. Recalculation is based upon Tables V or VI and reflects the higher age of the individuals. If the recalculation method is used, then in the year following the death of either the participant or spouse, only the surviving individual's life expectancy is used. The choice of using the *subtract one* or recalculation must be made by the plan's annuity starting date. The ability to recalculate will be stated in the plan. The default method under the code is recalculation (Regs. Sec. 1.401(a)9-1, Questions E-6, 7, and 8).

5.6.1.2 Defined-benefit plans

Benefits from a defined-benefit plan must be paid at least annually over the life of the participant or the lives of the participant and beneficiary under the option selected by the participant.

If a qualified plan fails to meet the minimum distribution rules, it may be disqualified. However, for plan years beginning after December 31, 1988, a plan will not be disqualified when there are isolated instances when the distribution rules under IRC Sec. 401(a)(9) are not satisfied. In addition, a 50-percent excise tax is imposed on the recipient for amounts that were required to be distributed but were not (IRC Sec. 4974). A waiver of the penalty may be requested by filing Form 5329, together with a letter of explanation but only after the excise tax is paid.

5.6.2 Required distributions at death

Distributions at death are subject to special minimum distribution rules of IRC Sec. 401(a)(9). These rules are applied based on whether the participant had begun to receive the monthly benefits upon attaining age 70^{1/2} (the required beginning date).

If the minimum distributions, for age 70^{1/2}, had begun, the payments continue to the designated beneficiary under the method already selected. If the participant and spouse had been recalculating the amount of distribution as described above, recalculation would continue, but based on the single life table for the survivor (Prop. Regs. Sec. 1.401(a)(9)-1, Q&A B-4).

If the individual dies before the required beginning date, the distributions must generally be fully paid out by December 31 of the fifth calendar year following the date of death. There are the following two exceptions to the five-year rule:

(Text continued on page 65)

a deceased participant's account. The tax is 15 percent of the excess of the value of the participant's benefits in all qualified plans, tax-sheltered annuities, and IRAs, over the present value of life annuity equal to the threshold amount, based upon the life expectancy of the participant had the participant lived (IRC Secs. 4980A(c) and (d)).

This tax is in addition to any estate taxes. Either the date of death or the alternate valuation date of the estate may be used to determine the value subject to the tax. If the balance of the grandfathered amount is greater than the life annuity in the determination, the grandfathered amount replaces the annuity value in determining the excess. The unified estate and gift tax credit and the marital deduction cannot be used to decrease the amount of the accumulation subject to tax (IRC Secs. 4980A(d)(2) and 2013(g)).

Spousal beneficiaries may elect to have the deceased participants' excess accumulations tax delayed until the spouse's death if the spouse is the sole beneficiary of all accounts. At the time of the spouse's death, the balance transferred and the spouse's benefits are aggregated for purposes of determining the spouse's excess accumulations tax (IRC Sec. 408(d)(3)(C)(ii), Regs. Sec. 1.401-2(b)(7)(ii)).

5.6 Required Distributions

All plans are required to make certain minimum distributions. Generally, distributions of benefits must commence in the calendar year in which a participant attains age 70-1/2 unless the participant is not a 5-percent owner of the employer company, but is still employed by the employer. A participant is permitted to delay the first required distribution until the next April 1, the annuity starting date. After age 70-1/2, minimum distributions are required by each December 31 (IRC Sec. 401(a)(9)).

5.6.1 Lifetime distributions

5.6.1.1 Individual account plans

The amount of the minimum distribution required at age 70-1/2 is based upon the joint life expectancy of the participant and any *designated beneficiary* named on the annuity starting date. The first-year minimum distribution for defined-contribution accounts is calculated by dividing the participant's balance by the life expectancy of the participant and the designated beneficiary, under Tables V or VI of Regulations 1.72-9. The balance for the first distribution used is the participant's account balance as of the plan's valuation date immediately preceding the calendar year when the participant attains age 70-1/2. For each

subsequent distribution, the next plan year valuation is used (Regs. Sec. 1.401(a)9-1(E)).

For purposes of utilizing the tables, married participants may either use the amount determined as of the first distribution date reduced by one for each year, or recalculate the remaining life expectancy for the participant and spouse. Recalculation is based upon Tables V or VI and reflects the higher age of the individuals. If the recalculation method is used, then in the year following the death of either the participant or spouse, only the surviving individual's life expectancy is used. The choice of using the *subtract one* or recalculation must be made by the plan's annuity starting date. The ability to recalculate will be stated in the plan. The default method under the code is recalculation (Regs. Sec. 1.401(a)9-1, Questions E-6, 7, and 8).

5.6.1.2 Defined-benefit plans

Benefits from a defined-benefit plan must be paid at least annually over the life of the participant or the lives of the participant and beneficiary under the option selected by the participant.

If a qualified plan fails to meet the minimum distribution rules, it may be disqualified. However, for plan years beginning after December 31, 1988, a plan will not be disqualified when there are isolated instances when the distribution rules under IRC Sec. 401(a)(9) are not satisfied. In addition, a 50-percent excise tax is imposed on the recipient for amounts that were required to be distributed but were not (IRC Sec. 4974). A waiver of the penalty may be requested by filing Form 5329, together with a letter of explanation but only after the excise tax is paid.

5.6.2 Required distributions at death

Distributions at death are subject to special minimum distribution rules of IRC Sec. 401(a)(9). These rules are applied based on whether the participant had begun to receive the monthly benefits upon attaining age 70-1/2 (the required beginning date).

If the minimum distributions, for age 70-1/2, had begun, the payments continue to the designated beneficiary under the method already selected. If the participant and spouse had been recalculating the amount of distribution as described above, recalculation would continue, but based on the single life table for the survivor (Prop. Regs. Sec. 1.401(a)(9)-1, Q&A B-4).

If the individual dies before the required beginning date, the distributions must generally be fully paid out by December 31 of the fifth calendar year following the date of death. There are the following two exceptions to the five-year rule:

1. If distributions begin in the calendar year following the date of death, the payments can be made over the designated beneficiary's life expectancy.
2. If the designated beneficiary is the spouse, the spouse may elect to delay the designations until the participant would have turned age 70¹/₂, or to rollover the balance to an IRA in his or her own name.

The minimum lifetime distributions apply separately to each qualified plan. That is, each plan must make the minimum distribution. However, the IRA accounts may be aggregated with payments made from only one IRA.

5.7 Taxation of IRA Distributions

Distributions from an IRA are included in the recipient's gross income under the annuity rules of IRC Sec. 72. Regardless of the nature of the income earned by the IRA, all distributions are taxed as ordinary income.

If all contributions to the IRA were made pretax, that is, there is no cost basis in the account, 100 percent of any distribution from the account will be included in income in the year of receipt. Otherwise, the exclusion ratio described in section 5.3 is applied.

For IRA distributions, IRS Form 8606 must be filed to claim exclusion for a nontaxable distribution. Instructions accompanying Form 1040 and 1040A contain a worksheet to aid in completion of Form 8606.

Example. Suppose Rose, prior to the year she takes a distribution, has contributed \$10,000 to her IRAs, \$300 of which was not deductible. In this year, she makes a nondeductible contribution of \$2,000 and, later in the same year, withdraws \$5,000. The fair-market value of investments remaining in IRAs at the end of the year is assumed to be \$20,000. Rose figures her taxable and nontaxable withdrawal as follows:

1. Add basis at the beginning of the year—\$300—to contributions made during the year (or for that year within the allowable period of the following year)—\$2,000. It is irrelevant at this stage of the calculations whether the contributions made during the year are deductible or not.
2. Divide the total—\$2,300—by fair-market value plus distributions—\$20,000 + \$5,000. The result is .092 (9.2 percent), which is known as the exclusion ratio. The portion of the \$5,000 distribution that is excluded from income is .092 multiplied by \$5,000, or \$460.
3. To determine the new basis that Rose has remaining in her IRA, deduct \$460 from the old basis, plus this year's nondeductible contributions. The new basis is $\$300 + \$2,000 - \$460 = \$1,840$.

Note that if this year's contribution had been nondeductible to the extent of \$1,000, the exclusion ratio would still have been .092, and the new basis would be \$840.

If an IRA has been converted to an annuity contract, distributions from the annuity are partly taxed and partly excluded from income tax in accordance with the exclusion ratio. If a recipient inherits an IRA from someone not his or her spouse and the decedent had a basis in the IRA, that basis remains an attribute of that identifiable IRA and cannot be aggregated with any other IRAs the recipient may have. A separate exclusion ratio is calculated, and a separate Form 8606 is filed. The same is true for an IRA inherited from a spouse, unless the recipient chooses to treat that IRA as his or her own, in which case it may be aggregated with other IRA accounts of the surviving spouse.

Making after-tax contributions to an IRA establishes a basis. Once all amounts in a recipient's aggregate IRAs have been distributed, any unrecovered basis can be claimed as a loss. The loss is treated as a miscellaneous itemized deduction on Schedule A, subject to the 2-percent floor.

5.7.1 Penalties related to premature distributions

Unless a recipient has reached age 59^{1/2}, a 10-percent penalty must be paid on distributions. This penalty is in addition to any regular income tax that is due, but does not apply to that part of a distribution arising from a return of basis.

Exceptions from the penalty apply to the disability or death of the recipient, for rollovers into another IRA, and for annuity distributions. Annuity distributions are substantially equal periodic payments made over the life of the IRA owner. This payment schedule must be followed for at least five years or until the taxpayer reaches 59^{1/2}, whichever occurs later.

5.7.2 Penalties related to excess distributions

The 1996 Act lifted the 15-percent excise tax on total retirement distributions in excess of the 4980A excess distribution limit for years 1997, 1998, and 1999. The excise tax was scheduled to resume beginning in the year 2000. The Tax Reform Act of 1997 permanently repealed this 15-percent excise tax for all future years.

5.7.3 Penalties related to insufficient distributions

If the required minimum distributions are not taken, the recipient must pay a penalty of 50 percent of the deficiency. The penalty should be paid but a refund requested in the case of reasonable cause. Form 5329,

together with a letter of explanation, may be used to request a waiver of penalty.

5.7.4 Determining required minimum distributions

IRC Sec. 401(a)(9) mandates that distributions begin by April 1 following the calendar year in which the recipient reaches age 70^{1/2} or separates from service (if the postponement election has been made, as discussed in section 5.6, herein). Proposed Treas. Reg. 1.401(a)(9)-1 discusses available options: the fixed-number-of-years method (also called the term certain method) or the life-expectancy-recalculation method. IRA contracts ordinarily permit the taxpayer to make an irrevocable choice between these two methods. The recalculation method, however, is often specified in the contract as the method of default if no choice is made. The choice must be made before the required beginning date of IRA distribution.

Life expectancy tables are built on the premise that for each year you live, you are apt to live a little longer. Thus, the recalculation method ordinarily results in distribution over a longer period of years if both recipients remain alive. It also minimizes the required minimum distribution that must be taken each year and minimizes the annual tax bill. However, the amount of the distribution is increased if one beneficiary's life expectancy goes to zero in the calendar year following the year of the death, resulting in a longer distribution. If no beneficiary has been named, the IRA plan's custodian must distribute the entire remaining balance before the last day of the year in which life expectancy is reduced to zero.

If the IRA owner is married and the spouse is the named beneficiary, the surviving spouse may avoid these consequences by rolling over the remainder of the account. If the beneficiary spouse dies first, the IRA owner cannot break out of the zero rule. Acceleration will take place in the year following the owner's death, unless the participant remarries.

Distributions to a beneficiary under the fixed method continue after the taxpayer's death for the number of years remaining in the contract. An IRA owner in poor health might elect the fixed method over a period of years in order to avoid the zero rule of the recalculation method while maximizing the period of tax-deferred accrual.

5.7.5 Inheritance of an IRA by a spouse

When a spouse takes an inherited IRA from which required minimum distributions have begun, distributions must continue at least as rapidly as under the method in effect on the date of death of the decedent spouse. Alternatively, the survivor could elect to accelerate the payments.

As a further option, a surviving spouse may elect to treat the inherited IRA as the surviving spouse's own IRA. This election operates to convert the inherited IRA to one that is owned and maintained by the surviving spouse. Either of the following actions operates as an election:

- Failure to conform to the minimum distribution rules following the owner's death
- Contribution of additional amounts into the inherited IRA

If the surviving spouse elects to treat the inherited IRA as his or her own, the following are possibilities.

- A surviving spouse less than 70¹/₂ years old with earned income can make further contributions to the IRA.
- The beginning date for distributions is based on the surviving spouse's age.
- The surviving spouse can name his or her own beneficiaries.
- The amount of required minimum distribution is based on rules for distribution to an IRA owner, rather than on rules for post-death distributions to a beneficiary.
- The surviving spouse can elect either a term-certain or life-expectancy distribution.

The surviving spouse may choose a beneficiary for the IRA that he or she inherited and now owns. For a young beneficiary, such as a child or grandchild, the deferral and payout periods may be extended many years. The actual joint-life expectancy cannot be used to determine payout, however. Distributions where the beneficiary is a younger non-spouse are based on the minimum distribution incidental death benefit (MDIB). This limit assumes that the beneficiary is only ten years younger than the IRA owner. The ten-year assumption somewhat reduces the advantage of naming a much younger beneficiary. However, if the IRA owner dies, the younger beneficiary may base distributions on the joint-life expectancy table.

Example. Suppose a 76-year-old IRA owner dies leaving a 73-year-old widow as beneficiary. The widow chooses to take over the IRA as her own and selects her 45-year-old son as beneficiary. Although their joint-life expectancy is 38.1 years, the distribution must be made according to the MDIB table, which gives a joint expectancy of 23.5 years. Assume the widow chooses a recalculation of life expectancy. In the following year, the distribution would continue to conform to the MDIB table, that is, it would be based on 22.7 years, then 21.8 years, and so forth. Then, suppose the widow herself dies after taking three years of distributions. Because she had taken the account as her own, the IRA passes to her surviving son.

(Had she originally taken the account as the beneficiary of her deceased husband, the funds in the IRA would have been distributed to her estate in the calendar year after her death.) The surviving IRA owner—her son—can now continue to take distributions from the IRA over the period remaining in their initial joint-combined-life expectancy (38.1 years). Since the IRA has been in distribution for three years, he may continue withdrawals based on 35.1 years. This amounts to only 2.85 percent annually, probably less than the growth rate of the IRA.

5.7.6 Distributions from a Roth IRA

After a five-year period, a distribution from a Roth IRA will be free from tax and penalty if it is—

- Made on or after age 59½ or death
- Made on account of disability, or
- Used for qualifying expenses by a first time homebuyer.

The five-year period begins with the first tax year for which a contribution was made to the Roth IRA. Rollovers may be made to a Roth IRA from a non-Roth IRA or from another Roth IRA. Rollovers are subject to the rollover rules in IRC 408(d)(3). Rollovers prior to age 59½ from a non-Roth IRA are treated as taxable distributions, although not subject to the present 10-percent penalty. The tax on amounts earned in the rolled-over non-Roth IRA may be spread over four tax years if the rollover is made prior to January 1, 1999.

5.8 Loans Treated as Distributions

Prior to TRA 1986, many plans utilized plan loans to provide participants with access to their account balance without causing the amounts to be taxed as distributions. However, with the loss of tax deductions for interest payments, much of the emphasis on plan loans is gone. The most frequent plans to permit loans are 401(k) plans, where employees request access to their own contributions. As more restrictions are placed on any in-service hardship distributions, administrators may wish to continue participant loans.

TRA 1986 placed restrictions on both the timing and size of participant loans. Failure to follow these rules will result in the taxation of the loan balance to the participant. A plan loan will not result in taxable income if, when aggregated with other plan loans, it does not exceed the lesser of the following:

- \$50,000, reduced by the highest outstanding loan balance during the preceding one-year period, or if greater, the outstanding balance on the date a new loan is made

- The greater of 50 percent of the vested account balance of the employee or \$10,000 (IRC Sec. 72(p))

Plan loans are also subject to the following.

- Loans must be made according to the terms of the plan document.
- Loans must, by their terms, be repayable within five years, unless they are used to acquire a dwelling unit used as the principal residence of the participant. This rule applies to loans made, renewed, renegotiated, modified, or extended after December 31, 1986 (IRC Sec. 72(p)(2)(B)).
- Loans must require substantially level amortization, with payment made at least quarterly (IRC Sec. 72(p)). It is best to require payroll withdrawals.
- Plan loans must be available to participants on a nondiscriminatory basis (Regs. Sec. 1.401(a)4-4).
- The IRS released a Proposed Regulation in early 1998 that clarifies the taxation of distributions that fail to comply with IRC Sec. 72(p). (Proposed Reg. Sec. 1.72(p)-1.)

For further information on requirements outside of this text, contact the Exemption Division of the Department of Labor at (202) 523-8881.

6. FIDUCIARY RESPONSIBILITIES

A plan fiduciary is any individual who exercises discretionary authority over the management or administration of an employee benefit plan or over the management or disposition of its assets. Fiduciaries include any individuals who render investment advice to the plan for direct or indirect compensation (ERISA Sec. 21(A)). A fiduciary may also include any accountant providing administrative direction to a plan sponsor on the distribution or management of assets. Fiduciaries are personally liable for any plan losses resulting from a breach of fiduciary duties as well as for surrendering any profits made through the improper use of plan assets. With some exceptions, every fiduciary and every person who handles plan assets must be bonded (ERISA Sec. 412).

A Federal court has held that an accountant who recommended an investment to an employee benefit plan was not a fiduciary under the ERISA rules. The court clarified the ERISA rules by establishing that a fiduciary is a person who performs any one of the following three tasks (*Cottrill v. Sparrow, Johnson & Ursillo, Inc.*, No. C.A.94-0118T, Dist. Ct. R.I. 1995):

1. Exercises discretionary authority over a plan or its assets
2. Renders investment advice for a fee
3. Has discretionary authority in the administration of a plan

6.1 Obligations

ERISA provides the basis for assessing fiduciary responsibility. In summary, fiduciaries must discharge their duties solely in the interest of participants and beneficiaries. Fiduciaries must operate the plan as follows:

- For the exclusive purpose of providing benefits to the participants and their beneficiaries while defraying expenses for administering the plan
- With the same care, skill, prudence, and diligence used by a person familiar with the conduct of an enterprise with similar character and aims
- By diversifying the investments of the plan to minimize the risk of large losses, unless such diversification is clearly imprudent
- According to its underlying documents and in a manner that is consistent with ERISA (ERISA Sec. 404)

If a plan has more than one fiduciary and a breach of fiduciary duties has been made by one of the fiduciaries, it is not sufficient that the other fiduciaries refuse to participate in the breach and then resign, but rather that each fiduciary must attempt to remedy the breach (ERISA Sec. 405) (see *Donovan v. Bierwirth*, 680 F2d 263 (2d Cir. 1981), for a discussion of the standards of conduct applying to a plan fiduciary when faced with a potential conflict of interest). An independent auditor of a plan generally does not have discretionary authority to administer the fund and is not a fiduciary.

In December 1989, Sec. 502(l) was added to ERISA. Under this section, the DOL has the power and authority to assess both a plan

(Text continued on page 71)

fiduciary and “any other person” who has knowing participation in a breach of fiduciary responsibility with a civil penalty. That penalty is 20 percent of the amount recovered from a fiduciary with respect to a violation.

6.2 Prohibited Transactions

In addition to bearing general fiduciary obligations, a fiduciary is restricted from allowing the plan to engage in certain specific transactions. For example, unless a statutory or administrative exemption applies, the fiduciary may not cause the plan to engage in any transaction that constitutes the following, either directly or indirectly:

- Sale, exchange, or leasing of any property between the plan and a party-in-interest (Note that contributions of unencumbered property to any plan other than a discretionary profit-sharing plan is deemed a prohibited transaction.)
- Lending of money or any other extension of credit between the plan and a party-in-interest
- Furnishing of goods, services, or facilities between the plan and a party-in-interest
- Transfer to, or use by or for the benefit of, a party-in-interest of any assets of the plan
- Acquisition, on behalf of the plan, of any employer real property or employer security, except for *qualified* real property or securities not in excess of 10 percent of plan assets in certain plans (ERISA Sec. 406 and IRC Sec. 4975)

A 15-percent nondeductible penalty tax is imposed upon a party-in-interest (disqualified person) participating in any prohibited transaction occurring after August 5, 1997. If the transaction cannot be corrected by placing the plan in a good financial position as if the party-in-interest had acted using the highest fiduciary standards, a 100-percent nondeductible penalty is imposed. The penalty is preceded by a 60-day notice (IRC Sec. 4961(A)). The penalty taxes for a prohibited transaction are reported on IRS Form 5330, and the transaction is identified on the 5500 Series Form.

6.2.1 Parties-in-interest

Parties-in-interest include the following:

- Any fiduciary or counsel to the plan; any person providing services to the plan

- The sponsoring employer
- The labor union representing plan participants
- Any employee, officer, director, or 10-percent-or-more shareholder of (1) a service provider, (2) the sponsoring employer, or (3) the labor union
- Certain relatives of other parties-in-interest
- Certain related business organizations and their owners (ERISA Sec. 3(14) and IRC Sec. 4975(e)(2))

Because the prohibited-transaction rules cover literally all dealings with parties-in-interest, various statutory and administrative exemptions are provided. The principal statutory exemptions are the following:

- Loans to plan participants (ERISA Sec. 408(b)(1) and IRC Sec. 4975(d)(1))
- Reasonable arrangements for services if no more than reasonable compensation is paid (ERISA Sec. 408(c)(2) and IRC Sec. 4975(d)(10))
- Receipt by a fiduciary of any benefit to which he or she is entitled as a participant (ERISA Sec. 408(c)(1) and IRC Sec. 4975(d)(9))

If a statutory exemption is not available, an administrative exemption may be requested. Certain transactions of a recurring nature have been exempted administratively through so-called class exemptions. Two important class exemptions permit the purchase and sale of life insurance policies between the plan and the insured participant (Prohibited Transaction Class Exemptions 77-7 and 77-8).

6.2.2 Exemptions for participant loans

A loan by a plan to a participant is a prohibited transaction unless the loan—

- Is available to all participants on a reasonably equivalent basis.
- Is not made available to members of the prohibited group in amounts greater than those available to rank-and-file employees.
- Is made in accordance with specific plan provisions.
- Bears a reasonable rate of interest.
- Is adequately secured. The loan can be secured by the participant's vested interest in the plan; however, the loans must not provide in-service distributions from pension plans (ERISA Sec. 408(b)(1) and IRC Sec. 4975(d)(1)).

Plan loans are prohibited for participants and their family members who are owner-employees or a more-than-5-percent shareholder of an S corporation (IRC Secs. 401(a)(13) and 4975(d)). A loan to a participant that is promptly loaned by the participant to the employer may be considered a prohibited indirect loan by the plan to the employer. Participant loans, even if exempt, are monitored by the IRS through the required disclosure on the Form 5500 series.

The final regulations under section 1.401(a)(4) required that any rights under a plan must not be nondiscriminatory in favor of the highly compensated employees. Participants' loans are considered a right under the plan. Certain restrictions, such as those specifying a minimum loan amount of one thousand dollars, may be permitted, as long as the restrictions do not discriminate in operation (Regs. Sec. 1.401(a)(4)-4).

6.3 Plan Investments

Plan investments are subject to the various fiduciary standards imposed by Title I, Part 4, of ERISA. These standards include the specific requirement to diversify the investments of the plan so as to minimize a risk of large losses, unless it is clearly prudent not to do so. Subject to these general fiduciary requirements, an investment is permissible under Title I of ERISA if it is not specifically prohibited under rules set forth in Section 406 of ERISA. In order to protect participants, there is generally a requirement that any assets held by the plan must be under the jurisdiction of the United States court system.

The IRC does not set forth specific rules governing the kinds of investments that may be made by a qualified plan. Nevertheless, the tax code sometimes indirectly precludes a particular investment by subjecting its income to tax. For example, an investment in collectibles purchased after 1981 (such as works of art, rugs, antiques, metals, gems, stamps, coins, whiskey) by an individually directed account in a qualified plan is treated as a distribution to the participant. The amount of the distribution is equal to the cost of the collectible (IRC Sec. 408(m)). Collectibles are not precluded as investments in a defined-benefit pension plan or in any defined-contribution plan that does not permit a participant to direct the investment of his or her account, however, they are subject to the prudence requirement. As a practical matter, however, a plan in which the sole participant is also the stockholder and plan trustee would typically not invest in collectibles.

6.3.1 Valuation of nonliquid assets

One troublesome aspect of holding nonliquid assets is the requirement that the assets of the plan be valued at current value each year (IRC

Sec. 412(c)(2) and DOL Prop. Reg. 2520.105-2(e)(2)(ii)). For such assets, an independent annual appraisal is suggested. Real estate, like other assets for which a ready market does not exist, tends to fluctuate in value and is not generally income-producing. So, while the asset may be permitted, fiduciaries are invested with the responsibility to make prudent investments. Finally, because of the custodial problems associated with assets that are not financial instruments, these assets can lead to prohibited transactions should they be used by the participant or trustee. Collectibles should be kept in a vault, not on the president's wall. Real estate must not be used by the participants for personal use. Assets that are not valued under a recognized national source are required to be identified on the 5500 Series Form for the plan.

6.3.2 Unrelated business taxable income

Income tax on unrelated business taxable income (UBTI) may place a handicap on certain kinds of investments by making the income associated with the investment taxable. UBTI results in taxes due to the extent that UBTI exceeds \$1,000 annually (IRC Sec. 512(b)(12)). UBTI is, essentially, a tax on business that is not related to the exempt nature of a trust. For a qualified plan, it generally falls into the two following categories:

1. *Income from unrelated trades or businesses.* The imposition of income tax on unrelated trade or business income is intended to eliminate a source of unfair competition by taxing otherwise tax-exempt organizations when they operate as a trade or business. Plan investments that may result in the imposition of this tax are certain limited partnership interests (IRC Sec. 513).
2. *Income from debt-financed property.* The imposition of income tax on debt-financed property is intended to limit the ability of tax-exempt organizations to invest in other than passive investments. The purchase of stock on margin is typical of an investment that would create taxable income. Borrowing to purchase employer stock by an ESOP is not (IRC Sec. 514(c)(8)). Income from debt-financed real estate, whether from sale or rentals, is taxable income if it is financed by the seller (IRC Sec. 514(c)(9)).

The possible imposition of a tax does not by itself preclude a particular investment. The pursuit of such an investment would focus on the net after-tax return. As is the case with any investment, the fiduciaries must minimize the risk of loss, particularly that associated with plan indebtedness.

6.3.3 Plan investments—overview

The tax-exempt character of the plan itself affects certain investment decisions. For example, trustees do not normally purchase tax-exempt

lower yielding municipal bonds, as their tax exemption is of little value to a qualified plan. The purchase of developed real estate is uncommon not so much for the resulting inability of the plan to use depreciation deductions, but for the loss of potential capital gains on sale. Further, real estate always has the potential for unforeseen liability that may be, in turn, attached to other plan assets. Participating in equity mortgages, however, is currently in vogue.

On the other hand, a number of investments are structured specifically for tax-exempt trusts. Zero-coupon bonds, for example, which yield no cash until maturity but cause the owner to realize imputed interest income, are common investments of plans because of their high yields. The insurance industry has provided a steady stream of investments in the form of guaranteed investment contracts (GICs). (See the new rules for GICs, Statement of Procedure 94-4.) However, trustees must assess the liquidity of these investments against the liquidity needs of future benefit payments and not cause the plan to incur a loss for sale in an off-market.

Profit sharing, stock bonus, ESOPs, and certain other individual account plans are permitted to invest more than 10 percent of their portfolios in employer securities. Restrictions abound, and such ownership is permitted only if the plan document explicitly so provides (ERISA Secs. 407 and 408(e)).

However, heavy investment in the employer's securities—

- May be inconsistent with prudent, diversified investment management.
- May prove to be a nonliquid investment because of the trustee's reluctance to unload the shares.

7. PLAN ADOPTION AND REPORTING

In order for a plan to be qualified, it must be adopted before the close of the plan year end. A plan document must comply as to form. It must include specific provisions required under IRC Secs. 401(a) and 501. The document must provide for administration and operation in compliance with ERISA.

ERISA established filing requirements for annual reports and identified certain participant notification procedures. These processes are part of the annual administration requirements of a plan. These responsibilities are placed with the plan administrator that is named in the plan document.

7.1 Adoption of Plan—Overview of Approval

The first step in assuring that a plan is qualified is to have the plan document approved by the IRS. Although it is not necessary to have a plan submitted to the IRS for approval, few if any employers avoid this procedure. The procedure has been simplified with new procedures for having the format and provisions of certain master plans preapproved by the IRS; these are prototype plans. Standardized plans are provided preapproved, if they meet strict adoption procedures.

Typically, the documents required for the adoption of a qualified plan and trust include the following:

- Resolutions that approve the adoption of the plan and trust, establish the IRC Sec. 415 limitation year, and appoint plan fiduciaries
- Plan and trust documents, which in some cases, may be combined into one document
- Applications for employer identification numbers for the trust and for the plan administrator
- A summary plan description (a simplified explanation of the plan and the claims procedure for requesting benefits)

All tax benefits, for both the employer and the employee, depend upon the plan's qualification in form. That is, the document is required to contain certain specific wording relating to coverage, minimum benefits, vesting, nondiscrimination, and the availability of benefits. These provisions are continually being updated by legislation and interpreted in regulations. As a result, almost all employers submit their plan document to the IRS for approval of new and amended documents. The request for a favorable letter of determination is filed on the following forms.

- 5300 Series Forms—Form 5300 for defined-benefit plans, or IRS Form 5301 for defined-contribution plans, which generally require supplemental filings.
- IRS Form 5302—Employee census with projection of coverage and benefit accrual.
- Notice to Interested Parties.

These forms require inclusion of the plan document and certain other attachments. Certain employee notices and a filing fee are required, depending on the kind of plan and whether or not it is a prototype plan.

In addition to this filing with the IRS, the plan administrator must mail a copy of the summary plan description to the DOL but, effective August 5, 1997, only if requested.

7.1.1 Advantages of master, prototype, or uniform plans

Plans are either individually drafted or are selected from preapproved forms (prototype plans). Although the individually drafted plan provides maximum flexibility as to coverage and benefits, it requires tailoring and is more costly to adopt. As an alternative to these attorney-crafted plans, an employer can adopt a prototype plan. Prototype plans can be implemented by simply completing the blanks of an adoption agreement, notifying the participants, and signing the form.

Some of these plans are fully approved by the IRS (Standardized Plans) and do not require any of the submissions discussed above. They do require a summary plan description and proper employee notification. Prototype plans have various formats and carry varying levels of IRS approval. The documents can be sponsored by trade associations, banks, insurance companies, regulated investment companies, actuaries, and law firms.

Basically, there are two kinds of prototype plans: standardized and nonstandardized. Both have been preapproved to some degree, and either may be adopted by any employer. However, a *nonstandardized* plan should be submitted to the IRS for approval by the employer. These plans are preapproved in format, but require the submission of employee data to assure that they do not potentially discriminate in operation. This filing is on a Form 5307, and generally is less costly than the filing of the 5300 and 5301. Upon approval of this filing, a favorable letter of determination is provided to the adopting employer. A *standardized* plan cannot be submitted to the IRS for approval. The adopting employer is given coverage under the master letter of determination provided to the prototype sponsor.

These two plans look alike in form but differ in application. The difference between the two plans lies in which plan options are available to adopting employers. Standardized plans are more restrictive in terms of benefits and coverage. For example, participants in a standardized plan receive a contribution if they work over five hundred hours, even if they terminate prior to year end. All members of the affiliated service group (IRC Sec. 414(m)) or controlled group (IRC Sec. 414(b)) are eligible to receive a contribution in the employer's plan. For many employers, a standardized plan will be unsuitable due to the required coverage under the more liberal eligibility provisions.

A service organization (for example, a law firm, a CPA firm or a bank) may sponsor a prototype plan if it can show that it has at least ten client adopters. Instructions may be found in Revenue Procedures 98-4 and 98-9. The sponsor secures a notification letter from the IRS regarding the plan; then the adopter (employer) secures a

determination letter. The IRS will not approve uniform plans for the following:

- Government or church plans
- Stock bonus plans
- Collectively bargained plans
- ESOPs
- IRC Sec. 403(b) annuities
- Age-weighted profit-sharing plans or cross-tested plans

Approval of the master prototype plan by the IRS is provided in the form of a master opinion letter. That letter is requested through Form 4461 for defined-contribution plans, and through Form 4461-A for defined-benefit plans.

Application software is available from the IRS that can generate Form 5307, "Application for Determination of Adopters of Master or Prototype, Regional Prototype, or Volume Submitter Plans." Send a 5.25-inch, DOS-formatted, double-density disk and a return postage-paid container to the Volume Submitter Coordinator at the IRS office in Atlanta, Baltimore, Brooklyn, Chicago, Cincinnati, Dallas, or Los Angeles.

7.1.2 Determination letters

Individual letters of determination are issued by the IRS to adopting employers confirming that the plan document that was adopted qualifies in form, under IRC Sec. 401(a), and that the trust is exempt from taxation under IRC Sec. 501. It is not necessary to secure a determination in advance of operation in order to secure a tax deduction, but it is prudent to do so. Revenue Procedure 98-6 sets out the general procedure to be followed.

Letters of determination issued to a sponsor of a standardized prototype plan cover the adopting employer and therefore do not require a separate submission. As is the case with any determination, any misstatement of facts or change in the document will void the determination letter. Although the determination letter covers the plan as to form, the employer must operate the plan in conformity with the plan and the law to maintain the favorable approval.

Note that cross-tested plans also require that the administrator demonstrate how the plan passes the nondiscrimination testing, jeopardizing the determination letter if the employer changes service providers.

7.1.2.1 Terminating plans

Determination letters are also suggested for terminating plans. A determination letter upon termination is generally requested for both form

(Is the document fully updated?) and operation (Have benefits been discriminatory?). Thus, this filing requires not only information on the current participants, but also information on participation and benefits over the last five to ten years.

The IRS and DOL have joint jurisdiction over qualified plans. The IRS monitors the tax aspects of the plan, while the DOL is charged with protecting the participants. Employers wishing to terminate a defined-benefit pension plan must request permission from the DOL. Small professional employers and family-only businesses are exempt from this requirement. These plans and all other employer plans may be submitted to the IRS for its approval at termination.

Distributions from a qualified plan receive favorable tax treatment and, in most cases, are permitted to be rolled over to an IRA. Invalid rollovers carry penalties and adverse tax consequences. As a result, most employers request a favorable letter of determination from the IRS as of the date of termination to assure that the plan is qualified and that the IRAs are valid. Such a filing is made with Form 5310. The termination filing is optional; however, the final Form 5500 for the plan reflects whether the Form 5310 has been requested. Presumably, the IRS will audit plans that do not request the determination letter.

7.1.3 Procedures for filing and appeal

Jurisdiction over qualified plans is handled through the ten district offices designated as key districts. A plan has been approved but not implemented to consolidate into one office to be located in Cincinnati. These are charged with the responsibility for issuing determination letters. In each of these districts, there is an Office of Employee Plans and Exempt Organizations (EP/EO). At the regional level, an assistant regional commissioner for EP/EO matters handles appeals related to plan determination matters.

The 5300 series forms are filed with the appropriate IRS key district director. During the review process for individually drafted plans and terminating plans, the IRS may request that specific plan amendments be adopted. The IRS may also reject the filing. Any recommendations or rejections by the IRS are the result of a review of the employer, employee, plan document, and operation of the plan. There are specific administrative procedures to address these responses by the IRS. If the applicant has exhausted the administrative remedies, the ultimate appeal procedures are to the Tax Court.

Single-employer plans are filed with the key district director for the district in which the employer's (or sponsoring employee organization's) place of business is located. For multiemployer plans, applications are filed in the district where the sponsor's principal place of business is located.

During consideration by the key district office, the applicant (or the key district office itself) may request technical advice from the national office of the IRS. If an adverse decision is anticipated, the applicant has the right to one conference with the national office.

In order to trigger an applicant's right of appeal, the key district director issues the applicant a notice of a proposed adverse determination, whereupon the applicant may request review by the IRS regional office. This review is requested by submitting a written request to the key district director within thirty days of the notice of the proposed adverse ruling. The key district director forwards the request to the regional office, where the applicant can request a conference. Unless the applicant does request regional office review, he or she will be deemed not to have exhausted his or her administrative remedies, and subsequent access to the Tax Court will be denied. If regional office review is requested and the review is favorable to the applicant, the key district office will issue a determination letter.

If the regional office does not issue a favorable decision, the applicant has recourse to the national office of the IRS. A written request must be filed within thirty days of the regional office's decision for this final phase of administrative procedures.

To justify review by the national office, sufficient cause must be asserted that issues in the case at hand are unique or novel, without any published precedent, or that the IRS position is—

- Contrary to law or regulations.
- Contrary to published precedent.
- Contrary to a court decision in which the IRS has acquiesced.
- In conflict with a determination in another region.

If the national office review is unsatisfactory, a declaratory judgment may be sought from the Tax Court. Certain conditions prerequisite to the appeal to the court can be found in IRC Sec. 7476, as follows:

- An adverse determination has been received with respect to an initial submission or the continuing qualification of a plan.
- The Treasury has failed to issue any determination as to the status.

In practice, the Tax Court has evidenced a reluctance to exercise jurisdiction. It is particularly important to adhere to the administrative routine, beginning with filing at the district level, through regional and national office review. Additionally, there are five conditions necessary to petition the Tax Court, which are called limitations in IRC Sec. 7476(b).

1. The plan has been put into effect.
2. The petitioner is the employer; the plan administrator is an employee qualified under prescribed regulations as an interested party, or the Pension Benefit Guaranty Corporation.
3. All administrative remedies available to the petitioner have been exhausted (and at least 270 days have expired since the request for determination was made).
4. The petitioner convinces the court that he or she has properly provided interested persons with notice of his or her filing of the request for a determination.
5. The petition is filed within ninety days after the final administrative determination. If no determination has been made, the petition must be filed within ninety days after the expiration of the 270-day period.

7.1.4 Locations of key district offices

Applications should be sent to the IRS Determination Letter Processing Office in Cincinnati at Internal Revenue Service, EP/EO Division, P.O. Box 3159, Cincinnati, OH 45201.

7.2 Reporting

Many documents and forms are utilized in the administration of a qualified plan; a number are required, others are optional. The following section includes a brief description of the forms that are typical of the small employer plan.

7.2.1 Participant notification

- *Participant statement*—This statement reflects the vesting and account balance for defined-contribution plans and projected, accrued, and vested benefits for defined-benefit plans. It is required that one be given within thirty days of any participant's request, unless one has been received within the last year. For that reason, most employers provide the statement at least annually. Failure to deliver a participant with the required statement subjects the sponsor to a \$100 per day penalty payable to the participant.
- *Summary plan description (SPD)*—Participants must be given this document and any material modifications within ninety days of entering the plan or within 120 days of the effective date of the plan (ERISA SEC. 104(b)). This document must provide the participant with a plain-English explanation of the benefits under the plan. It must also describe the claims procedure available to a participant.

- *Designation of beneficiary*—This applies to plans that provide a death benefit. Generally, the spouse of the participant is the required beneficiary; however, with the consent of the spouse, that designation may be changed.
- *Summary annual report*—The format for this report is determined by the DOL. The form includes the latest financial information on the plan (ending assets, income, and expenses) and identifies how the employee can obtain more information on the plan.

7.2.2 Annual filing forms

A plan administrator must file an annual report within seven months after the end of the plan year. This report is filed on the 5500 Series Form, depending on the kind of plan and size of the employer.

The following five documents are various forms that are a part of the annual report:

1. *Annual report, 5500 Series*—For plan years prior to 1999, and for plans with less than one hundred participants at the beginning of the year, the 5500 C/R is used. Plans with over one hundred participants use the 5500, a special rule that applies to employers with between 80 and 120 employees. Audited financial statements are a part of the 5500 filing. A 5500 EZ is used for plans covering only the business owners. One-participant plans covering business owners and having assets less than \$100,000 at the end of the plan year are relieved from this reporting.

The IRS will release a single, Unified Form 5500 for use by all plans in 1999.

2. *Annual Return of Fiduciary of Employee Benefit Trust, Schedule P*—This is an optional form and starts the statute of limitations with respect to income taxation of the trust. It is strongly recommended. If the plan has taxable income, this form is replaced with the required 990T.
3. *Insurance Information, Schedule A*— This form must be attached if the plan holds insurance as an investment; it is optional for the 5500 EZ.
4. *Actuarial Information, Schedule B*—Defined-benefit plans must attach this schedule, which certifies the funding of the plan.
5. *Annual Registration Statement Identifying Separated Participants With Deferred Vested Benefits, Schedule SSA*—This schedule must be filed for terminated participants that have not received a distribution of their account balance and have been terminated for over one plan year.

Miscellaneous documents required periodically are the following:

- *Resolutions amending the plan*—Resolutions authorizing annual plan contributions are required by the time the contributions are due.
- *Summary of material modifications to summary plan description*—This modification of the plan must be communicated to the participants within 210 days after the end of the plan year. It must also be filed with the DOL within the 210-day period.
- *Updated summary plan descriptions*—If the plan has not been materially modified, the SPD is updated, filed with the DOL, and provided to the plan participants every five years or, if no changes have been made, every ten years.

Documents required in the event of distribution are the following.

- *Withholding Certificate for Pensions Annuity Payments, Form W-4P*—This form is used to identify the withholding for periodic payments.
- *Statement for Recipients of Total Distributions From Profit-Sharing, Retirement Plans, and Individual Retirement Arrangements, Form 1099-R*—This form is used to report distributions from a plan or IRA.

Documents that must be filed for terminating defined-benefit pension plans include the following.

- IRS Form 5310, to notify the IRS and the Pension Benefit Guaranty Corporation of the plan termination
- Distributable Benefits From Employee Pension Benefit Plans, Form 6088
- A copy of the plan document, all amendments, and resolutions regarding plan termination

In addition, numerous penalties for failure to file IRS forms in a timely manner may be imposed, including the following.

- IRS penalty of \$25 for each day the Form 5500 is late
- DOL penalty of \$1,000 for failure to file Form 5500, including omission of the Schedule B
- \$1 for each participant, for each day, for failure to file Form 5500, Schedule SSA

7.3 Audit Guidelines

The IRS has issued guidelines for examiners of employee plans (Ann. 95-99, 1995-48 IRB). These guidelines focus the examiner's attention on the following:

- The Code Sec. 415(b) benefit limitations for defined benefit plans (but not including the changes made to Code Sec. 415(b) by the Retirement Protection Act of Title VII of the Uruguay Round Agreements Act (sometimes referred to as “GATT,” PL 103-465);
- Required minimum distributions under Code Sec. 401(a)(9) (including before-death and after-death distributions);
- The timing of distributions under Code Sec. 401(a)(14); and
- Notification and other requirements under the Code Sec. 401(a)(31) rules on optional direct transfers of eligible rollover distributions.

8. SIMPLIFIED EMPLOYEE PENSION PLANS AND SIMPLE PLANS

Small employers have a practical alternative to adopting a qualified plan. It is the simplified employee pension (SEP). An SEP is essentially one or more IRAs to which an employer makes annual contributions. An employer may contribute to an IRA established by an employee or establish one for the employee. SEPs are attractive due to their simplified administration. Form 5500 C/R is not required. Probably one of the unique features of SEPs is that they do not have to be adopted before the end of the employer's tax year. Employers must execute the plan document before the due date of the employer's tax return, including extensions.

Employer contributions are discretionary and subject to a 15-percent-of-pay limitation (IRC Sec. 408(k)). Beginning in 1987, SEP contributions were excluded from an employee's income for all payroll taxes.

SEPs may be adopted through a model agreement (Form 5305-SEP) available from the IRS, or through a plan sponsored by a financial institution. The government form places the following restrictions on adoption of the government format. Generally, a non-5305-SEP is more attractive to an employer. Employers precluded from adopting an SEP under form 5305-SEP include the following:

- Those that have ever maintained a defined-benefit plan
- Those that use the services of leased employees
- Those that are members of a controlled group or an affiliated service group, or members of a group of trades or businesses under common control, unless all members of such groups participate under the SEP
- Those that sponsor another plan at the same time

SEPs are also provided by financial institutions that may have less restrictive requirements. Procedures are also provided for individually designed SEPs. SEPs are subject to the top-heavy and family aggregation rules.

For employers wishing to permit deductible employee contributions (salary reduction SEPs or SARSEPs), Form 5305A-SEP can be used. These plans are limited to employers with less than twenty-six employees. Special rules apply to the ADP tests and minimum contribution requirements. These plans may not be implemented after December 31, 1996, but existing plans may be maintained.

Although an SEP is not required to file a Form 5500 C/R, there are other notification requirements. The trustee or custodian (who cannot be the employer or an individual) is required to provide each participant with a statement of the value in his or her account by the later of January 31 of the subsequent year or thirty days after the contribution has been deposited. Form W-2 is used (Prop. Regs. Sec. 1.408-9). The employer must provide participants with notification of the adoption of an SEP. The trustee or custodian sponsoring the IRAs that are part of the SEP must report the deposit to the IRS on Form 5498 and provide the same information to the participants.

8.1 Qualification Requirements

SEPs have eligibility provisions that are less restrictive than those of qualified plans. In general, an employer cannot omit contributions from employees who work part-time or terminate prior to the end of the year if they otherwise meet the eligibility requirements. Contributions are required for each employee who—

- Has reached age twenty-one.
- Has performed services for the employer during at least three of the immediately preceding five calendar years (an employer may elect to reduce this requirement).
- Has received an amount at least equal to the year's SEP compensation limit (see appendix 2).

To avoid disqualification, all eligible employees must be included. That is, an SEP cannot restrict contributions to those who have a minimum number of hours or who are employed on the last day of the year (Prop. Regs. Sec. 1.408-7(d)(3)). Contributions are generally made at the same percentage for everyone; however, integrated allocations are permitted for certain SEPs (IRC Secs. 401(l)(2) and 408(k)(3)).

Contributions to an SEP must be fully vested when made. If the SEP is top-heavy, the minimum contribution requirements must be met (see section 3.8 of this chapter).

8.2 Deduction Limits

Employer contributions are deductible under rules similar to those of profit-sharing plans. The maximum deductible contribution is the lesser of \$30,000 or 15 percent of each employee's taxable compensation (see appendix 2 for cost-of-living adjustments). The excess IRA contributions excise tax applies to SEPs (IRC Sec. 4973). Certain SEPs may be integrated with Social Security. The rules that apply to integration are similar to the integration rules for defined-contribution plans (IRC Secs. 401(1)(2) and 408(k)(3)). Individuals may contribute an additional \$2,000 to an IRA. The employer's SEP is considered an employer plan in determining the deductibility of that IRA contribution (IRC Secs. 219(g)(5)(A)(v) and 408(j)).

8.3 Taxation of Distributions

Distributions from an SEP are taxed as ordinary income unless they are rolled over to another IRA within sixty days of receipt of the distribution (IRC Sec. 408(d)(3)(A)). An additional 10-percent excise tax is imposed on premature withdrawals made before age 59½ (IRC Sec. 72(t)) (see section 5.4 of this chapter for exceptions). An employee must not be prohibited from immediately withdrawing employer contributions to an SEP.

Distributions from an SEP are not eligible for lump-sum distributions treatment (see section 5.1 of this chapter).

8.4 Elective Contributions to an SEP (Pre-1997 Law)

An employer can allow employees a choice of receiving cash or a contribution to an SEP. Employee-elective deferrals to an employer-sponsored SEP are subject to the IRC Sec. 402(g) limit. That limit is the 401(k) salary reduction limit (see appendix 2 for cost-of-living adjustments). In addition, a special ADP test is required for SEPs. It is similar to the ADP test for IRC Sec. 401(k) CODAs. Under this test, no averaging of the elective deferrals for the HC employees is permitted. Thus, the percentage deferral for any HC employee cannot exceed the average for the nonhighly compensated by more than the IRC Sec. 401(k) limits (see section 3.9 of this chapter).

8.5 SIMPLE Plans

SBJPA of 1996 created the Savings Incentive Match Plan for Employees (SIMPLE) for small employers. Beginning after December 31, 1996, an eligible employer can establish a SIMPLE retirement plan to receive many of the tax-favored benefits of qualified plans without meeting many of the requirements (IRC Sec. 408(p)).

8.5.1 SIMPLE plan contributions

Under a SIMPLE, elective contributions are made to an IRA on behalf of the employee. The employer must make either:

- A 100 percent matching contribution on elective salary deferrals of an employee up to 3 percent of the employee's compensation, or
- A nonelective contribution of 2 percent of each eligible employee's compensation.

An employer may elect to match at a percentage of compensation less than 3 percent, but not less than 1 percent, for two years during any five-year period. (IRC Sec. 408(p)(2)(C))

An eligible employee may make elective deferrals up to \$6,000 per year, expressed as either a percentage of compensation or as a specific dollar amount.

8.5.2 Compensation for SIMPLE purposes

Compensation for purposes of SIMPLE plan purposes is W-2 compensation plus elective deferrals. For self-employed individuals, compensation is net earnings from self-employment, without regard to elective deferrals or other SIMPLE contributions.

The IRC Sec. 401(a)(17) compensation of \$160,000 (for 1998) applies to the 2-percent nonelective contribution, but not to the 3-percent matching contribution.

8.5.3 Other SIMPLE requirements

An employer must deposit a participant's elective deferrals no later than the thirtieth day following the last day of the month in which the deferrals were made. The employer must make the matching or nonelective contributions no later than the due date of the employer's tax return (including extensions) for the employer's year in which the SIMPLE's calendar year ends (IRC Sec. 408(p)(5)(A)). The employer may deduct the deferral, matching, and nonelective contributions to a SIMPLE plan. The 15 percent of compensation limitation that applies to a SEP does not apply to a SIMPLE plan.

Plan participation must be provided for any employees who received at least \$5,000 in compensation from the employer during any two preceding years and whom the employer reasonably expects to receive at least \$5,000 in compensation during the year. During the sixty-day period prior to the beginning of any year, any eligible employee may elect to participate in the SIMPLE plan or may modify an election.

An eligible employer is an employer who:

- Employed not more than 100 employees during the preceding calendar year.
- Does not maintain any other qualified plan.

The related employer rules of IRC Sec. 414(b) apply in determining whether an employer is an eligible employer.

9. OTHER KINDS OF PLANS

Although defined-benefit pension, money-purchase pension, stock bonus, and profit-sharing plans represent the four broad categories of qualified retirement plans, variations on the basic themes are common. A few of the variations are described below.

9.1 Thrift or Savings Plans

Thrift plans, once common, have lost favor since the general acceptance of 401(k) plans. Thrift plans permit after-tax employee contributions. TRA 1986 introduced a new nondiscrimination test under Section 401(m) that applies to after-tax employee contributions. These rules generally require that the percentage of after-tax contributions for the HC employees meet the same percentage limitations of 401(k) elective deferrals. Traditionally, after-tax contributions have only been made by the higher paid employees, and thus the average for the NHC employees tends to be close to zero. Although an advantage remains to having employee contributions grow tax-deferred, the restrictions on withdrawals and administration generally offset any advantage.

Characteristics of thrift plans are the following.

- Payroll deductions grow on a tax-deferred basis.
- Company contributions are conditioned upon both profits and employee contributions.

After-tax employee contributions to profit-sharing plans are usually made voluntarily. Some larger plans require mandatory after-tax contributions by employees to pension plans (defined-benefit and defined-contribution) as a condition of employment. These plans are subject

to new nondiscrimination rules that apply to the employer provided benefits (IRC, see 401(a)(4)). Other plans may require after-tax contributions as a condition for participation. Such plans are permitted as long as they are not so burdensome that lesser paid workers fail to participate, thus making the plans discriminatory. For the most part, these plans are seen in municipal or governmental plans (Regs. Secs. 1.401-3 and 4).

9.2 Stock Bonus Plans

A stock bonus plan is established and maintained by an employer to provide benefits similar to those of a profit-sharing plan. Contributions are generally made by the employer and may either be in cash or in company stock. Benefits are ordinarily distributable in the stock of the employer company; however, an employer can be forced to purchase that stock (a put option). Rules on allocating stock to participants' accounts and contribution limits are similar to rules covering profit-sharing plans (IRC Sec. 401(a)23 and Reg. Sec. 1.401-1(a)(2)(iii)).

If the employer's stock is not publicly traded and more than ten percent of the plan's total assets are securities of the employer, certain voting rights of the employer's stock are, in effect, passed through to the participants.

Unless elected otherwise by the participant, distributions from a stock bonus plan must begin not later than one year after the plan year in which the participant separates from service due to the attainment of normal retirement age or due to disability or death, or after five years if separation is for other reasons (IRC Sec. 409(o)(1)(A)). Unless the participant elects otherwise, distributions must proceed in substantially equal payments over a period not longer than the greater of one of the following:

1. Five years
2. Five years plus one additional year (but not more than five additional years) for each \$140,000 (for 1997) by which the participant's account balance exceeds \$710,000 (IRC Sec. 409(o)(1)(C))

Participants entitled to a distribution from the plan have a right to demand that benefits be distributed in the form of employer securities (IRC Sec. 409(h)(1)). If the securities are not readily tradeable, the employer must repurchase them or provide a sixty-day put option (IRC Secs. 409(h)(1)(B) and 409(h)(4)). In certain cases, cash may be an acceptable medium for distribution (IRC Sec. 409(h)(2)).

One stock bonus plan is an ESOP. It generally differs in that it borrows to purchase a large block of employer stock. (See section 3.10 of this chapter.)

9.3 Money-Purchase Pension Plans

Money-purchase pension plans are defined-contribution pension plans that must meet the rules of IRC Sec. 401(a) relating to pensions. Money-purchase pension plans have the following characteristics.

- Employer contributions are mandatory.
- Employer contributions typically are either a specified amount or a percentage of an employee's compensation.
- Contributions must be definitely determinable and, thus, can neither be based on profits nor otherwise be under the employer's discretion (Rev. Rul. 72-302).
- Employer contributions cannot be based on an employee's discretionary contributions.
- The normal form of benefit must be an annuity; however, lump sums are generally provided as an option.
- Under certain conditions, age and service contribution formulas are permitted. The formulas must not result in prohibited discrimination (Regs. Sec. 1.401(a)(4)-2(a)(4)). Certain age-weighted allocations are also permitted (Regs. Sec. 1.401(a)(4)-8(b)). See the discussion of target benefit plans below.

Forfeitures may be (but need not be) reallocated to the current plan participants, or may be used to reduce future employer contributions (IRC Sec. 401(a)(8)).

9.4 Target Benefit Plans (Hybrid Plans)

A target benefit plan is a type of money-purchase pension plan. Thus, annual contributions are subject to the lesser of 25 percent of pay or \$30,000 (see appendix 2 for current amount). These contributions are determined under a formula in the plan that is based upon actuarial concepts. In some ways, these plans are like defined-benefit plans:

- Employer contributions are mandatory.
- The annual contributions are based on approved actuarial methods that provide level funding to a targeted benefit for each participant.
- Forfeitures may not be reallocated to other participants.
- Contributions may not be conditioned on profitability.

Target benefit plans resemble defined-contribution plans in the following ways.

- Actuarial certifications are not required for the year-end Form 5500 C/R filings.
- Individual accounts for participants must be maintained.
- Benefits are based on the amounts that can be purchased from a participant's individual account.
- Insurance by the Pension Benefit Guaranty Corporation is not available.

Although these plans are discussed often, they currently make up less than one percent of employer plans. The 1.410(a)(4) regulations describe the new rules for designing and funding these plans. Those regulations also permit a similar plan, the age-weighted plan (Regs. Sec. 1.401(a)(4)-8(b)).

10. ACCOUNTING FOR PENSION PLANS

Generally accepted accounting principles (GAAP) must be used by employers as a guide for the financial statements that are part of the Form 5500 filing. The accounting requirements that apply to defined-benefit and defined-contribution plans were completely changed by Financial Accounting Standards Board (FASB) Statements of Financial Accounting Standards Nos. 87 and 88. Implementation of these standards was not required until 1987 (1989 for some small companies) for calendar-year reporting. Recognition of minimum liability (discussed below) was not required until 1989. These pronouncements settle the following three major accounting issues.

1. How much pension expense should be charged annually?
2. What assets and liabilities should appear on the company's balance sheet?
3. What disclosures are necessary?

10.1 Calculation of Pension Expense— Defined-Benefit Pension Plans

Annual pension expense is determined as a function of the following five factors.

1. Service cost, also called normal cost, determined actuarially as the present value of benefits attributed to employee service during the period. If future compensation levels are incorporated in the benefit formula, then the *benefits/years-of-service* approach, which uses future

pay, must be the basis for this period's cost. (Pension liability calculated under the benefits/years-of-service approach—called the projected benefit obligation rather than the accumulated benefit obligation—is based on current pay levels and used for calculating minimum liability.)

2. Interest accrued on the present value of the projected benefit obligation outstanding during the period.
3. The actual return on plan assets, determined based on the fair value of plan assets at the beginning and the end of the period and adjusted for benefit payments and contributions.
4. Prior service cost (resulting from plan amendments or unfunded liability at adoption, as amortized, whether as a declining charge or a straight-line charge).
5. Gains and losses as a result of differences between expected and actual experience in respect to both assets and liabilities.

Gains and losses measure the effect of the plan's experience on the assumptions used, including return on plan assets, mortality experience, employee turnover, and salary levels. Gains and losses reflecting differences between expected and actual values might be significant in dollar amounts. To prevent wide fluctuations that might be caused by these differences, the *corridor approach* is used. The corridor approach requires amortization over the remaining service period of active employees of gains and losses in excess of 10 percent of the greater of the projected benefit obligation or the market-related asset value. Certain single-occurrence gains and losses that might arise from closing a plant or providing termination benefits in conjunction with a reduction in workforces or the discontinuance of a business segment are to be recognized as part of the immediate effect of the occurrence.

The extent of gains and losses on plan assets is measured by the market-related approach, which encompasses the use of a moving average of asset values over a period of time. The time horizon and the weighing scheme are both somewhat a matter of the management's choice.

To the extent that pension expense is overfunded or underfunded annually by asset contributions, prepaid pension cost (asset) or accrued pension cost (liability) accounts are created.

10.2 Minimum Liability

A liability must be recognized when the accumulated benefit obligation exceeds the fair value of the plan assets. The account to be debited as this liability is recognized is an intangible asset called, perhaps, deferred pension cost. If an accrued pension cost or liability account already

exists, only the additional liability to bring the total up to the minimum needs to be recorded. No asset may be recorded if the fair value of the assets exceeds the accumulated benefit obligation.

10.3 Required Financial Statement Presentation and Disclosures

Excess of pension expense over amounts funded appears as a long-term liability, while an asset is shown when plan contributions exceed expense. After 1988, an additional liability appears if the accumulated benefit obligation exceeds the fair value of the plan assets. The debit is normally to an intangible asset account. If this debit is greater than the unrecognized prior service cost, the excess is reported as a contra account to stockholders' equity. Footnotes must include the following.

- A description of the plan, including groups covered, kind of benefit formula, funding policy, assets held, and the nature and effect of significant matters affecting comparability among the periods presented
- The components making up net pension expense for the period
- A reconciliation of the funded status of the plan with the amounts reported in the balance sheet, showing the amount of the following:
 - Plan assets at fair value
 - Projected benefit obligation
 - Unrecognized prior service cost
 - Unrecognized net gain or loss
 - Any remaining unrecognized net obligation or net asset existing at the date of initial application of FASB Statement No. 87
 - Additional liability recognized
 - Prepaid pension cost or accrued pension cost recognized

10.4 Amortization of Transition Amounts and Prior Service Costs

Amortization is required for the transition amount that comes about when companies switch to the new standards (that is, from FASB Statement No. 8 to FASB Statement No. 87). The transition amount is the difference between the projected benefit obligation and the fair value of the plan assets (an unrecognized net asset or net obligation). Straight-line amortization is useful over the greater of the average remaining service life of current participants in the plan or, if the employer so elects, fifteen years.

10.5 Accumulated Versus Projected Benefit Obligation

For different purposes, two benefit approaches are used in the FASB pronouncements. The accumulated benefits approach bases pension expense (and liability) on current salary levels. The benefits/years-of-service approach makes its calculations on the estimated future pay of the employees covered by the plan. In most cases, the benefits/years-of-service approach, upon which is based the projected benefit obligation, will be used to determine expense and the accrued pension liability (in the case of underfunding). For purposes of calculating the possible minimum liability, the accumulated benefit obligation is used.

11. NONQUALIFIED PLANS

ERISA formulated the rules under which employers are permitted to maintain qualified plans. These rules require that retirement benefits be funded, be placed in a trust, and provide certain minimum coverage. Qualified plans must be established under IRC Sec. 401(a) and be funded in a tax-exempt trust described in IRC Sec. 501. If this occurs, participants are permitted favorable tax benefits.

There are, however, situations in which the employer does not want either to fund benefits or to provide minimum vesting. This generally results where an employer wants to provide additional retirement benefits to a select group of employees. Such plans are called nonqualified deferred compensation plans. These plans are permitted wide latitude in structure and operation as long as they meet certain exemptions. They must be structured to avoid application of ERISA.

The following advantages are available to nonqualified plans:

- They are generally less rigorous in coverage and vesting, making them easier and less costly to set up and maintain.
- Officers and other highly compensated or shareholder-employees or any select groups of management can be the only targeted group for benefits.
- Participants generally can avoid current taxation on their benefit accruals.

However, employers cannot take a deduction for their contributions until the time employees are taxed on the benefits. Generally, these plans must not be funded and should not be set up without professional advice. Despite an employer's intentional avoidance of

ERISA rules, in rare cases, a nonqualified plan may trigger statutory requirements for participation, vesting, disclosure, and reporting.

11.1 Deferral of Compensation

Under certain conditions, nonqualified arrangements can assist selected employees by deferring taxability of part of their income. To achieve this deferral, the arrangement must be structured so that the employee is not in actual constructive receipt of the benefits. It is also essential that the employee not enjoy any of the economic benefits of the arrangement until the year when the amounts are to be taxed. The general rules on constructive receipt follow. Note that Treasury Reg. Sec. 1.83 and, particularly, Revenue Ruling 60-31, 1960-1, CB 174, relate to the timing of the participant's taxation. The last three of the following items provide a simplified overview.

- Income, although not actually reduced to the taxpayer's possession, is constructively received by him or her in the taxable year during which it is credited to his or her account, set apart for him or her, or otherwise made available so that he or she could have drawn upon it during the taxable year, if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions (Regs. Sec. 1.451-2(a)).
- An employee will be considered to have the economic benefit of property that has not actually or constructively been received if interest in the property can be assigned by the employee to another person.
- Similarly, the employee has the economic benefit if the property is placed in a trust or escrow account on his or her behalf and is not subject to a substantial risk of forfeiture.
- A risk of forfeiture exists if the legal obligation to pay the employee is subject to a substantial contingency such as, for example, the future performance of substantial services by the employee (IRC Secs. 83(a) and (b)).

Nonqualified arrangements must be unfunded and generally represent an unsecured promise to pay in a later year. An arrangement of this kind is referred to as a pay-as-you-go plan or as terminal funding. In order for the employee to achieve tax deferral, the agreement to defer payment to the later year must be made before the payment is earned, and the employer's obligation to make payment must not be represented by a promissory note or secured in any way (Rev. Rul. 60-31, 1960-1, CB 174). An arrangement will be considered to be funded

and the funds constructively received if funds are placed in a trust, custodial, or escrow account or are used to make payments toward an annuity contract, and the employee has a right to receive the payment directly from the trust, account, or annuity (or to transfer rights to another) even if the right will come about only at a future date.

If the funds are segregated but remain part of the general assets of the company subject to claims of creditors, they will not be taxed to the employee. This is true even if they are vested. Under such an arrangement, the employee is a general and unsecured creditor of the company.

The employer's obligation will be considered to be unfunded if the company is designated as the sole beneficiary of a grantor trust of the corporation, account, or annuity. Alternatively, even though payment may be secured by funds set aside in a trust, account, or annuity, the company's payment obligation could be made contingent on the employee's continued performance of services with the company during the period designated for tax deferral. Either technique fulfills the objective of tax deferral.

Under IRC Sec. 3121(v)(2), an amount deferred under a nonqualified deferred compensation plan shall be taken into account for purposes of Social Security when the services are performed. In other words, if an employee did not reach the Social Security maximum and amounts were deferred under a deferred compensation agreement, the deferred amounts would be subject to Social Security tax at the time they were deferred. If the employee exceeded the Social Security maximum at the time of the deferral, the compensation would not be subjected to Social Security tax. Because of the above, deferred compensation payments are not subject to Social Security tax when actual payment is made.

11.2 Department of Labor Considerations

It is crucial to be aware that nonqualified deferred compensation plans (even those that an employer may intend to be unfunded) are likely to fall under ERISA's requirements for participation, vesting, and funding, unless the plan is both (1) unfunded and (2) maintained by the employer "primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees." Therein lies the particular attraction to start-up companies of nonqualified and unfunded plans. If they are unfunded and also carefully targeted to the select group of management or highly compensated employees (exactly the group likely to be seen as most critical to motivate and reward), a number of the complexities of ERISA can be avoided.

Unfunded plans maintained primarily to provide deferred compensation for a select group of management or highly compensated employees are exempt from the participation, vesting, funding, and fiduciary responsibility provisions of ERISA. Little guidance is provided in determining what will constitute this select group.

DOL Regulation 2520.104-23 provides an alternative form of compliance with the reporting and disclosure requirement of ERISA for plans targeted to a select group of management or highly compensated employees. The reporting and disclosure provisions can be satisfied by filing a statement with the Secretary of Labor that includes the following:

- The name and address of the employer
- The employer's identification number
- A declaration that the employer maintains a plan or plans primarily for the purpose of providing deferred compensation to a select group of management or highly compensated employees
- A statement of the number of such plans and the number of employees in each plan
- Plan documents, if any, upon request by the Secretary

If the alternative method is not used, other reporting requirements apply, including the requirements to file certain annual reports and to provide a summary plan description.

11.3 Securing Deferred Compensation

To provide assurance to participants that there will be funds to pay their deferred compensation, an employer may set aside funds to meet the promise of future payments. This security arrangement must be carefully designed to avoid taxation under the doctrine of constructive receipt. Often, these instruments are defined as rabbi trusts. Private letter rulings released by the IRS have approved such an approach as long as the assets are available to the claims of the general creditors of the corporation (Private Letter Rulings 8113107 and 8329070). Additionally, the working premise of the DOL seems to be that trusts of this nature will be treated as unfunded plans.

11.4 Taxation of Nonqualified Arrangements

Regardless of the employer's status as an accrual- or cash-basis taxpayer, the employer's contributions to a trust created under a nonqualified

plan cannot be deducted until the time when the amounts are taxable to the participant (IRC Sec. 404(a)(5) and Regs. Sec. 1.404 (b)-1). Recipients include the payments as gross income in the year in which the benefits become either vested or transferable or are no longer subject to a substantial risk of forfeiture (see section 11.1 of this chapter).

REFERENCES

- AICPA. *Checklists and Illustrative Financial Statements for Defined Pension Plans: A Financial Accounting and Reporting Practice Aid*. New York: American Institute of Certified Public Accountants, Inc., 1998.
- . *Checklists and Illustrative Financial Statements for Health and Welfare Benefit Plans: A Financial Accounting and Reporting Practice Aid*. New York: American Institute of Certified Public Accountants, Inc., 1998.
- . *Employee Benefit Plans Industry Developments—1998*. (Audit Risk Alerts. Complement of AICPA Audit and Accounting Guide: Audits of Employee Benefit Plans.) New York: American Institute of Certified Public Accountants, Inc., 1998.
- Allen, Everett T., Jr. *Pension Planning: Pensions, Profit-Sharing, and Other Deferred Compensation Plans*, 7th ed. Homewood, Ill.: Irwin/McGraw-Hill, 1992.
- Aska, Melanie, and Joan Gucciardi. *Pension Distribution Answer Book*. New York: Panel Publishers, 1995.
- Asquith, Nancy. *WG&L Pension and Benefits Fact Book*. Boston: Warren, Gorham & Lamont, 1991.
- Bruce, Stephen R. *Pension Claims: Rights and Obligations*, 2d ed. Washington, D.C.: BNA Books, 1993.
- Cady, Donald F. *Field Guide to Estate Planning, Business Planning and Employee Benefits*, 5th ed. Cincinnati: National Underwriter Co., 1993.
- Canan, Michael J. *Qualified Retirement and Other Employee Benefit Plans*. St. Paul, Minn.: West Publishing Co., 1997.
- Castagnera, James O. *Employment Law Answer Book: Forms and Checklists*. New York: Panel Publishers, 1994.
- Coleman, Barbara J. *Primer on Employee Retirement Income Security Act*, 4th ed. Washington, D.C.: BNA Books, 1993.
- Combe, Cynthia M., and Gerald Talbot. *Employee Benefits Answer Book*, 4th ed. New York: Panel Publishers, 1995.

- Employee Benefits Research Institute. *Fundamentals of Employee Benefit Programs*, 5th ed. Washington, D.C.: Employee Benefits Research Institute, 1997.
- Friedman, Jacob I., et al. *ERISA Fiduciary Answer Book*, 2d ed. New York: Panel Publishers, 1995.
- Gee, Judith Boyers. *Pensions in Perspective: A Guide to Qualified Retirement Plans*, 4th ed. Cincinnati: National Underwriter Co., 1993.
- Golub, Ira M., et al. *COBRA Handbook*, 3d ed. Gaithersburg, MD: Aspen Publishers, Inc., 1996.
- Goodman, Randolph M. *Retirement and Benefit Planning: Strategy and Design for Businesses and Tax-Exempt Organizations*. Charlottesville, Va: LEXIS Law Publishing, 1994.
- Guerard, Yves, and Glenn Jenkins. *Building Private Pension Systems: A Handbook*. San Francisco: I C S Press, 1993.
- Hardy, C. Colburn, and Howard J. Weiner. *Pension Plan Strategies*. Los Angeles: Practice Management Information Corporation, 1995.
- Harrison, Debbie. *Pension Power: Understand and Control Your Most Valuable Asset*. New York: John Wiley & Sons, Inc., 1995.
- Krass, Stephen J. *The Pension Answer Book*, 11th ed. New York: Panel Publishers, 1995.
- Kushner, Michael G., and Dana Domone. *ERISA: The Law and the Code*. Washington, D.C.: BNA Books, 1995.
- Kushner, Michael G., et al. *Employee Benefits Desk Encyclopedia: An Annotated Compendium of Frequently Used Terms*, 2d ed. Washington, D.C.: BNA Books, 1996.
- Langbein, John H., and Bruce A. Wolk. *Pension and Employee Benefit Law*. 2d ed. Westbury, N.Y.: Foundation Press, 1995.
- Lewis, Stuart M., and Michael G. Kushner, eds. *ERISA: Related Statutes*. Washington, D.C.: BNA Books, 1995.
- Mamorsky, Jeffrey D. *Employee Benefits Handbook*, 3d ed. Boston: Warren, Gorham & Lamont, 1992.
- McNeil, Bruce J. *401 (K) Plans: A Comprehensive Guide*. New York: John Wiley & Sons, Inc., 1996.
- . *Nonqualified Deferred Compensation Plans*. St. Paul, Minn.: West Publishing Co., 1997.
- Mitchell, William D. *Employee Fringe and Welfare Benefit Plans*. St. Paul, Minn.: West Publishing Co., 1997.

- Nonqualified Deferred Compensation Answer Book*, 2d ed. New York: Panel Publishers, 1994.
- Payroll Answer Book*. Gaithersburg, MD: Aspen Publishers, 1998.
- Pension Answer Book, The*, revised ed. Gaithersburg, MD: Aspen Publishers, Inc., 1997.
- Pension Plans: Stronger Labor ERISA Enforcements Should Better Protect Plan Participants*. Upland, Penn.: DIANE Publishing Co., 1995.
- RIA In-House Professional Staff. *Pension and Benefits Law*, 1996, rev. ed. New York: Research Institute of America, 1996.
- Roomkin, Myron J., ed. *Profit Sharing and Gain Sharing*. Metuchen, N.J.: Scarecrow Press, Inc., 1990.
- Salisbury, Dallas L., ed. *ERISA 20 Years Later: A Look Back, A Look Ahead: The Proceedings, December 6, 1994*. Washington, D.C.: Employee Benefit Research Institute, 1995.
- Serota, Susan P., and Frederick A. Brodie, eds. *ERISA Fiduciary Law*. Washington, D.C.: BNA Books, 1995.
- Smith III, Henry A., et al. *Nonqualified Deferred Compensation Answer Book*, 3d ed. New York: Panel Publishers, 1995.
- Steinberg, Richard M. et al. *Pensions and Other Employee Benefits: A Financial Reporting and ERISA Compliance Guide*, 4th ed. New York: John Wiley & Sons, Inc., 1993.
- White, Jane et al. *J. K. Lasser's Employee Benefits for Small Business*, 2d ed. Indianapolis: Macmillan General Reference, 1993.
- Wollengerg, John B. *Pension Plans for Small and Mid-sized Businesses*. New York: John Wiley & Sons, Inc., 1996.

APPENDIX 1: Selected ERISA Pension Plan Reporting and Disclosure Requirements

| <i>Document</i> | <i>Type of Information</i> | <i>To Whom</i> | <i>When</i> |
|---|---|--|--|
| Summary Plan Description (SPD) | A booklet or similar document written in easily understandable language that tells how the plan operates; when employees are eligible to receive their pensions; how to calculate the amount of their benefits; and how to file claims. | All plan participants, free of charge | Within 90 days after an employee becomes a participant in a plan. |
| Summary of Material Modification (SMM) | Summary description of any change or modification made to SPD information. | U.S. Department of Labor (DOL) | Within 120 days after the plan is adopted. |
| Updated SPD | Updates booklet or document to include all changes, modifications. | All plan participants and DOL | Within 210 days after end of plan year in which the change was adopted. |
| Summary Annual Report | Data on plan's financial activities. (Full Annual Report must be provided if requested in writing.) | All plan participants and DOL | Within 210 days after end of plan year in which 5-year period ends if plan was amended; 10 years if not. |
| Survivor Coverage Data | Information on plan's survivor coverage and how it affects participants and spouses. | All plan participants | Within 9 months after the end of the plan year. |
| Benefit Statement | Total benefits a participant has accrued and vested benefits, if any, that have accrued, or date they become vested. | All plan participants | Reasonable period after employee becomes a participant. |
| Form 5500 Series (5500, 5500-C, 5500-R) | Identification, operations, tax qualification, minimum funding, fiduciary, and financial data. | Plan participants or beneficiaries | Within 60 days when requested in writing but not more than once a year; and upon termination of employment or upon break in service. |
| | | Internal Revenue Service (IRS); participants, if written request | By the last day of 7th month after end of the plan year. |

| <i>Document</i> | <i>Type of Information</i> | <i>To Whom</i> | <i>When</i> |
|----------------------------|---|---|--|
| Schedule A | Data on insurance premiums and disbursements to pay premiums, number of persons covered under insurance contract, etc. | IRS | By last day of 7th month after end of the plan year (as attachment to Form 5500 Series). |
| Schedule B | Actuarial data that must be filed by defined-benefit plans and certain other plans subject to ERISA's minimum funding requirements. | IRS | By last day of 7th month after end of the plan year (as attachment to Form 5500 Series). |
| Schedule C | A listing of most persons who provide services to a pension plan and the amount of compensation paid them. Also, a listing of all plan trustees and most service-providers terminated during the year, with the reason for the termination. | IRS | By last day of 7th month after end of the plan year (as attachment to Form 5500 Series). |
| Schedule SSA | Lists terminated employees and the amount of their vested benefits. | IRS (which forwards data to Social Security Administration) | By last day of 7th month after end of plan year for any year in which vested employee terminates (as attachments to Form 5500 Series). |
| Form 5310 (Parts I and II) | Provides notice of merger, consolidation, or transfer of pension plan assets or liabilities, or plan termination. | IRS | At least 30 days before the plan merger, consolidation, or transfer. |
| Form 5558 | Requesting an extension of time of up to 2 1/2 months which may be granted any filer for filing the Form 5500 Series. | IRS | By last day of 7th month after end of plan year. Form must be filed on time. |

APPENDIX 2: Limitations Affected by Cost-of-Living Adjustments

| | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 |
|--|-----------|-----------|-----------|-----------|-----------|-----------|
| <i>Annual Limitations</i> | | | | | | |
| Benefit and Compensation Limitations* | | | | | | |
| Maximum Benefit (DBP), IRC Sec. 415(b) | \$115,641 | \$118,800 | \$120,000 | \$120,000 | \$125,000 | \$130,000 |
| Maximum Contribution, IRC Sec. 415(c) | 30,000 | 30,000 | 30,000 | 30,000 | 30,000 | 30,000 |
| Maximum Compensation, IRC Sec. 401(a)(17) | 235,840 | 150,000 | 150,000 | 150,000 | 160,000 | 160,000 |
| 401(k) and SEP Salary Reduction | 8,994 | 9,240 | 9,240 | 9,500 | 9,500 | 10,000 |
| Excess Distribution Threshold, 4980A | 144,551 | 148,500 | 150,000 | 155,000 | 160,000 | repealed |
| Highly Compensated Employee Definition, IRC 414(q)* | | | | | | |
| An Employee | 96,368 | 99,000 | 100,000 | 100,000 | 80,000 | 80,000 |
| Top-Paid Group | 64,245 | 66,000 | 66,000 | 66,000 | NA | NA |
| Officers | 56,821 | 59,400 | 60,000 | 60,000 | NA | NA |
| SEP Compensation Limit | 385 | 396 | 400 | 400 | 400 | 400 |
| <i>Social Security Information</i> | | | | | | |
| OASDI Tax Rate | 6.2% | 6.2% | 6.2% | 6.2% | 6.2% | 6.2% |
| HI Tax Rate | 1.45% | 1.45% | 1.45% | 1.45% | 1.45% | 1.45% |
| OASDI Wage Base | 57,600 | 60,600 | 61,200 | 62,700 | 65,400 | 68,400 |
| HI Wage Base | 135,000 | none | none | none | none | none |

*These limits are applied on a plan-year basis for plan years beginning on the calendar year



Employment Regulations



EMPLOYMENT REGULATIONS

1. INTRODUCTION

2. SOURCES

- 2.1 Federal Statutes and Regulations
- 2.2 State and Local Statutes and Regulations
- 2.3 Common Law
- 2.4 Collective Bargaining Agreements
- 2.5 Written Employment Agreements

3. DEFINITIONS

- 3.1 Independent Contractor or Employee

4. FEDERAL WAGE AND HOUR REQUIREMENTS

- 4.1 Covered vs. Exempt Employees
- 4.2 Minimum Wage Requirements
- 4.3 Overtime Pay
 - 4.3.1 Overtime computations
- 4.4 Amounts Treated as Wages for Agricultural Employees
- 4.5 Tipped Employees
- 4.6 Holiday Pay
- 4.7 Vacation and Sick Pay
- 4.8 Rest Periods and Coffee Breaks
- 4.9 Child Labor Laws
- 4.10 Employer's Records
 - 4.10.1 Employee information
 - 4.10.2 Form W-4
 - 4.10.3 Form I-9
 - 4.10.4 Statement of deductions
 - 4.10.5 Form of records and their retention
 - 4.10.6 Timing of wage payments
- 4.11 Penalties
- 4.12 Payroll Deductions
- 4.13 Handicapped Workers
- 4.14 Termination
 - 4.14.1 Termination pay
 - 4.14.2 Final wage payment
 - 4.14.3 Form W-2
- 4.15 Leaves of Absence
 - 4.15.1 Time off to vote
 - 4.15.2 Military leave
 - 4.15.3 Disability leave

4.15.4 Jury leave

4.15.5 Family and medical leave

4.16 Family Employment

5. DISCRIMINATION

5.1 Definition

5.2 Federal Legislation

5.2.1 Prohibited actions

5.2.2 Sexual harassment

5.2.3 Employer's obligations

5.3 Age Discrimination in Employment Act (ADEA)

5.4 Americans With Disabilities Act of 1990 (ADA)

5.5 State Antidiscrimination Laws

5.6 Comparable Worth

5.7 Affirmative Action

6. NATIONAL LABOR RELATIONS BOARD

6.1 General Provisions

6.2 Prohibited Practices

6.2.1 Employers

6.2.2 Labor organizations

6.3 Penalties

7. PAYROLL REQUIREMENTS

7.1 Federal Insurance Contribution Act (FICA)

7.1.1 Agricultural employment

7.1.2 Household employment

7.2 Federal and State Income Tax

7.3 Unemployment Tax

7.4 Deposit of Payroll Taxes

7.4.1 FICA and federal income tax

7.4.2 Rules for depositing federal liability

7.4.3 State income tax

7.5 Magnetic Media Reporting

8. POSTEMPLOYMENT ISSUES

8.1 Covenants Not to Compete

8.2 Wrongful Discharge

8.2.1 Constructive discharge

8.3 Insurance Continuation

8.3.1 Employers covered by COBRA

8.3.2 Right to continue insurance coverage

8.3.3 Period of coverage

EMPLOYMENT REGULATIONS

REFERENCES

APPENDIX 1: State Labor Agencies

APPENDIX 2: State Civil Rights Agencies

APPENDIX 3: State Equal Employment Opportunity Agencies

1. INTRODUCTION

Employment is regulated by the federal government, by state and local governments, by collective bargaining agreements, and by written or oral employment contracts. This chapter covers wages and hours, labor relations, discrimination issues, and certain post-employment issues. Occupational health and safety is covered in the chapter on workers' compensation, and employee benefits and U.S. immigration laws are also covered in other chapters of the manual.

These employment regulations exist to protect employees with regard to such items as wages and hours, unlawful discrimination, and hiring policies.

2. SOURCES

Employment regulation stems from several sources. Federal statutes, state statutes, local ordinances, collective bargaining agreements, common law, and private employment contracts all interact to govern the employer/employee relationship.

Even though federal statutes may not exist in a given area, state and local statutes, along with collective bargaining agreements, should be closely reviewed for possible applicability.

2.1 Federal Statutes and Regulations

The federal government draws its authority to regulate employment from such laws as the Fair Labor Standards Act (FLSA), the Civil Rights Act of 1964 (specifically Title VII), the Age Discrimination in Employment Act of 1967, the 1974 Employee Retirement Income Security Act (ERISA), the 1986 Comprehensive Budget Reconciliation Act (COBRA), the Immigration and Naturalization Act of 1986, and the National Labor Relations Act.

The agencies authorized by Congress to regulate in this area are

- The Department of Labor (DOL).
- The Equal Employment Opportunity Commission (EEOC).
- The National Labor Relations Board (NLRB).

2.2 State and Local Statutes and Regulations

States and local governments may regulate in areas that have not been preempted by Congress. This means states and local governments may

and do regulate in areas not regulated by Congress or where Congress does not expressly or by implication prevent it.

Sources of state regulation can be found in state statutes and administrative rules and regulations. This chapter summarizes *sources* of information on each state and describes general circumstances in states because it would not be practical to cover each state in detail. A listing of the state labor agencies is found at the end of this chapter; to obtain more specific statutory and regulatory information, apply to these sources.

2.3 Common Law

Because many areas of employment law have been heavily contested, both federal and state statutory laws have been interpreted and modified by the courts. Also, labor and payroll management guides such as those published by Commerce Clearing House and Prentice-Hall provide detailed state-by-state information as well (see references to the chapter). Under our common-law system, court-made law is another source of regulation.

2.4 Collective Bargaining Agreements

Collective bargaining agreements, when negotiated, provide a source of regulation for the specific employment relationship mandated by the agreement. Such agreements are valid and enforceable, assuming their provisions are legal and reasonable.

2.5 Written Employment Agreements

Where written employment agreements exist, they are a source of regulation for the specific employment relationships covered by the agreements. As long as the agreements are not illegal or unconscionable, they are valid and enforceable.

3. DEFINITIONS

The following definitions apply throughout this chapter. Different statutes tend to define the terms differently, so the terms must be considered in relation to specific statutes.

Employee. Any individual who performs services at the direction and control of an employer, both as to what shall be done and how it

shall be done. An employer has the right to hire and fire an employee and also furnishes the tools and a place to work.

Independent contractor. Persons in business for themselves who are not under the direct supervision of another employee.

Workweek. A fixed and regular recurring period of 168 hours—seven consecutive 24-hour periods—that may start on any day of the week. Some collective bargaining agreements define a workweek to be less than seven days.

Holiday. A day customarily observed in the community in celebration of some historical or religious occasion.

Pay period. Period of service for which a payment of wages is ordinarily made to an employee. Each state governs the length of pay periods.

Vacation. A period of rest from work normally for a specific time frame, normally enjoyed with recreational activities.

Leave. A period for which permission to be absent from work has been granted.

3.1 Independent Contractor or Employee

An employer who erroneously categorizes an employee as an independent contractor may be liable for failure to pay unemployment insurance contributions, minimum wages, overtime, or Social Security, and for failure to withhold income tax. Additionally, employees who have been erroneously classified as independent contractors are covered by the National Labor Relations Act, and, if they are wrongfully discharged, the employer may be held liable for reinstatement of the discharged employee with back pay and restoration of lost benefits.

Statutes, such as the National Labor Relations Act and the Fair Labor Standards Act, do not provide a uniform definition of *independent contractor*. Various administrative agencies and the courts have not formulated one uniform definition, but instead look at the specific facts of each case and the purpose of each law in determining whether a worker is an independent contractor. Because of this, an individual who is considered an independent contractor, for purposes of unemployment insurance, may be determined to be an employee under the Fair Labor Standards Act (FLSA).

Under common law, an employer-employee relationship generally is determined to exist when an employer has the right to control and direct the worker, not only in terms of what needs to be accomplished but also with respect to details and the means by which the result is accomplished. Stated differently, an employee is subject to the will and control of the employer not only in regard to what shall be done, but

also *how* it shall be done. As long as the employer has the right to direct and control the manner in which the services are performed, an employer-employee relationship is deemed to exist.

Historically, the courts have also looked at other factors beyond the single determinative issue of control. The courts have found that other major factors that characterize an employer-employee relationship include the fact that the individual has the same wages, hours, or working conditions as other employees, and that the individual is subject to the same personnel policies as other employees, or that the employer furnishes the employee with tools or a place to work as he or she similarly furnishes to other employees.

Conversely, if a person exercises control or direction merely with respect to what is to be accomplished and not to the means and methods for accomplishing the result, an individual working with that person is normally deemed to be an independent contractor. Examples include construction contractors, lawyers and accountants engaged in the pursuit of an independent trade or business, and other similar professional trades or businesses.

An individual's status is determined on a case-by-case basis, and requires an examination of all the factors surrounding a particular working relationship. For the most part, the courts have looked at the "right to control," both in terms of the result to be accomplished and the manner and means by which the result is achieved.

In case of doubt over a worker's status, IRS Form SS-8, "Determination of Employee Work Status for Purposes of Federal Employment Taxes and Income Tax Withholding," can be completed and submitted to the IRS by either the firm or the worker. If submitted by the worker, the worker must consent to disclosure of his or her name and of the contents of Form SS-8 to the firm.

The following is a list of factors described in Revenue Ruling 87-41 bearing on the "right to control" that should be considered when determining the employment status of an individual:

- **Instructions:** Generally, an individual is an employee if required to follow instructions, oral or written, regarding where, when and how the work is to be completed.
- **Training:** If an individual is trained by an employee, that individual is ordinarily also considered an employee.
- **Integration:** If an individual's services to a business have a direct bearing on the success or continuation of that business, that individual normally is subject to a certain amount of control, indicating that the individual is an employee.
- **Services Rendered Personally:** If an employer is concerned with not only how well a job is completed but who completes the job, the

services are considered personal, which thereby indicates that the individual performing the services is an employee.

- **Hiring, Supervising & Paying Assistants:** If an employer makes payments to, supervises and hires individuals, it is generally considered that the individuals are employees. However, if one individual pays, hires, and supervises other individuals under a contract to provide labor and materials, the supervisor normally would be considered an independent contractor, not an employee.
- **Continuing Relationship:** An employer-employee relationship exists if a continuing relationship is established between the employer and the individual performing the services.
- **Set Hours of Work:** If an employer sets hours of work, an employer-employee relationship normally exists.
- **Full-Time Work Required:** If an individual does not engage in other work, but devotes full time to the business, that individual would normally be considered an employee.
- **Place of Work:** If an individual performs work on the employer's premises that could be performed elsewhere, the individual is normally considered an employee. The fact that the individual is on the employer's premises implies that the employer controls the direction and supervision of the work.
- **Sequence of Work:** If an individual's work must be completed in a certain sequence, the employer is establishing control and therefore the individual is considered an employee.
- **Reports:** If an individual is required to submit reports to the employer, the individual is normally considered an employee.
- **Method of Payment:** Independent contractors are normally paid by the job, whereas employees are normally paid by the hour, week or month.
- **Payment of Business Expenses:** An independent contractor normally is not reimbursed for business and traveling expenses, whereas an employee is normally reimbursed by the employer for such expenses.
- **Furnishing of Tools & Materials:** Employees normally are furnished tools and materials by the employer, whereas an independent contractor normally must furnish these items himself or herself.
- **Investment:** An individual who must provide facilities for the performance of work is normally considered an independent contractor. For example, independent contractors often must provide their own premises for work, clothing, and other instruments.

- **Risk of Loss:** An employee normally is not in a position to realize a loss, whereas an independent contractor may realize a profit or loss as a result of work.
- **Working for More than One Firm at a Time:** An individual who performs services for more than one firm at a time is generally considered an independent contractor.
- **Availability of Services to General Public:** An individual who holds out services to the general public is generally considered an independent contractor.
- **Right to Discharge:** If an employer has the right to discharge an individual, that individual is normally considered an employee. An independent contractor normally cannot be discharged as long as the contract is fulfilled.
- **Right to Quit:** If an individual has the right to terminate work efforts, that individual normally is considered an employee. An independent contractor must complete the contract before terminating the relationship.

In early 1996, the IRS released a draft copy of an internal IRS Training Guide entitled "Employee or Independent Contractor." The guide may not be cited as authority by employers in classifying workers. The training guide moves the focus away from compiling numbers of factors and toward gathering evidence illustrating how the parties view their relationship and the extent of an employer's behavioral and financial control over a worker.

Additionally, the IRS announced in Rev. Proc. 96-9 (IRB No. 1996-2) that it will conduct a test of an early referral program for employment tax issues, allowing taxpayers to request early referrals of employment tax issues, including worker classification issues, to the Appellate Office of the IRS.

Under a new worker classification settlement program, businesses that filed Form 1099 information returns and failed to meet the requirements for Section 530 (1978 Revenue Act) relief would be allowed to reclassify workers prospectively and pay only a specified tax assessment, not to exceed a one-year tax liability. In IRS Notice 98-21, the IRS extended the classification settlement program until further notice.

4. FEDERAL WAGE AND HOUR REQUIREMENTS

4.1 Covered vs. Exempt Employees

All employees of certain enterprises having workers engaged in interstate commerce, producing goods for interstate commerce, or handling,

selling, or otherwise working on goods or materials that have been moved in or produced for such commerce by any person, are covered by the Fair Labor Standards Act.

A covered enterprise is the related activities performed through unified operation or common control by any person or persons for a common business purpose and

- Whose annual gross volume of sales made or business done is not less than \$500,000 (exclusive of excise taxes at the retail level that are separately stated); or
- Is engaged in the operation of a hospital, an institution primarily engaged in the care of those who are physically or mentally ill or disabled or aged, and who reside on the premises, a school for children who are mentally or physically disabled or gifted, a pre-school, an elementary or secondary school, or an institution of higher education (whether operated for profit or not for profit); or
- Is an activity of a public agency.

Some employees are specifically exempted from the requirements of the Fair Labor Standards Act. As a basic rule, bona fide executive, administrative, and professional employees (including academic administrative personnel and teachers) and outside salespeople are exempt from the minimum wage and overtime requirements if they meet the tests set forth for each category.

Whether employees are exempt depends on

- Their duties and responsibilities.
- The salary paid (except in the case of doctors, lawyers, teachers, and outside salespeople).

The following partial lists represent employees who are fully or partially exempt from minimum wage, equal pay, and overtime pay requirements of the FLSA. A complete listing can be found in payroll management guides such as those published by Commerce Clearing House (CCH) and Prentice Hall (see references to the chapter).

- Fully exempt from minimum wage, equal pay, and overtime pay:
 - Executive, administrative, or professional employees, including teachers, who meet minimum salary levels
 - Outside salespersons
 - Employees of amusement or recreational establishments that have seasonal peaks
 - Agricultural employees with very specific limitations (see a payroll guide for details)

- Fully exempt from only the overtime requirements:
 - Employees of motor carriers subject to regulation by the secretary of transportation
 - Seamen
 - Agricultural employees
 - Taxicab drivers
 - Household domestic employees
- Partially exempt from overtime pay requirements:
 - Commissioned employees of retail or service establishments
 - Private hospital employees
 - Employees of hotels, motels, or restaurants

4.2 Minimum Wage Requirements

The minimum wage (federal) for agricultural and nonagricultural employees is \$5.15 per hour, effective September 1, 1997. State law also covers minimum wage and overtime provisions. The FLSA prevails over less beneficial state laws where both cover the same employees. Where requirements fixed by state law are higher than those under the FLSA, state law prevails.

Employees can be paid on an hourly, salary, monthly, piecework, or any other basis as long as the minimum hourly requirement is met. Calculations and requirements of the minimum hourly rate are as follows:

- A week in which the minimum rate is underpaid cannot be averaged with a week in which it is overpaid to satisfy the minimum requirement.
- Employees hired solely on the hourly rate *must* be paid at least the minimum rate.
- A fixed weekly salary divided by the number of hours worked must equal or exceed the minimum rate.
- Wages paid on a piece-rate basis meet the minimum requirements if the average hourly earnings for the workweek equal or exceed the minimum rate.

4.3 Overtime Pay

Generally, overtime pay must be paid on hours over forty worked in a workweek. The overtime pay must be one and one-half times the employee's regular hourly rate. The *regular hourly rate* is normally defined to

be the average rate paid for hours worked during the week. It is the employee's total weekly compensation, less exclusions provided for in the FLSA, divided by total weekly hours worked. Calculations and requirements on overtime pay are these:

- The overtime pay is figured on a workweek basis whether the employee is paid on a daily, weekly, biweekly, monthly, or piecework basis.
- The FLSA prevails over less beneficial state laws where both cover the same employees. Where requirements fixed by state law are higher than those under the FLSA, state law prevails.
- Each workweek stands alone. Overtime worked in one week may not be offset against nonovertime hours worked in another week.
- The FLSA contains no provision that requires the employer to pay an employee overtime for hours worked in excess of eight hours per day or for work on holidays, Saturdays, or Sundays, although some state and local statutes contain such provisions.
- An employer's order prohibiting overtime does not relieve the employer of the responsibility to pay overtime, if the employee is permitted to work.
- Overtime does not need to be paid weekly. It can be paid on the normal payday.

4.3.1 Overtime computations

Following are examples of computing overtime.

Hourly rate (regular pay rate for an employee paid by the hour). If more than forty hours are worked, at least one and one-half times the regular rate for each hour over forty is due, where regular rate is defined per paragraph one of section 4.3, above.

Example. An employee paid \$5.15 an hour works 44 hours in a workweek. The employee is entitled to at least one and one-half times \$5.15, or \$7.73, for each hour over forty. Pay for the week would be \$206 for the first forty hours, plus \$30.92 for the four hours of overtime—a total of \$236.92.

Piece rate. The regular rate of pay for an employee paid on a piecework basis is obtained by dividing the total weekly earnings by the total number of hours worked in the same week. The employee is entitled to an additional one-half times this regular rate for each hour over forty besides the full piecework earnings.

Example. An employee paid on a piecework basis works forty-five hours in a week and earns \$236.25. The regular pay rate for this week is \$236.25

divided by forty-five, or \$5.25 an hour. In addition to the straight-time pay, the employee is entitled to \$2.63 (one-half the regular rate) for each hour over forty.

Time and a half. Another way to compensate a pieceworker for overtime, if agreed to before the work is performed, is to pay one and one-half times the piece rate for each piece produced during overtime hours. The piece rate must then be the one actually paid during non-overtime hours and must be enough to yield at least the minimum wage per hour.

4.4 Amounts Treated as Wages for Agricultural Employees

Although most agricultural labor is considered covered employment under the Federal Insurance Contribution Act (FICA), only cash payments constitute wages for purposes of the FICA and only if the cash remuneration paid during the year is \$150 or more per employee or the employer's total payroll is \$2,500 or more (including noncash wages) for the year. However, wages paid to a farmworker who receives less than \$150 in annual cash wages are not subject to FICA even if the employer paid \$2,500 or more in that year to all farmworkers, if the farmworker—

- Is employed in agriculture as a hand harvest laborer,
- Is paid piece rates in an operation that is usually paid on a piece-rate basis in the region of employment,
- Commutes daily from his or her home to the farm, and
- Had been employed in agriculture less than thirteen weeks in the preceding calendar year.

The amounts paid to these seasonal farmworkers count toward the \$2,500 or more test for determining FICA coverage of other farm workers.

Cash includes checks and other monetary forms of exchange, but not noncash items such as lodging, food, clothing, or payment of other goods or commodities. Noncash payments for agricultural employees are not subject to FICA, federal, or state tax withholding or unemployment taxes.

Special rules under the FLSA and state law apply to minimum wage and overtime pay for agricultural employees. Payroll management guides such as those published by Commerce Clearing House (CCH) and Prentice Hall, along with applicable state law, should be reviewed.

4.5 Tipped Employees

Wages paid to a tipped employee are deemed to be increased by up to 50 percent of the applicable statutory minimum wage rate but not more than the actual tips received by the employee. In paying the wages of a tipped employee, the employer is allowed to credit up to 50 percent of the employee's statutory minimum wage as coming from tips. Each state sets its own maximum tip credit.

Example. Assume the statutory minimum wage is \$5.15. The employer is allowed to pay a tipped employee \$2.58 per hour ($5.15 - (5.15 \times .50)$)

(Text continued on page 15)

provided that the employee actually received tips equal to or in excess of the tip credit.

To qualify as a tipped employee, the employee must be engaged in an occupation in which it is customary to receive more than \$30 per month in tips.

4.6 Holiday Pay

Employers are not required by the FLSA to pay employees who do not work holidays or to pay at a premium rate for those who do work on holidays. Employers should also review state law holiday pay requirements.

4.7 Vacation and Sick Pay

Employers are not required by the FLSA to give employees vacations, paid or otherwise, or to pay sick pay. Employers should also review state law sick pay requirements.

4.8 Rest Periods and Coffee Breaks

The FLSA does not require that employees be given rest or meal periods or coffee breaks. However, if rest periods and coffee breaks are given, governmental enforcement agents require them to be counted as hours worked if they last twenty minutes or less.

4.9 Child Labor Laws

The FLSA child labor provisions protect children who are employed. The provisions protect the educational opportunities of minors and prohibit their employment in jobs under conditions detrimental to their health or well-being. The Secretary of Labor provides lists of hazardous occupations for both farm and nonfarm jobs, in which minors below specified ages may not be employed.

Regulations governing youth employment in farm versus nonfarm jobs differ somewhat. A complete list of ages and acceptable work may be obtained by contacting the state labor agency as listed in Appendix 1 or the local office of the

U.S. Department of Labor
Employment Standards Administration
Wage and Hour Division

Minors of any age may be employed by their parents at any time in any occupation on a farm owned and operated by their parents, although many state statutes exist to provide more restrictive regulations. Such state statutes should be referred to for specifics.

4.10 Employer's Records

Every employer subject to the provisions of the FLSA must maintain records on its employees and their wages, hours, and pay. This is true even with respect to exempt employees in determining whether the conditions for exemption are satisfied.

4.10.1 Employee information

The records for each covered employee must include the following:

- Full name
- Home address
- Date of birth if employee is younger than nineteen
- Sex and occupation
- Time and day on which the employee's workweek begins
- Regular hourly pay rate, the basis on which wages are paid, and regular rate exclusions
- Hours worked each workday and each workweek
- Total daily or weekly straight-time wages
- Total overtime excess compensation for the workweek
- Total additions to or deductions from wages paid each pay period
- Total wages paid each pay period
- Date of payment and the pay period covered
- Retroactive wage payment under government supervision
- The basis for payment of any wages differential to employees of the opposite sex in the same establishment

4.10.2 Form W-4

Employers are required to retain on file for each employee Form W-4, Employee's Withholding Allowance Certificate. The information on this form is used to determine the amount of income tax withholding per payroll for the employee. If an employee claims more than ten exemptions or exemption from income tax withholding if wages are expected

to exceed \$200 per week, the employer is required to send a copy of the form to the Internal Revenue Service along with the next Form 941, Employers Quarterly Federal Tax Return, filed.

4.10.3 Form I-9

Employers are required to retain on file a completed Form I-9, Employment Eligibility Verification, for all employees hired after November 7, 1986. Form I-9 was developed for verifying that persons are eligible to work in the United States. Form I-9 does not need to be filed with any authorities.

4.10.4 Statement of deductions

Some states require that employees be given a statement of deductions for each wage payment. Other states require that such information be given employees at stipulated intervals. A complete list of requirements by state can be found in a payroll management guide such as those published by Commerce Clearing House (CCH) or Prentice-Hall (see references to this chapter).

4.10.5 Form of records and their retention

There are no specific guidelines as to the particular form that the employer's records must follow. However, the records will be considered inadequate if the specified information must be computed from scattered, unrelated, or illegible sources.

Most of the employer's records on an employee's wages and hours must be retained for three years, although it is recommended that retention be for a longer period, normally five years. There is significant disagreement about the length of time to retain records beyond that required by law.

4.10.6 Timing of wage payments

Each state governs the required frequency with which wage payments must be made. A payroll management guide such as those published by Commerce Clearing House or Prentice-Hall contains details (see references to this chapter).

4.11 Penalties

Any person found to willfully violate the Fair Labor Standards Act may be subject to a fine up to \$10,000 or imprisonment up to six months.

Employers may be subject to civil liability to employees of unpaid minimum wages or overtime pay plus an equal amount as liquidated damages as well as attorneys' fees and costs, if a willful violation occurs.

If an employer is found to have discriminated against an employee for filing a complaint under this statute, the employer may also be subject to additional liability to that employee as a court may deem appropriate.

4.12 Payroll Deductions

Payroll deductions fall into seven categories:

1. Deductions to cover the cost of furnishing board, lodging, and other facilities to employees.
2. Deductions for other items such as tools and uniforms that are not regarded as facilities.
3. Social Security tax and other deductions required by law.
4. Reductions in a fixed salary paid for a fixed workweek in weeks when the employee fails to work the full schedule.
5. Deductions for disciplinary reasons.
6. Garnishment. If an employer is required under court order to make payment to an employee's creditor, the payments are equivalent to payment to the employee. The amount withheld from a wage payment may not exceed restrictions imposed by the federal garnishment law. The wage garnishment law also prohibits the firing of an employee whose pay is garnished for the payment of a single debt.
7. Other deductions authorized by the employee in writing and permitted by law, such as union dues.

4.13 Handicapped Workers

Special reduced minimum wage rates are allowed under the FLSA for people whose earning capability is impaired due to age, physical or mental deficiency, or injury. A certificate authorizing employment at a lower rate must be obtained from the authorized regional representative of the Wage and Hour Administrator. The following rules apply to these certificates:

- Applications must be made on an official form signed by the handicapped worker and the employer.
- Certificates remain in effect no longer than twelve months.
- Applications for renewal will be reviewed by the administrator's representative.

- Descriptions of alleged handicaps must be detailed.
- A medical certificate is required when the handicap is not clearly obvious.
- The disability must be a specific handicap to the proposed employment.

4.14 Termination

4.14.1 Termination pay

Dismissal payments and severance pay are any payments made by an employer on account of the involuntary separation of an employee from the service of the employer. These payments are subject to FICA, income tax withholding, and unemployment tax.

4.14.2 Final wage payment

Each state governs the time within which a final wage payment must be made to a terminated employee.

4.14.3 Form W-2

Upon termination, employees may request that their Form W-2 be issued to them. The employer is required to furnish the form within thirty days of the request or final payment of wages, whichever is later.

4.15 Leaves of Absence

4.15.1 Time off to vote

Many states have laws that allow employees to take time off to vote. Although state laws vary, a general pattern exists. Ordinarily, an employee who is entitled to vote may leave work for a specified time without penalty or deduction from wages. The employer designates the length of the absence, although minimum time periods may be imposed by state law.

4.15.2 Military leave

The FLSA does not provide specific guidelines with regard to payment of wages during military leave. If an employee is on temporary leave from the job to serve in a state National Guard unit and the employer pays the employee the difference between the regular salary and the amount received from the state, the difference is considered wages and is subject to withholding.

4.15.3 Disability leave

The FLSA does not specify guidelines regarding disability leave. Company policy governs the length of any disability leave and other specifications. Many companies address disability leaves through funding provided by short-term and long-term disability insurance programs.

Federal statute specifies that sex discrimination includes discrimination on the basis of pregnancy, and that pregnant workers must be treated similarly to employees affected by other medical conditions. Pregnant workers have a qualified right to reinstatement of employment, and equal employment opportunity assures that pregnant workers will not lose their jobs on account of pregnancy. Many states guarantee pregnant women a certain number of pregnancy disability leaves in a manner similar to other disability leaves.

4.15.4 Jury leave

Under the Jury System Improvement Act of 1978, employers are prohibited from discharging, threatening to discharge, intimidating, or coercing any permanent employee as a result of that employee's jury duty service.

Employers who violate this act

- Are liable for lost wages due to the employee.
- May be forced to provide other appropriate relief such as reinstatement of an employee discharged because of the employee's jury leave.
- Are subject to a civil penalty of up to \$1,000 for each violation to each employee.

4.15.5 Family and medical leave

The Family and Medical Leave Act of 1993 entitles eligible employees to job-protected, unpaid leave of up to twelve workweeks for either of the following:

- Upon the birth or adoption of a child of the employee or the placement of a child with the employee for foster care
- When the employee, employee's spouse, child, or parent has a serious health condition which requires care from the employee

Employers must continue to pay their share of health insurance premiums throughout the leave. The employee is guaranteed job reinstatement, or its equivalent, at the end of the leave.

Employer.

Organizations engaged in commerce or in any industry or activity affecting commerce who employ fifty or more employees for each working day during each of twenty or more calendar workweeks in the current or preceding calendar year are subject to the requirements of this act.

Eligible employee.

An eligible employee is an employee who

- Works for a business which employs fifty or more workers within 75 miles of the employee's work site.
- Has been working for that employer for at least twelve months prior to the requested leave.
- Has worked at least 1,250 hours during the time of his employment.

Effective date.

The leave requirements were generally effective August 5, 1993, six months after the enactment date. Employers should review the Family and Medical Leave Act of 1993 thoroughly to be certain they are in compliance with its provisions.

4.16 Family Employment

The employment of family members is subject to special rules.

Income tax withholding. No statutory exclusion is granted from the withholding of income tax from wages paid between family members. All agricultural wages subject to Social Security withholding are subject to federal income tax withholding whether paid to family or nonfamily members.

FICA tax. Work performed by a child under eighteen years of age employed by a parent is exempt from FICA tax. This exemption ceases on the child's eighteenth birthday. (See also the Social Security chapter herein.)

The family service exception does not apply to work performed for a corporation where services are being performed by a child. The same is generally true for partnerships.

Federal unemployment tax. Services performed by an individual for a child or spouse and services performed by a child under the age of twenty-one in the employ of a parent are not subject to federal unemployment tax. (See section 3.8, on "Exemptions," of the Unemployment Insurance chapter.)

5. DISCRIMINATION

5.1 Definition

Employment discrimination is the failure to apply similar terms and conditions of employment to all persons equally where no reasonable distinction can be found between those favored and those not favored.

(Text continued on page 21)

5.2 Federal Legislation

Federal statutes prohibit discrimination in employment against those individuals who belong to a protected class: race, color, religion, sex, national origin, or age. For government contractors, discrimination is also prohibited for physical and mental handicap and against veterans.

5.2.1 Prohibited actions

These statutes specifically prohibit discrimination against any member of a protected class in any aspect of employment, including hiring, promotion, compensation, employee benefits, and termination. They also cover limiting, segregating, or classifying employees or applicants for employment in any manner that would deprive or tend to deprive any member of a protected class of employment opportunities or otherwise adversely affect that individual's employment status.

Employees who feel they have been discriminated against can obtain relief under provisions of the federal Equal Employment Opportunity Act and various state and local statutes.

5.2.2 Sexual harassment

Title VII of the Civil Rights Act of 1964, as well as state and local antidiscrimination laws, prohibit sexual harassment on the job. Sexual advances, verbal and physical, are considered sexual harassment when

- Submission to the advance is made either explicitly or implicitly a term of employment.
- Submission to or rejection of the advance is used as a basis for employment decisions.
- The advances substantially interfere with the individual's work performance or make the working environment intimidating, hostile, or offensive.

Penalties include injunctive relief, reinstatement or rehiring (with or without back pay), or any other equitable relief a court deems appropriate (including attorneys' fees).

5.2.3 Employer's obligations

An employer should have a policy stating clearly and concisely that discrimination and sexual harassment in the workplace are prohibited. In conjunction with these policies, there should also be a mechanism in place that will promptly and effectively permit an employee to raise a complaint with responsible management and require management

to investigate and respond to complaints about discrimination and sexual harassment.

In November, 1993, the U.S. Supreme Court ruled that individuals who sue their employers for sexual harassment do not need to prove severe psychological harm. Rather, the court held that it is sufficient if a reasonable person would find the atmosphere hostile or abusive.

Two primary reasons employers should have both a policy and a procedure are that

- Complaints may be resolved before expensive governmental investigation and litigation.
- Employers may not be subject to liability if an employee does establish discrimination in the workplace, but failed to report it.

5.3 Age Discrimination in Employment Act (ADEA)

Employers are prohibited from discriminating against any individual because of that individual's age. Since the coverage of this law is under the Commerce Clause of the U.S. Constitution, only employers who are engaged in an industry in interstate commerce are affected. The purpose of the age discrimination law is to encourage the hiring of individuals based on ability rather than age. Many states also have statutes prohibiting discrimination based on age.

Employer coverage. Employers covered by ADEA must

- Be engaged in industry affecting commerce.
- Employ twenty or more workers for each working day in each of twenty or more weeks in the current or preceding calendar year.

Employee coverage. Generally, the age discrimination law covers employees over forty years of age.

Enforcement. The Age Discrimination Employment Act is enforced under the Fair Labor Standards Act by the Equal Employment Opportunity Commission (EEOC). Enforcement is obtained through individual employee suits and collective actions by employees.

5.4 Americans With Disabilities Act of 1990 (ADA)

On July 26, 1990, the Americans With Disabilities Act of 1990 (ADA) was signed into law. The employment provisions of the act were effective July 26, 1992, for employers with twenty-five or more employees. Employers with fifteen to twenty-four employees had until July 26, 1994, to comply with the ADA, whereas employers with fewer than fifteen employees are exempt from the provisions of this act.

The ADA is designed to give comprehensive civil rights protection to disabled individuals in the following areas:

- Employment
- Transportation
- Public accommodations
- Telecommunications
- State and local services

One provision of the ADA is that businesses must make reasonable accommodations in the work environment to provide disabled individuals with equal employment opportunities. Changes required to make reasonable accommodations are not required if they impose “undue hardship” on the operations of the employer’s business.

Employers should review the ADA thoroughly to be certain they are in compliance with its provisions.

5.5 State Antidiscrimination Laws

Appendixes at the end of this chapter summarize the respective state agencies in the area of civil rights and equal employment opportunity.

5.6 Comparable Worth

The Equal Pay Act of 1963 requires that workers receive equal pay for similar jobs, regardless of the sex of the individual employed. The objective is to prevent wage discrimination in the workplace based on gender.

Comparable worth addresses the difference in compensation that cannot be accounted for except by the individual’s sex. Wages should be based on the worth of the work, not on the sex of the person doing the work. To conform to comparable-worth guidelines, major studies are frequently required to determine the worth of work.

5.7 Affirmative Action

Affirmative action is the attempt to systematically dismantle discrimination against protected classes. Its proponents believe that affirmative action is one of the few effective methods to resolve discrimination.

Although a statement of affirmative action is not mandated by law for all employers, many companies establish a plan. Under provisions

of the Equal Employment Opportunity Act, government contractors and others must issue and follow affirmative action programs. Employers should also review federal and state law to determine their responsibilities in this area.

6. NATIONAL LABOR RELATIONS BOARD

6.1 General Provisions

The purpose of the National Labor Relations Act (NLRA) is to ensure that labor strife does not impede interstate commerce in a major way and to encourage the collective bargaining process as a means to accomplish this purpose. It attempts to protect against abuses of the collective bargaining process on the part of employers, employees, and unions by prohibiting certain unfair labor practices.

This act gives employees the right to form, join, or assist labor organizations and to bargain collectively through representatives of their own choosing as well as engage in other concerted activities for the purpose of collective bargaining or other mutual aid or protection. This act also gives employees the right to refrain from these activities unless an agreement requiring membership in a labor organization exists. The act is administered by the National Labor Relations Board through regional offices.

6.2 Prohibited Practices

6.2.1 Employers

The following acts are considered unfair labor practices on the part of employers:

- To interfere with employees in the exercise of their rights to organize.
- To dominate or interfere with the formation or administration of any labor organization, including financial or other support.
- To discriminate against any employee with respect to hiring, discharge, or conditions of employment in order to discourage or encourage union membership or because the employee has filed charges or given testimony under this act.
- To refuse to bargain collectively with the representatives of their employees.

6.2.2 Labor organizations

Labor organizations and their agents (including employees) may not

- Restrain or coerce
 - Employees with respect to their rights under this act.
 - Employers in their selection of their representatives for collective bargaining or grievance adjustment purposes.
- Cause or attempt to cause an employer to discriminate against an employee when such discrimination would be an unfair labor practice.
- Refuse to bargain collectively with an employer.
- Engage in or induce or coerce others to engage in unlawful strikes.
- Require excessive membership fees from employees.
- Require payment from an employer for services that have not been or will not be rendered.
- Picket unlawfully.
- Enter into an agreement with an employer in which the employer agrees to cease doing business with any other employer. (There is an exception for the construction industry.)

6.3 Penalties

The National Labor Relations Board (NLRB) has the power to prevent unfair labor practices. If the NLRB finds that any person has engaged or is engaging in any unfair labor practices, it has the power to issue a cease-and-desist order and to take any affirmative action, including reinstatement of employees with or without back pay, consistent with the policies of the NLRA. If the order is not complied with, the NLRB has the right to seek enforcement in any of the Courts of Appeals of the United States.

Employers. Employers may be forced to cease or desist from engaging in unfair labor practices, reinstate employees with or without back pay, and perform other acts consistent with the policies of the NLRA.

Labor organizations, agents. Labor organizations may be ordered to cease and desist from engaging in unfair labor practices along with any other acts, consistent with the purposes of the NLRA.

Employees. Employees who participate in unlawful strikes may be terminated from employment.

Others. Any person who willfully interferes with the NLRB or any member or agent is subject to a fine of not more than \$5,000 or imprisonment for up to one year.

7. PAYROLL REQUIREMENTS

Employers are required to withhold payroll taxes (FICA and federal and state income tax) from covered employees' wages and remit the withholding to the proper federal and state offices. Employers also must pay payroll taxes for their share of Social Security (FICA tax) and federal and state unemployment taxes. For a complete listing of types of employment and requirements for withholding employment taxes, see IRS Circular E: *Employer's Tax Guide*, which is available at any IRS office or by mail from the Internal Revenue Service.

7.1 Federal Insurance Contribution Act (FICA)

The FICA tax rate is 7.65 percent for both employees and employers. Consult the chapter on Social Security for the current maximum Old Age, Survivors, and Disability Insurance (OASDI) wage base. The 1.45 percent Medicare Hospital Insurance (HI) portion of the total 7.65 percent rate has no maximum wage base and applies to all earned income.

7.1.1 Agricultural employment

Because of the part-time, irregular nature of farm work, farmers hiring seasonal help are subject to special rules governing how farm workers' wages are reported for Social Security purposes. Any time the wages of a farm worker exceed \$150 in cash during a calendar year, Social Security tax must be paid on the wages. Similarly, wages may count if they are paid on a time basis, such as by the hour, day, week, or month, for any part of twenty or more days during a calendar year. Also, if the total payroll of the agricultural employer is \$2,500 or more for the year, any cash wages paid are subject to Social Security tax.

7.1.2 Household employment

Effective in 1995, household employee cash wages of \$1,000 or more are subject to FICA. The \$1,000 test applies separately to each household employee. The value of food, lodging and other noncash items is not subject to FICA. Taxes on wages are paid and reported on Schedule H of Form 1040. See IRS Publication 926 for a further discussion on household employees.

7.2 Federal and State Income Tax

Tables for withholding income tax from employees' wages can be found in IRS Circular E: *Employer's Tax Guide* and state withholding booklets.

7.3 Unemployment Tax

A separate chapter in this manual is devoted to Unemployment Insurance. The Federal Unemployment Tax Act and state unemployment insurance requirements are discussed in sections 3 through 6 of that chapter.

7.4 Deposit of Payroll Taxes

7.4.1 FICA and federal income tax

Employers must make deposits of the FICA and federal income tax withheld from employees' wages plus the employer's share of FICA when the liability reaches certain limits. The following calculation should be used to determine the federal payroll liability.

| | | |
|--|---------------|-------------------|
| Total Social Security wages | XXX | |
| × combined employee/employer Social Security rate | <u>× .124</u> | |
| Social Security tax | | XXX |
| | | |
| Total Medicare wages | XXX | |
| × combined employee/employer Medicare rate | <u>× .029</u> | |
| Medicare tax | | <u>XXX</u> |
| | | |
| Total FICA tax | | XXX |
| FWHT (federal income tax withheld) | | <u>+ XXX</u> |
| Liability | | <u><u>XXX</u></u> |

7.4.2 Rules for depositing federal liability

On September 22, 1992, the IRS issued Regs. Secs. 31.6302-0 through 31.6302-3. These regulations changed the payroll tax deposit requirements for wages paid after January 1, 1993.

“Lookback” rule. The new payroll tax deposit rules enable employers to determine a standard deposit cycle for an entire year by looking

back to prior payroll tax liabilities. Using the “lookback” rule, an employer can determine whether the depositor is monthly or semi-weekly by examining the employment tax liability during the “lookback” period.

“Lookback” period. The “lookback” period used for determining whether an employer will be a monthly or a semiweekly depositor is the twelve-month period that ended with the preceding June 30. For example, the “lookback” period for calendar year 1999 is the period July 1, 1997, to June 30, 1998. The IRS notifies businesses at the beginning of each year regarding which deposit category applies.

Monthly depositor. If the aggregate amount of employment taxes reported for the “lookback” period is \$50,000 or less, the employer is a monthly depositor. If an employer is a monthly depositor, each month’s payroll taxes are due on the fifteenth day of the following month, or on the next banking day, should the fifteenth not be a banking day.

Semiweekly depositor. If the aggregate amount of employment taxes reported for the “lookback” period is over \$50,000, the employer is a semiweekly depositor. For wages paid on Wednesday, Thursday, and Friday, employment taxes must be deposited on the following Wednesday. For wages paid on Saturday, Sunday, Monday, and Tuesday, employment taxes must be deposited by the following Friday.

One-day rule. Accumulated employment taxes of \$100,000 or more are due the next banking day, regardless of the employer’s deposit status. If a monthly depositor incurs a \$100,000 liability, that employer automatically becomes a semiweekly depositor the day after the \$100,000 liability is incurred. The employer is then considered a semi-weekly depositor for the remainder of the calendar year and for the following calendar year.

The Treasury has developed the Electronic Federal Tax Payment System (EFTPS), an electronic fund transfer system to remit payroll taxes and convey deposit information directly to the Treasury. All employers who deposited more than \$50,000 of payroll taxes in 1995 and 1996 are now required to start using EFTPS by January 1, 1999. The system will continue to be phased in over a period of years by increasing the percentage of total taxes subject to the new EFTPS system each year.

7.4.3 State income tax

All state income tax withheld from employees’ wages must be deposited with the proper state agency. Deposit rules vary by state.

7.5 Magnetic Media Reporting

Employers who file 250 or more Forms W-2 are required to use magnetic media under Reg. 301.6011-2. For purposes of IRS regulations, *magnetic*

media refers to magnetic tape and diskette. However, regulations indicate that the use of diskette may be limited for Forms W-2.

The IRS regulation provides for a waiver for employers who can show that they will be subject to hardship if required to file a return on magnetic media. A request for waiver (Form 8508) must be submitted at least forty-five days before the filing of the first return for which the waiver is sought. The waiver is in effect for one year at a time.

Employers required to file on magnetic media, but who fail to do so, are deemed under the regulation to have failed to file the necessary returns, and will be subject to applicable penalties.

8. POSTEMPLOYMENT ISSUES

8.1 Covenants Not to Compete

A covenant not to compete is a clause in an employment agreement under which an employee agrees not to compete with his or her employer while employed and after terminating employment. To be enforceable, these covenants must be reasonably necessary to protect the employer and they cannot be so restrictive as to prevent the former employee from self-support. Generally, they cannot exceed a geographic area larger than that covered by the employment agreement and are rarely valid if they exceed one year. Unreasonable covenants are not enforceable. Some states allow their courts to edit these covenants to make them reasonable; others simply refuse to enforce them.

8.2 Wrongful Discharge

Wrongful discharge is an action based on the claim that an employee was unlawfully discharged from employment. This claim can be based on some form of discrimination, retaliation for the attempt to exercise a right, or violation of an employment agreement. The employee may be seeking reinstatement, back wages, and/or punitive damages.

An employer's best defense to any legal action is one supported by contemporaneous records. In particular, employee discipline, including warnings, should be documented in writing. Employees should be asked to sign the document.

8.2.1 Constructive discharge

Constructive discharge is similar to wrongful discharge. The difference is that, under constructive discharge, the employee was not discharged

but rather the employer made working conditions so unreasonable that the employee was forced to quit.

8.3 Insurance Continuation

The federal Consolidated Omnibus Budget Reconciliation Act of 1986 (COBRA) supersedes most state law relating to insurance coverage continuation following employment termination. State law will override federal law to the extent that the state law provides greater benefits to the employee.

8.3.1 Employers covered by COBRA

All employers of twenty or more employees, with health insurance plans (self-insured or through an insurance carrier), must offer continuation of insurance coverage on termination of employment or death.

8.3.2 Right to continue insurance coverage

Persons other than employees have the right to continue insurance coverage. Continued coverage must be offered to

- Voluntarily and involuntarily terminated employees, except employees discharged for gross misconduct.
- Employees who may lose coverage because of change in employment status from full-time to part-time.
- Employees' spouses and spouses who are divorced, widowed, or separated, and their dependents.
- Dependent children who might become ineligible because of divorce, marriage, or age.

8.3.3 Period of coverage

Insurance coverage may continue for a maximum of eighteen months. Spouses and dependents are eligible for thirty-six months of continuation. Coverage may be terminated if a qualified person fails to pay a premium or if he or she becomes covered by another group plan.

REFERENCES

Alexander Consulting Group Staff. *1996 Quick Reference to ERISA Compliance*. New York: Panel Publishers, 1996.

- Anderson, Ronald A., and David P. Twomey. *Business Law and the Regulatory Environment: Principles and Cases*. Cincinnati: South-Western Publishing Company, 1995.
- Bennett-Alexander, Dawn D., and Laura B. Pincus. *Employment Law for Business*, 2d ed. Burr Ridge, Ill.: Irwin Professional Publishing, 1997.
- Bixby, Michael B., et al. *The Legal Environment of Business*, 4th ed. Cincinnati: South-Western Publishing, 1996.
- BNA's Business & Human Resources Services Staff. *Individual Employment Rights*. (Labor Relations Reporter Series). Washington, D.C.: BNA Books, 1986. Loose-leaf service.
- BNA Editorial Staff. *Grievance Guide*, 9th ed. Washington, D.C.: BNA Books, 1995.
- Bohlman, Herbert M. *The Legal, Ethical, and Regulatory Environment of Business*. Cincinnati: South-Western Publishing, 1998.
- Bokat, Stephen A., and Horace A. Thompson, eds. *Occupational Safety and Health Law, 87-95 Supplement*. Washington, D.C.: BNA Books, 1997.
- Boumil, Marcia M., et al. *Law and Gender Bias*. Littleton, Colo.: Fred B. Rothman & Co., 1995.
- Castagnera, James O. *Employment Law Answer Book: Forms and Checklists*, rev. ed. New York: Panel Publishers, 1994.
- Chinski, Arthur. *Employee Termination: The Right of Fair Treatment*. Santa Monica, Calif.: Institute of Business Law, 1992.
- Cihon, Patrick J., and James O. Castagnera. *Labor & Employment Law*, 2d ed. Cincinnati: South-Western Publishing Co., 1993.
- Coleman, Barbara J. *Primer on ERISA*, 4th ed. Washington, D.C.: BNA Books, 1993.
- Convington, Robert N., and Kurt Decker. *Individual Employee Rights in a Nutshell*. St. Paul, Minn.: West Publishing Co., 1995.
- Crump, D. W. *Contracts of Employment*, 7th ed. Charlottesville, Vir.: LEXIS Law Publishing, 1994.
- Decker, Kurt H. *Drafting & Revising Employment Contracts*. New York: John Wiley & Sons, Inc., 1996.
- . *Employee Privacy Law and Practice*. New York: John Wiley & Sons, Inc., 1996.
- Deskbook Encyclopedia of Employment Law*, 6th ed. Rosemount, Minn.: Data Research, Inc., 1993.

- Employment Law Answer Book*, 3rd ed. Gaithersburg, Md: Aspen Publishers, 1995.
- Employment Law Answer Book*. New York: Panel Publishers, 1994.
- Goetsch, David L. *Occupational Safety & Health in the Age of High Technology: For Technologists, Engineers & Managers*, 2d ed. Upper Saddle River, N.J.: Prentice Hall, 1995.
- Goldstein, Valerie H. *The E-Z Legal Guide to Employment Law*. Deerfield Beach, Fla.: E-Z Legal Forms, 1995.
- Gross, Allen J. *Employee Dismissal Law: Forms and Procedures*. 1997 Cumulative Supplement, 2 vols. New York: John Wiley & Sons, Inc., 1996.
- Holland, James, and Stuart Burnett. *Employment Law*, 4th ed. Holmes Beach, Fla.: Gaunt, Inc., 1997.
- Holloway, William J. and Michael J. Leech. *Employment Termination: Rights and Remedies*, 2d ed. Washington, D.C.: BNA Books, 1993.
- Kahn, Steven C., Barbara B. Brown, Michael Lanzarone, and Brent E. Zepke. *Personnel Director's Legal Guide*. Rev. ed. Boston: Warren, Gorham & Lamont, 1994.
- Kalet, Joseph. *Primer on FLSA and Other Wage and Hour Laws*, 3d ed. Washington, D.C.: BNA Books, 1994.
- Kushner, Michael. *ERISA Regulations*. Washington, D.C.: BNA Books, 1997.
- Larson, Arthur, and Lex K. Larson. *Employment Discrimination*. 4 vols. New York: Matthew Bender & Company, Inc., 1975. Loose-leaf service. Supplemented.
- Leader, Lawrence. *Drafting Employment and Termination Agreements*. New York: Matthew Bender & Company, Inc., 1993.
- Levin-Waldman, Oren M. *Making Unemployment Insurance Work: Reforming Unemployment Insurance*. Annandale-on-Hudson: Bard College Publications, 1996.
- Liebman, Lance M., and Mark A. Rothstein. *Employment Law, 1996 Supplement to Cases and Materials On*, 3rd ed. Westbury, N.Y.: Foundation Press, Inc., 1996.
- Mansdorf, S. Z. *Complete Guide to Industrial Safety in Manufacturing*. Upper Saddle River, N.J.: Prentice Hall, 1993.
- Morin, William J. *Successful Termination*, rev. ed. New York: DBM Publishing, 1993.
- Nobile, Robert J. *Guide to Employee Handbooks*. Boston: Warren, Gorham & Lamont, 1993.

- Perritt, Henry H. *Employee Dismissal Law & Practice*, 4th ed. New York: John Wiley & Sons, Inc., 1997.
- Player, Mack A., Elaine W. Shoben, and Risa L. Lieberwitz. *Cases & Materials on Employment Discrimination Law*. St. Paul, Minn.: West Publishing Company, 1995.
- . *Federal Law of Employment Discrimination in a Nutshell*, 3d ed. St. Paul, Minn.: West Publishing Company, 1992.
- Rothstein, Mark A., et al. *Employment Law*. Vols. 1 and 2. St. Paul, Minn.: West Publishing Company, 1996.
- Ruzicho, Andrew J., and Louis A. Jacobs. *Employment Practices Manual: A Guide to Minimizing Constitutional, Statutory & Common Law Liability*, rev. ed. New York: West Group, 1994.
- Sack, Steven. *The Hiring and Firing Book: A Complete Legal Guide for Employers*. Merrick, N.Y.: Legal Strategies, Inc., 1996.
- Sedmak, Nancy, and Chrissie Vidas. *Primer on Equal Employment Opportunity*. 6th ed. Washington, D.C.: BNA Books, 1994.
- Twomey, David P. *Equal Opportunity Law*. 3rd ed. Cincinnati: South-West Publishing Co., 1996.
- . *Labor and Employment Law: Text and Cases*. Cincinnati: South-West Publishing Co., 1997.
- Vedder, Richard K. *Out of Work: Unemployment and Government in Twentieth-Century America*. New York: New York University Press, 1997.
- Visconti, Ron, and Richard Stiller. *Rightful Termination*. Menlo Park, Calif.: Crisp Publications, Inc., 1994.
- Walsh, James. *Rightful Termination*. Santa Monica, Calif.: Merritt Company, 1994.
- What You Ought to Know About Family and Medical Leave: What Are the Rules—Who Is Eligible—What Is Required*. Riverwoods, Ill.: CCH, Inc., 1995.

APPENDIX 1: State Labor Agencies**ALABAMA**

Alabama Labor Dept.
100 N Union St.,
Ste 620
P.O. Box 303500
Montgomery, AL 36130-3500
(334)242-3460
FAX (334)240-3417

ALASKA

Dept. of Labor, Wage & Hour
1100 W 8th St
Room 302
P O Box 20630
Juneau, AK 99802-0630
(907)465-4842
FAX (907)465-3584

ARIZONA

Arizona Labor Dept.
P O Box 19070
Phoenix, AZ 85005-9070
(602)542-4515
FAX (602)542-3104

ARKANSAS

Dept. of Labor
10421 W Markham
Little Rock, AR 72205
(501)682-4500
FAX (501)682-4535

CALIFORNIA

Dept. of Industrial
Relations
Div. of Administration
P O Box 420603
San Francisco, CA 94142
(916)323-4920
FAX (916)703-4780

COLORADO

Dept. of Labor and
Employment
1515 Arapahoe Tower 2,
Ste 700
Denver, CO 80202-2117
(303)620-4400
FAX (303)620-4485

Dept. of Labor & Employment
Industrial Claim Appeals Office
1515 Arapahoe St. Tower 3,
Ste 350
Denver, CO 80202-2117
(303)620-4277
FAX (303)620-4271

Div. of Labor

Labor Standards Unit
1515 Arapahoe St. Tower 2,
Ste 375
Denver, CO 80202-2117
(303)572-2241
FAX (303)620-4599

CONNECTICUT

State Board of Labor Relations
38 Wolcott Hill Road
Wethersfield, CT 06109-1114
(860)566-7537
FAX (860)566-7035

Carl R. Olandt

UC Director of Accounts
Connecticut Dept. of Labor
200 Folly Brook Blvd
Wethersfield, CT 06109-1114
(860)566-2128
FAX (860)566-7697

DELAWARE

Office of the Secretary
Delaware Dept. of Labor
4425 N Market Street
Wilmington, DE 19802
(302)761-8001
FAX (302)761-6621

DISTRICT OF COLUMBIA

Dept. of Employment
Services
500 C St., N.W., Ste 600
Washington, D.C. 20001
(202)724-7100
FAX (202)724-7112

FLORIDA

Div. of Jobs and Benefits
Dept. of Labor and
Employment Security
1320 Executive Center Dr
300 Atkins Bldg
Tallahassee, FL 32399-0667
(850)488-7228
FAX (850)487-1753

GEORGIA

Dept. of Labor
Sussex Pl
148 International Blvd., N.E.,
Rm. #392
Atlanta, GA 30303-1751
(404)656-3780
FAX (404)651-6438

HAWAII

Information Office
Dept. of Labor and
Industrial Relations
830 Punchbowl St., Rm 321
Honolulu, HI 96813
(808)586-8842
FAX (808)586-9099

IDAHO

Dept. of Labor
317 Main St
Boise, ID 83735-0001
(208)334-6318
FAX (208)334-6301

ILLINOIS

Illinois Dept. of Labor
160 N LaSalle St. C-1300
Chicago, IL 60601
(312)793-2800
FAX (312)793-5257

INDIANA

Dept. of Labor
402 W Washington St., W195
Indianapolis, IN 46204
(317)232-2655
FAX (317)233-3790

Mediation and Conciliation
(317) 232-2673

Building and Factory Inspection
IOSHA Administrator
(317)232-2693

Bureau of Child Labor
(317)232-2675

Minimum Wage and Wage
Claims
(317)232-2673

IOWA

Div. of Labor
1000 East Grand Ave
Des Moines, IA 50319-0209
(515)281-3606
FAX (515)281-7995

KANSAS

Employment Standards
Kansas Dept. of Human
Resources
433 SW Topeka Blvd
Topeka, KS 66603-3151
(913)296-4062
FAX (913)368-6462

KENTUCKY

Labor Cabinet
1047 U.S. Hwy 127 South
Ste 4
Frankfort, KY 40601-4381
(502)564-3070
FAX (502)564-2248

LOUISIANA

Dept. of Labor/Labor Program
Section
P O. Box 94094
Baton Rouge, LA 70804-9094
(504)342 7690
FAX (504)342-2717

MAINE

Labor Relations Board (MLRB)
90 State House Station
Augusta, ME 04333-0090
(207)287-2015

MARYLAND

Div. of Labor and Industry
1100 N Eutaw St., Room 604
Baltimore, MD 21201
(410)767-2236
FAX (410)767-2220

MASSACHUSETTS

Div. of Occupational Safety
100 Cambridge St.,
Room 1107
Boston, MA 02202
(617)727-3452
FAX (617)727-0726

MICHIGAN

Dept. of Consumer and
Industry Services
525 W Ottawa
Williams Bldg 4th Floor
Lansing, MI 48909
(517)373-1820
FAX (517)373-2129

MINNESOTA

Bureau of Mediation Services
1380 Energy Lane, Ste 2
St. Paul, MN 55108-5253
(612)649-5421
FAX (612)643-3013

Dept. of Labor and

Industry
443 Lafayette Rd
St Paul, MN 55155
(612)296-6107
FAX (612)297-1329

MISSISSIPPI

Occupational Safety and
Health Branch
Mississippi Workers'
Compensation Commission
1428 Lakeland Drive
P O Box 5300
Jackson, MS 39296-5300
(601)987-4284
FAX (601)987-4233

MISSOURI

Dept. of Labor and
Industrial Relations
3315 W Truman Blvd
P O Box 504
Jefferson City, MO 65102-0504
(573)751-4091
FAX (573)751-4135

Div of Labor Standards
3315 W Truman Blvd
P O Box 449
Jefferson City, MO 65102-0504
(800)475-2130/(573)751-3403
FAX (573)751-3721
E-mail labor_standards@
dolr.state.mo.us

MONTANA

Wage & Hour Unit
Labor Standards Bureau
Employment Relations Div
Dept. of Labor &
Industry
P O Box 6518
Helena, MT 59604-6518
(406)444-5600
FAX (406)444-4140

NEBRASKA

Dept. of Labor
550 S Sixteenth St
P O Box 94600
Lincoln, NE 68509-4600
(402)471-9000
FAX (402)471-2318

NEVADA

Nevada State Labor
Commission
555 E. Washington Ave.
Ste 4100
Las Vegas, NV 89101-1050
(702)486-2650
FAX (702)486-2660

NEW HAMPSHIRE

Dept. of Labor
95 Pleasant St.
Concord, NH 03301
(603)271-3176
FAX (603)271-6149

NEW JERSEY

Dept. of Labor
John Fitch Plaza
CN-385
Trenton, NJ 08625
(609)292-2000
FAX (609)393-7375

NEW MEXICO

Dept. of Labor/Labor &
Industrial Division
Wage and Hour Bureau
501 Mountain Rd., N.E.,
Rm 106
Albuquerque, NM 87102
(505)841-8983
FAX (505)841-9317

NEW YORK

State Labor Relations Act
New York State Employment
Relations Board, 6th Fl.
One Penn Plaza
New York, NY 10119
(212)564-2441
FAX (212)564-2903

NORTH CAROLINA

North Carolina Dept. of
Labor/Labor Standards
Bureau
Wage and Hour Office
413 N Salisbury St.
Raleigh, NC 27603-5942
(919)733-2152/(800)522-6762
FAX (919)715-3858

NORTH DAKOTA

North Dakota Dept of
Labor
13th Fl., State Capitol
600 E. Boulevard Ave., Dept
406
Bismarck, ND 58505-0340
(701)328-2660
FAX (701)328-2031

OHIO

Ohio Bureau of Employment
Services (OBES)
Wage & Hour Division
145 S. Front St
P O Box 1618
Columbus, OH 43216
(614)644-2239
FAX (614)728-8639

OKLAHOMA

State Dept. of Labor
4001 N Lincoln Blvd.
Oklahoma City, OK 73105
(405)528-1500
FAX (405)525-5603

OREGON

Employment Relations Board
528 Cottage St., N.E.
Suite 400
Salem, OR 97310
(503)378-3807 ext. 221
FAX (503)373-0021

All Other Labor Laws

Bureau of Labor and Industries
State Office Bldg
800 NE Oregon St., #32
Portland, OR 97232-2109
(503)731-4070
FAX (503)731-4103

PENNSYLVANIA

State Public & Private Sector
Labor Relations Acts
Pennsylvania Labor Relations
Board
1601 Labor and Industry
Bldg
Seventh and Forster Sts.
Harrisburg, PA 17120
(717)787-1091
FAX (717)783-2974

All Other Labor Laws

Dept. of Labor and Industry
1700 Labor and Industry
Bldg
Seventh and Forster Sts.
Harrisburg, PA 17120
(717)787-3756
FAX (717)787-8826

PUERTO RICO

Dept. of Labor and Human
Resources
505 Munoz Rivera Ave
Hato Rey, PR 00918
(787)754-5262
FAX (787)753-2097

RHODE ISLAND

State Labor Relations Act
Rhode Island Labor Relations
Board
610 Manton Ave
Providence, RI 02909
(401)457-1820
FAX (401)457-1821

SOUTH CAROLINA

Dept. of Labor, Licensing
& Regulation
110 Centerview Drive
P O Box 11329
Columbia, SC 29211-1329
(803)896-4300
FAX (803)896-4393

SOUTH DAKOTA

Dept. of Labor
Div of Labor and
Management
Kneip Bldg
700 Governor's Dr
Pierre, SD 57501-2277
(605)773-3681
FAX (605)773-4211

TENNESSEE

Dept of Labor
 Andrew Johnson Tower,
 Second Floor
 710 James Robertson Parkway
 Nashville, TN 37243-0655
 (615)741-2582
 FAX (615)741-5078

TEXAS

Labor Law Enforcement,
 Education & Regulation
 Dept
 101 E. 15th St
 Austin, TX 78778-0001
 (512)837-9559
 FAX (512)834-3526

UTAH

State Labor Div
 Industrial Commission of Utah
 160 East 300 South, 3d Fl
 P O Box 146630
 Salt Lake City, UT 84114-6630
 (801)530-6801
 FAX (801)530-7609

VERMONT

Dept of Labor and
 Industry
 National Life Drive Drawer 20
 Montpelier, VT 05620-3401
 (802)828-2288
 FAX (802)828-2195

VIRGINIA

Dept of Labor and
 Industry
 13 S Thirteenth St
 Richmond, VA 23219
 (804)371-7414
 FAX (804)786-9877

WASHINGTON

Dept of Labor and
 Industries
 P O Box 44001
 Olympia, WA 98504-4001
 (360)902-4200
 FAX (360)902-4202

WEST VIRGINIA

Div of Labor
 Capitol Complex, Rm 319
 Bldg 3
 Charleston, WV 25305
 (304)558-7890
 FAX (304)558-3797

WISCONSIN

Dept of Workforce
 Development
 P O Box 7946
 Madison, WI 53707
 (608)266-7552
 FAX (608)266-1784

WYOMING

Dept of Employment
 Labor Standards Div
 6101 Yellowstone, Rm 259C
 Cheyenne, WY 82002
 (307)777-7261
 FAX (307)777-5633

APPENDIX 2: State Civil Rights Agencies

These agencies have overall responsibility for preventing and redressing discrimination due to race, color, sex, age, national origin, religion, or handicap in employment, education, housing, public accommodations, and credit.

ALABAMA

Equal Opportunity Commission
Birmingham District Office
1900 3rd Ave North
Birmingham, AL 35203-2397
(800)669-4000
FAX (205)731-2101

ALASKA

State Commission for Human Rights
800 A St
Suite 204
Anchorage, AK 99501-3699
(907)274-4692
FAX (907)278-8588
TTY/TDD: (907)276-3177

ARIZONA

Civil Rights Div.
Off. of Attorney Gen
1275 W Washington
Phoenix, AZ 85007-2926
(602)542-3263
FAX (602)542-8885

ARKANSAS

None—Each agency handles its own grievances.

CALIFORNIA

Dept. of Fair Employment & Housing
2014 T St., Ste 210
Sacramento, CA 95814
(916)227-2873
FAX (916)227-2870

COLORADO

Civil Rights Div
Dept. of Regulatory Agencies
1560 Broadway
Rm. 1050
Denver, CO 80202-5143
(303)894-2997
FAX (303)894-7830
TTY (303)894-7832

CONNECTICUT

Comm on Human Rights & Opportunities
21 Grand St.
Hartford, CT 06106-1507
(860)541-3400
FAX (860)246-5068

DELAWARE

Office of Labor Law Enforcement
DE Dept. of Labor
4425 N Market St.
Wilmington, DE 19810
(302)761-8200
FAX (302)761-6601

FLORIDA

State Dept. of Labor & Employment Security
Off. of Civil Rights & Minority Affairs
2670 Executive Ctr Circle West
Ste 200, Sutton Building
Tallahassee, FL 32399-2157
(904)488-5905
FAX (904)921-4210

GEORGIA

Human Relations Commission
225 Peachtree Street
South Tower, Suite 1207
Atlanta, GA 30303
(404)651-9115
FAX (404)656-6046

HAWAII

Office of Affirmative Action
Office of the Governor
No. 1 Capitol District
250 South Hotel Street,
Rm 102
Honolulu, HI 96813
(808)586-0197
FAX (808)586-0159

IDAHO

Human Rights Comm
1109 Main St., Ste 400,
Box 83720
Boise, ID 83720-0040
(208)334-2873
FAX (208)334-2664

ILLINOIS

Dept. of Human Rights
100 W Randolph
James R. Thompson Center
Suite 10-100
Chicago, IL 60601
(312)814-6200
FAX (312)814-6251

INDIANA

Civil Rights Comm
Indiana Government Center
North
100 N Senate Ave., Rm. N103
Indianapolis, IN 46204
(317)232-2600
FAX (317)232-6580

IOWA

Civil Rights Comm
211 E. Maple, 2d Fl.
Des Moines, IA 50309-1858
(515)281-4121
FAX (515)242-5840

KANSAS

Kansas Human Rights Comm
900 S W Jackson, Ste 851 S.
Topeka, KS 66612-1258
(785)296-3206
FAX (785)296-0589

KENTUCKY

Comm. on Human Rights
The Heyburn Bldg., 7th Floor
332 W Broadway
Louisville, KY 40202
(502)595-4024
FAX (502)595-4801
TDD (502)595-4084

LOUISIANA

Louisiana Human Rights Comm
P O Box 94094
Baton Rouge, LA 70804-9094
(504)342-6969
FAX (504)342-2063

MAINE

ME Human Rights Comm
51 State House Station
Augusta, ME 04333-0051
(207)624-6050
FAX (207)624-6063

MARYLAND

Comm on Human Relations
William Donald Schaefer Tower
6 St. Paul Street, 9th Floor
Baltimore, MD 21202-2274
(410)767-8600
FAX (410)333-1841

MASSACHUSETTS

Comm Against Discrimination
One Ashburton Pl.
Rm. 601
Boston, MA 02108
(617)727-3990
FAX (617)720-6053

MICHIGAN

Director, Enforcement Bureau
State of Michigan Plaza Bldg
1200 Sixth Ave
Detroit, MI 48226
(313)256-2629
FAX (313)256-1703

MINNESOTA

Dept. of Human Rights
Army Corps of Engineers
Centre
190 East 5th St., Ste 700
St. Paul, MN 55101
(612)296-5663
FAX (612)296-9042

MISSISSIPPI

Equal Employment
Opportunity Dept.
Employment Security Comm.
P O Box 1699
Jackson, MS 39215-1699
(601)961-7421
FAX (601)961-7405

MISSOURI

Comm on Human Rights
Labor & Industrial Relations
Dept.
3315 West Truman Blvd.
P O Box 1129
Jefferson City, MO 65102-1129
(573)751-3325
FAX (573)751-2905

MONTANA

Human Rights Bureau
Dept. of Labor & Industry
P O. Box 1728
Helena, MT 59624-1728
(406)444-2884
FAX (406)444-2798

NEBRASKA

Equal Opportunity Comm
301 Centennial Mall So.
5th Floor
P O Box 94934
Lincoln, NE 68509-4934
(402)471-2024
FAX (402)471-4059

NEVADA

Equal Rights Comm.
1515 E. Tropicana Ave.,
Ste 590
Las Vegas, NV 89158
(702)486-7161

NEW HAMPSHIRE

Comm for Human Rights
163 Loudon Rd.
Concord, NH 03301-6053
(603)271-2767
FAX (603)271-6339

NEW JERSEY

Div on Civil Rights
Dept. of Law & Public Safety
CN 089
Trenton, NJ 08625-0089
(609)984-3100
FAX (609)777-0466

NEW MEXICO

Department of Labor
Human Rights Div
Aspen Plaza
1596 Pacheco St.
Santa Fe, NM 87505
(505)827-6838
FAX (505)827-6878

NEW YORK

Div of Human Rights
Executive Dept
55 W. 125th St.
New York, NY 10027
(212)961-8562
FAX (212)961-8552

NORTH CAROLINA

Human Relations Comm
Dept. of Administration
217 W Jones St
Raleigh, NC 27603
(919)733-7996
FAX (919)733-7940

NORTH DAKOTA

Dept. of Labor
600 E. Boulevard Ave
6th Fl., State Capitol
Bismarck, ND 58505-0340
(701)328-2660
FAX (701)328-2031

OHIO

Civil Rights Comm.
1111 E. Broad St., Ste 301
Columbus, OH 43205-1379
(614)466-2785
FAX (614)644-8776
TTY (614)466-9353

OKLAHOMA

Human Rights Comm.
2101 N Lincoln Blvd
Jim Thorpe Bldg., Rm. 480
Oklahoma City, OK 73105
(405)521-3441
FAX (405)522-3635

OREGON

Civil Rights Div.
Bur of Labor & Industries
800 NE Oregon St., #32
Portland, OR 97232
(503)731-4075
FAX (503)731-4069

PENNSYLVANIA

Human Relations Comm
101 S. Second St.
Suite 300
P.O Box 3145
Harrisburg, PA 17105-3145
(717)787-4412

RHODE ISLAND

Commission for Human Rights
10 Abbott Park Place
Providence, RI 02903-3768
(401)222-2661
FAX (401)222-2616

SOUTH CAROLINA

Human Affairs Commission
P O Box 4490
Columbia, SC 29240
(803)253-6336
FAX (803)253-4191

SOUTH DAKOTA

Div of Human Rights
118 W Capitol Ave
Pierre, SD 57501-2000
(605)773-4493
FAX (605)773-6893

TENNESSEE

Human Rights Comm
530 Church St., Ste 400
Cornerstone Square Bldg
Nashville, TN 37243-0745
(615)741-5825
FAX (615)532-2197

TEXAS

Comm. on Human Rights
6330 Hwy. 290 East, Ste 250
P.O Box 13493
Austin, TX 78711
(512)437-3450
FAX (512)437-3478

UTAH

Labor Comm
Anti-Discrimination Div
P.O Box 146630
Salt Lake City, UT 84114-6630
(801)530-6801
FAX (801)530-7609
TDD (801)530-7685

VERMONT

Civil Rights Unit
Public Protection Div
Off of Attorney Gen.
109 State St.
Montpelier, VT 05609-1001
(802)828-3171 or
(802)828-3657
FAX (802)828-2154

VIRGINIA

Virginia Council of Human
Rights
P O Box 717
Richmond, VA 23206
(804)225-2292
FAX (804)225-3294

WASHINGTON

Human Rights Comm
711 S. Capitol Way, Ste 402
P.O Box 42490
Olympia, WA 98504-2490
(360)753-6770
FAX (360)586-2282

WEST VIRGINIA

Human Rights Comm.
Rm. 108A
1321 Plaza East
Charleston, WV 25301-1400
(304)558-2616
FAX (304)558-0085

WISCONSIN

Dept of Workforce
Development/Equal
Rights Division
P O. Box 8928
Madison, WI 53708
(608)266-6860
FAX (608)267-4592

WYOMING

Dept of Administration &
Information
Emerson Bldg, Rm 104
Cheyenne, WY 82002
(307)777-7201
FAX (307)777-3633

DISTRICT OF COLUMBIA

Dept. of Human Rights &
Local Business
Development
441 4th St. N.W., Rm 970
9th Fl North
Washington, DC 20001
(202)724-1385
FAX (202)724-3787

GUAM
Dept of Law
Office of Attorney General
Ste 2-200E
Judicial Center Bldg
120 W O'Brien Dr
Agana, GU 96910
(671)475-3324
FAX (671)472-2493

PUERTO RICO
Civil Rights Comm.
P.O. Box 192338
Hato Rey, PR 00919-2338
(787)764-8686/(787)764-8690
FAX (787)765-9360

VIRGIN ISLANDS
Civil Rights Comm.
P.O. Box 6645
St Thomas, VI 00801-6645
(809)774-5666 ext. 177/175
FAX (809)774-9710

APPENDIX 3: State Equal Employment Opportunity Agencies

These agencies enforce laws promoting equal employment opportunity.

ALABAMA
Equal Opportunity
Employment Off
Dept. of Industrial Relations
649 Monroe St.
Montgomery, AL 36130
(334)242-8495
FAX (334)242-2048

ALASKA
Office of the Governor
Equal Employment
Opportunity
3601 C St., Ste 250
Anchorage, AK 99503
(907)269-7495
FAX (907)269-7497

ARIZONA
Governor's Office of Equal
Opportunity
1700 W Washington, Ste 156
Phoenix, AZ 85007
(602)542-3711
FAX (602)542-3712

ARKANSAS
Office of Personnel
Management
Dept. of Finance &
Administration
201 DFA Bldg
1509 West 7th St.
P O Box 3278
Little Rock, AR 72201
(501)682-1823
FAX (501)682-5094

CALIFORNIA
Dept. of Fair Employment and
Housing
2014 I St., Ste 210
Sacramento, CA 95814
(916)227-2873
FAX (916)227-2870

COLORADO
Civil Rights Div
Dept. of Regulatory Agencies
1560 Broadway
Rm 1050
Denver, CO 80202-5143
(303)894-2997
(800)262-4845
FAX (303)894-7830
TTY (303)894-7832

CONNECTICUT
Comm on Human Rights
& Opportunities
21 Grand St
Hartford, CT 06106-1507
(860)541-3400
FAX (860)246-5068

DELAWARE
Office of Labor Law
Enforcement
DE Dept. of Labor
4425 N Market St.
Wilmington, DE 19810
(302)761-8200
FAX (302)761-6601

FLORIDA
Florida Commission on
Human Relations
325 John Knox Rd.
Suite 240, Bldg F
Tallahassee, FL 32303-4149
(850)488-7082
FAX (850)488-5291

GEORGIA
The Georgia Commission on
Equal Opportunity
710 International Tower-
Peachtree Center
229 Peachtree St NE
Atlanta, GA 30303
(404)656-1736
FAX (404)656-4399

HAWAII
Off. of Affirmative Action
Off. of the Governor
No. 1 Capitol District
250 S. Hotel, #102
Honolulu, HI 96813
(808)586-0073
FAX (808)586-0076

IDAHO
Human Rights Comm
1109 Main St., Ste 400,
P O Box 83720
Boise, ID 83720-0040
(208)334-2873
FAX (208)334-2664

ILLINOIS
Dept. of Human Rights
100 W Randolph
James R. Thompson Center
Suite 10-100
Chicago, IL 60601
(312)814-6200
FAX (312)814-6251

INDIANA
Civil Rights Comm
Indiana Government Center
North
100 N Senate Ave, Rm N103
Indianapolis, IN 46204
(317)232-2600
FAX (317)232-6580

IOWA
Civil Rights Comm
211 E. Maple St., 2nd Floor
Des Moines, IA 50309-1858
(515)281-4121
FAX (515)242-5840

KANSAS
Human Resource Mgmt &
Diversity
Personnel Services
Kansas Dept. of Admn
900 SW Jackson
Rm 951-5
Landon State Office Bldg
Topeka, KS 66612-1251
(913)296-1844
FAX (913)291-3715

KENTUCKY
Comm on Human Rights
The Heyburn Bldg, 7th Floor
332 W Broadway
Louisville, KY 40202
(502)595-4024
FAX (502)595-4801
TDD (502)595-4084

LOUISIANA
Dept. of Labor
Office of Equal Opportunity &
Compliance
1001 N 23rd St., Rm 244
P O Box 94094
Baton Rouge, LA 70804-9094
(504)342-3075
FAX (504)342-7961

MAINE
ME Human Rights Comm
51 State House Station
Augusta, ME 04333-0051
(207)624-6050
FAX (207)624-6063

MARYLAND
Comm on Human Relations
6 St Paul St., 9th Fl
Baltimore, MD 21202-1631
(410)767-8600
FAX (410)333-1841

MASSACHUSETTS
Office of Affirmative Action
One Ashburton Place
Rm 213
Boston, MA 02108
(617)727-7441
FAX (617)727-0568

MICHIGAN
Enforcement Bureau
Dept. of Civil Rights
1200 Sixth Ave
Detroit, MI 48226
(313)256-2629
FAX (313)256-1703

MINNESOTA
Dept. of Economic Security
Tax Accounting
390 N Robert St., 4th Floor
St. Paul, MN 55101
(612)296-6141
FAX (612)297-5283

MISSISSIPPI
Equal Employment
Opportunity Dept.
Employment Security Comm.
P O Box 1699
Jackson, MS 39215-1699
(601)961-7421
FAX (601)961-7405

MISSOURI
Comm on Human Rights
Labor & Industrial Relations
Dept.
3315 W Truman Blvd.
P O Box 1129
Jefferson City, MO 65102-1129
(573)751-3325
FAX (573)751-2905

MONTANA
Human Rights Bureau
Dept. of Labor & Industry
P O Box 1728
Helena, MT 59624-1728
(406)444-2884
FAX (406)444-2798

NEBRASKA
Nebraska Equal Opportunity
Comm.
301 Centennial Mall South,
5th Floor
P O Box 94934
Lincoln, NE 68509-4934
(402)471-2024
FAX (402)471-4059

NEVADA
Equal Rights Comm.
1515 E. Tropicana Ave.,
Ste. 590
Las Vegas, NV 89158
(702)486-7161
FAX (702)486-7054

NEW HAMPSHIRE
Comm. for Human Rights
163 Loudon Rd.
Concord, NH 03301-6053
(603)271-2767
FAX (603)271-6339

NEW JERSEY
Dept. of Personnel
Div of Equal Employment
Opportunity & Affirmative
Action
44 South Clinton Ave., CN 315
Trenton, NJ 08625-0315
(609)777-0919
(609)292-9335

NEW MEXICO
New Mexico Dept. of Labor
Human Rights Division
Aspen Plaza, 1596 Pacheco St.
Santa Fe, NM 87505
(505)827-6838/(800)566-9471
FAX (505)827-6878

NEW YORK
Dept. of Civil Service
W Averell Harriman State
Office Building
Campus Bldg #1
Albany, NY 12239
(518)457-9375
FAX (518)457-6875

NORTH CAROLINA
Equal Opportunity Services
Div
Off of State Personnel
116 W Jones St.
Raleigh, NC 27603-8004
(919)733-0205
FAX (919)733-0653

NORTH DAKOTA
Dept. of Labor
State Capitol
600 E. Blvd.
Dept. 406
Bismarck, ND 58505-0340
(701)328-2660
FAX (701)328-2031

OHIO
Civil Rights Comm.
220 Parsons Ave.
Columbus, OH 43266-0543
(614)466-2785
FAX (614)644-8776

OKLAHOMA
Employment Security Comm.
Oklahoma State Employment
Service
Will Rogers Memorial Office
Bldg
P O Box 52003
Oklahoma City, OK 73152-2003
(405)557-7255
FAX (405)557-7256

OREGON
Employment Department
875 Union St., NE
Salem, OR 97311-0030
(503)947-1488
FAX (503)947-1487

PENNSYLVANIA
PA Human Relations Comm.
101 S. Second St.
Suite 300
P O Box 3145
Harrisburg, PA 17105-3145
(717)787-4412

RHODE ISLAND
Dept. of Admin., Div of
Human Services
Equal Opportunity Off.
1 Capitol Hill
Providence, RI 02908-5865
(401)222-3090
FAX (401)222-6391

SOUTH CAROLINA
Human Affairs Comm.
2611 Forest Dr, Ste 200
P O Box 4490
Columbia, SC 29211
(803)737-7800
FAX (803)253-4191

SOUTH DAKOTA
Bur. of Personnel
500 East Capital
Pierre, SD 57501-5070
(605)773-3148
FAX (605)773-4344

TENNESSEE
Equal Employment
Opportunity
Dept. of Employment Security
500 James Robertson Pkwy
12th Fl., Davy Crockett Tower
Nashville, TN 37245-0300
(615)741-5292
FAX (615)741-3203

TEXAS
Office of the Governor
Human Resources Division
P O Box 12428
Capitol Station
Austin, TX 78711
(512)463-5873
FAX (512)463-8464

UTAH
Labor Commission
Anti-Discrimination and
Labor Div
P O Box 146630
Salt Lake City, UT 84114-6630
(801)530-6801
FAX (801)530-7609
TDD (801)530-7685

VERMONT
Office of the Attorney General
Civil Rights
Pavilion Office Bldg.
109 State St
Montpelier, VT 05609-1001
(802)828-3171
FAX (802)828-2154

VIRGINIA
Office of Equal Employment
Services
Dept. of Personnel & Training
101 N 14th St.
Richmond, VA 23219
(804)225-2136
FAX (804)371-7401

WASHINGTON
Workforce Diversity Program
Dept. of Personnel
521 S. Capitol
P.O. Box 47530
Olympia, WA 98504-7500
(360)753-3758
FAX (360)586-4694

WEST VIRGINIA
Personnel Div
Bldg. 6, Rm B-416
1900 Kawawha Blvd. E.
Charleston, WV 25305
(304)558-3950
FAX (304)558-1587

WISCONSIN
 Dept. of Workforce
 Development
 Equal Rights Division
 P.O. Box 8928
 Madison, WI 53708
 (608)266-6860
 FAX (608)267-4592

WYOMING
 Dept. of Employment, Div of
 Labor Standards/Fair
 Employment
 6101 Yellowstone
 Room 259C
 Cheyenne, WY 82002
 (307)777-7261
 FAX (307)777-5633

DISTRICT OF COLUMBIA
 Dept. of Human Rights &
 Local Business
 Development
 441 4th St. N.W., Rm 970
 9th Fl North
 Washington, DC 20001
 (202)724-1385
 FAX (202)724-3786

AMERICAN SAMOA
 Dept. of Human Resources
 American Samoa Government
 Pago Pago, AS 96799
 (684)633-4485
 FAX (684)633-1139

GUAM
 Dept. of Labor
 P O Box 9970
 Tamuning, GU 96931-9970
 (671)475-0101
 FAX (671)477-2988

NORTHERN MARIANA
 ISLANDS
 Dept. of Labor & Immigration
 Commonwealth of the
 Northern Mariana Islands
 Caller Box 10007
 C.K. Saipan, MP 96950
 (670)664-2000
 FAX (670)664-3153

PUERTO RICO
 Fair Employment
 Labor & Human Resources
 Dept.
 505 Munoz Rivera Ave
 Hato Rey, PR 00918
 (787)754-5377
 FAX (787)763-2227

VIRGIN ISLANDS
 Dept. of Labor
 Labor Relations Division
 P O Box 148
 St. Thomas, VI 00804-0148
 (340)776-3700
 FAX (340)774-5908

WISCONSIN

Dept. of Industry, Labor &
Human Relations
Equal Rights Division
P.O. Box 8928
Madison, WI 53708
(608)266-6861
FAX (608)267-4592

WYOMING

Dept. of Employment, Div. of
Labor Standards/Fair
Employment
6101 Yellowstone
2nd Floor, North Bldg.,
Room 259C
Cheyenne, WY 82002
(307)777-7261
FAX (307)777-5633

DISTRICT OF COLUMBIA

Dept. of Human Rights &
Minority Business
Development
441 4th St. N.W., Rm. 970
9th Fl. North
Washington, DC 20001
(202)724-1385
FAX (202)724-3786

AMERICAN SAMOA

Dept. of Human Resources
American Samoa Government
Pago Pago, AS 96799
(684)633-4485
FAX (684)633-1139

GUAM

Dept. of Labor
P.O. Box 9970
Tamuning, GU 96931-9970
(671)475-0101
FAX (671)477-2988

**NORTHERN MARIANA
ISLANDS**

Dept. of Labor & Immigration
Commonwealth of the
Northern Mariana Islands
Caller Box 10007
C.K., Saipan, MP 96950
(670)288-8805
FAX (670)234-7787

PUERTO RICO

Fair Employment
Labor & Human Resources
Dept.
505 Munoz Rivera Ave.
Hato Rey, PR 00918
(809)754-5377
FAX (809)763-2227

VIRGIN ISLANDS

Div. of Labor Relations
Dept. of Labor
P.O. Box 148
St. Thomas, VI 00804
(809)775-3498
FAX (809)774-0853

WORKERS' COMPENSATION

1. INTRODUCTION

- 1.1 Background
- 1.2 Purpose

2. DEFINITIONS

3. FEDERAL REGULATIONS

- 3.1 Coverage
- 3.2 Compulsory Coverage
- 3.3 Employees
- 3.4 Employers
- 3.5 Financing and Recordkeeping
- 3.6 Rates
- 3.7 Wage Base
- 3.8 Accidental Injury
- 3.9 Arising Out of Employment
- 3.10 In the Course of Employment
- 3.11 Occupational Diseases
- 3.12 Accident Reports
- 3.13 Benefits
 - 3.13.1 Categories of benefits
 - 3.13.2 Vocational rehabilitation
 - 3.13.3 Death benefits
 - 3.13.4 Benefits for pre-existing disabilities
- 3.14 Tax Consequences

4. OCCUPATIONAL SAFETY AND HEALTH

- 4.1 Background
- 4.2 Scope and Purpose
- 4.3 Compliance With OSHA
- 4.4 Relation to State Laws

5. STATE INFORMATION AND OFFICES

REFERENCES

APPENDIX: Occupational Safety—State Agencies and Addresses

1. INTRODUCTION

1.1 Background

Before workers' compensation benefits became statutory, injured employees who sought compensation for a loss were obliged to sue their employers under the civil negligence laws. Such action normally was very lengthy and costly, and often the employee did not receive any compensation at all. As the inequity of this system became widely realized, states developed plans whereby employees gave up their right to sue the employer for negligence. In return, the employer was required to guarantee certain benefits. A system of insurance was designed to implement this plan, and workers' compensation was formed. In the course of time, workers' compensation has shifted the burden of industrial injury to the cost of production and established a system compensating employees for injuries, under state law.

1.2 Purpose

The purpose of workers' compensation laws is to provide a uniform and fair system of compensating employees for work-related injuries, diseases, and deaths.

Workers' compensation laws make the employer strictly liable to an employee for injuries sustained by the employee that arise out of and in the course of employment. This liability is paid for by workers' compensation insurance policies, self-insured employer plans, or state funds. In awarding compensation for injuries, negligence on the part of the employer or employee is disregarded, with compensation uniformly held to be a no-fault exclusive remedy. All states have workers' compensation laws that provide medical, compensation, and other benefits for injuries. Although these laws vary from state to state, they are broadly similar in their provisions.

2. DEFINITIONS

Employer. An entity engaged in a business effecting commerce that has employees (29 U.S.C. Section 652(5)).

Employee. One employed in a business of an employer that effects commerce (29 U.S.C. Section 652(6)).

Commerce. "Trade, traffic, commerce, transportation, or communication among the several states, or between a state and any place

outside thereof, or within the District of Columbia, or a possession of the United States . . . , or between points in the same state but through a point outside thereof" (29 U.S.C. Section 652(3)).

3. FEDERAL REGULATIONS

3.1 Coverage

A determination of the exact jurisdiction and benefits applicable to a particular workers' compensation claim depends on the jurisdiction and benefit provisions of each state's workers' compensation statute. Each state has its own law establishing benefits and jurisdictional considerations. In addition to state laws, there are several federal workers' compensation statutes that provide workers' compensation coverage for certain specified groups of employees.

Exemptions from workers' compensation coverage are discussed in section 3.3 of this chapter.

3.2 Compulsory Coverage

Workers' compensation laws are classified as either compulsory or elective. Under a compulsory law, every employer must accept the act and must provide the specified compensation benefits. Under an elective act, employers have the option of either accepting or rejecting the benefits under the act. However, if the act is rejected, the employer loses the customary common law defenses, such as assumption of the risk by an employee, negligence of fellow employees, and contributory negligence of an employee.

Today, most states have compulsory workers' compensation laws. Accordingly, some form of insurance is mandatory for covered employers. Specific requirements for coverage, as well as penalties for failure to insure, vary considerably from state to state and can be learned only by examining the appropriate state regulations. Section 5 of this chapter discusses specific state requirements for coverage. New employers should contact their state workers' compensation authority to determine the exact requirements for workers' compensation insurance.

3.3 Employees

Compensation for work-related injuries will only be paid to employees, a definition that generally includes both part-time and temporary em-

employees. Professional and managerial employees are also considered employees. Certain types of employees may nevertheless be excluded from coverage under workers' compensation laws (for example, partners, some corporate officers, family members, volunteers, farm and domestic labor, and students). State regulations must be examined to determine exemption.

Sole proprietors are not considered "employers" or "employees" and are generally not covered under workers' compensation laws. Again, it is necessary to examine state laws to make a final determination.

The employer is responsible for compensating the injured employee. In general, workers are compensated for their loss of wages while out of work because of an injury, for their permanent disabilities and loss of wage-earning capacity, and for their medical needs. The amount of compensation varies from state to state, and benefits are paid directly by an employer's workers' compensation insurer or from a self-insured fund. Specific categories of benefits are discussed in section 3.13 of this chapter.

3.4 Employers

All employers covered under workers' compensation regulations are classified into specific groups by the nature of their business and activities, classifications based on the degree of risk of injury and accidents involved in the business.

All employers must be aware of their primary legal responsibilities and duties to injured employees. Under workers' compensation laws, the exact definition of *employer* varies from state to state. For example, some states base their definition on the number of employees a particular person employs. Again, individual state statutes must be reviewed. Whenever an employer is required to provide workers' compensation coverage, most laws require that he or she file certain reports and keep certain records.

3.5 Financing and Recordkeeping

Covered employers are liable for the cost of workers' compensation insurance, and the cost may not be passed along to employees.

Accurate wage records must be kept for all covered workers and be available for review, inspection, or audit at all times. Failure to comply may result in penalties and fines.

Management is responsible for understanding and meeting the requirements of the various workers' compensation statutes in states where its employees are situated. Management must establish a system to ensure that covered employees and their salary bases are properly accounted for and reported. Employees should be properly classified and these classifications periodically reviewed in connection with rate changes. The claims-handling process should also be re-evaluated periodically.

3.6 Rates

Accident experience throughout American business is compiled by the National Council on Compensation Insurance. The council is recognized by all insurance carriers and state fund administrators. Rates are determined in accord with a standard nationwide rate-making procedure approved by the National Association of Insurance Commissioners. The National Council on Compensation Insurance has issued an experience-rating-plan manual that is standard with all insurance companies.

Workers' compensation rates are assigned to employers based on the employer's classification. The rate is usually expressed as a percentage of payroll paid by an employer and is adjusted according to the employer's accident record. Employers in the same classification may have different rates based on the number of accidents their workers experience. In this way, the cost of workers' compensation is spread out more justly.

3.7 Wage Base

The rate assigned an employer is applied to the employer's wage base to determine the employer's workers' compensation liability. The wage base is the estimated wages an employer will pay in a year and should be adjusted periodically according to state regulations.

Wage-base audits are periodically completed to determine whether an employer has overpaid or underpaid. A wage-base audit compares the estimated wage base to the actual wages paid for a specified period.

3.8 Accidental Injury

Most state and federal workers' compensation laws require that an injury be "accidental" in nature. The majority of states accept an injury as accidental if its cause was of a chance nature or if its effect was the unexpected result of the routine performance of an employee's normal

job duties. A few states require proof that an employee's injury was in some way unusual and not merely the result of performing normal job duties.

3.9 Arising Out of Employment

All state and federal workers' compensation laws require that an injury "arise out of" employment in order to be compensable. An injury generally is said to arise out of employment when conditions of employment cause the injury.

3.10 In the Course of Employment

All state and federal workers' compensation laws also require that an injury occur "in the course of" employment. The time, place, and activity of the employee are demonstrative of whether the injury occurred in the course of employment. For example, in most states, many injuries that occur while employees are on their way to and from work are generally held not to occur in the scope of the employment and are not covered under workers' compensation laws.

3.11 Occupational Diseases

In addition to coverage for accidental injuries, most workers' compensation laws provide compensation for employees who sustain occupational diseases that arise out of and in the course of employment. In general, while an accidental injury arises from a specific event, occupational diseases result from repeated exposure over a long period of time to some condition that is characteristic of the employment. The exact definition of an occupational disease and the benefits payable for such a disease vary from state to state. Some states provide workers' compensation coverage not only for physical diseases, but also for mental diseases arising from employment, such as work-related mental and emotional stress and psychiatric disorders.

3.12 Accident Reports

Employees are legally required to report accidents to their employers as soon as possible. In turn, employers are required to submit reports of accidents and injuries to the proper authorities in their state. In many states the report should be made to the state workers' compensation board, but this varies from state to state. Failure by an employer to

report an accident may result in penalties and fines. These limitation periods vary from state to state and may require that a claim be filed as soon as one year following an injury, or as long as three years.

3.13 Benefits

An employee can recover the costs of hospitalization, medical care, and other expenses resulting from a work-related injury. In addition, an employee is generally entitled to receive disability benefits as a replacement for temporary wage loss while out of work following an injury or as compensation for a permanent disability.

3.13.1 Categories of benefits

There are four basic categories of workers' compensation benefits:

1. *Temporary Total Benefits.* These benefits are for a disability that is temporary in quality and total in character. They are wage loss benefits and are generally payable to employees out of work following an injury and before maximum medical improvement is reached.
2. *Temporary Partial Benefits.* These benefits are for a disability that is temporary in quality and partial in character. They are wage loss benefits and are payable when an employee returns to work at a lighter-duty and lower-paying job, but before the employee reaches maximum medical improvement.
3. *Permanent Partial Benefits.* These benefits are for a disability that is permanent in quality and partial in character. They are monetary benefits in addition to medical treatment and care for a permanent disability and may be based on a percentage of anatomical disability or on a permanent loss of wage-earning capacity, depending on the provisions of a state's statute. The amount of permanent partial benefits may be based upon the part of the body that is injured, such as the arm, the leg, or the back.
4. *Permanent Total Benefits.* These benefits are for a disability that is permanent in quality and total in character. They are payable when an employee is permanently unable to return to work at his or her regular job or to any form of gainful employment.

3.13.2 Vocational rehabilitation

When an employee is physically unable to return to work at his or her regular job following a work-related injury, but is able to work at alternative jobs, most workers' compensation laws require employers to provide vocational rehabilitation services. Vocational rehabilitation may include vocational guidance, counseling, testing, retraining, and relo-

ation. Job placement, education, and assistance in modification of an employee's home to accommodate a disability may also be included in vocational rehabilitation.

The extent of required vocational rehabilitation varies considerably from state to state. Some states provide for a fund from which an employer may seek payment to cover the cost of rehabilitation. Other states do not provide for such a fund, and the cost of rehabilitation is usually directly paid by the employer's workers' compensation insurer.

3.13.3 Death benefits

When an employee dies as the result of a work-related injury, his or her surviving spouse, children, or other dependents may be entitled to death benefits. The amount of such benefits varies depending on whether a dependent was totally dependent on the deceased employee's income for support, or only partially dependent. Death benefits may also include some reimbursement for funeral expenses and some education costs for minor children through college. The specific requirements and amounts of death benefits vary substantially from state to state.

3.13.4 Benefits for pre-existing disabilities

In some cases, an employee's work-related permanent disability may be superimposed over a pre-existing disability or injury. In such situations, some states have special funds established under the workers' compensation statute that may be responsible for payment of permanent disability benefits to an employee for a pre-existing disability. The policy behind such special funds is to ensure that an employer is responsible for only the disability caused by a work-related injury and to encourage employers to hire employees with pre-existing disabilities or handicaps.

3.14 Tax Consequences

Workers' compensation premiums are deductible as a business expense by employers. Benefits are not taxable to an employee upon receipt.

4. OCCUPATIONAL SAFETY AND HEALTH

Occupational safety and health standards help create a safe and healthful work environment, which in theory reduces the number of workers' compensation claims filed against employers.

4.1 Background

The Occupational Safety and Health Act (OSHA) was enacted by Congress in 1970 because states were perceived as not providing adequate protection for workers. It is an attempt to provide uniform standards and a method of enforcement.

In general, OSHA covers all employers and employees in all fifty states, the District of Columbia, Puerto Rico, and all other federal territories. The act does not cover self-employed persons, farms where only immediate members of the farmer's family work, and workplaces already protected by other federal laws. Although federal agencies are covered, OSHA does not cover employees of state and local governments. However, many states have laws with requirements similar to those of OSHA.

4.2 Scope and Purpose

The purpose of the act is to "assure so far as possible every working man and woman in the Nation safe and healthful working conditions. . . ." The statute looks to a number of methods to carry out this purpose. These methods include voluntary efforts by employees and employers as well as joint labor/management to reduce hazards, standards promulgated by the federal Secretary of Labor, effective means to enforce the standards, research into causes and prevention of occupational injuries and disease, and encouragement of state efforts.

4.3 Compliance With OSHA

Employers have an obligation to provide places and working conditions free from recognized hazards, and both employers and employees have an obligation to comply with OSHA standards. Employers and employees who do not comply with OSHA standards may be subject to civil fines and/or imprisonment. The nature of the fine and the length of imprisonment depend on the nature of noncompliance.

Enacted safety standards are published in the Code of Federal Regulations. Proposed safety standards are published in the Federal Register. Employers may obtain temporary or permanent variances from standards by showing that noncompliance is due to circumstances beyond their control or that existing working conditions are as safe as the proposed OSHA standards. Employees have the right to a hearing on employers' requested variances.

4.4 Relation to State Laws

This act is not meant to affect any workers' compensation act or any existing common law or statutory duties, rights, or liabilities of employers and employees with respect to occupational safety and health. States may regulate any occupational safety or health issue with respect to which there are no standards in effect under OSHA. They may also regulate issues already covered by OSHA standards upon submission to and approval of a plan for development of standards and enforcement that are at least as effective as OSHA standards and enforcement. See the Appendix at the end of this chapter for a complete list of state occupational safety agencies and addresses.

5. STATE INFORMATION AND OFFICES

A compulsory statute applies to all employers who are not specifically excluded, and excluded employers are often covered voluntarily. An elective statute either applies to all employers who elect to be covered by the statute or does not apply to those employers who reject the statute. Employers who opt out of elective statutes may be sued without being able to use common-law defenses that were available before the statutes were enacted.

The penalty for the failure to insure varies widely from state to state. It can include a fine, imprisonment, or an injunction from doing business or engaging in employment activities. Many states also allow injured workers to sue their employers with the common-law defenses either as an alternate remedy to the compensation provided by the statute or in addition to that compensation. If the employer is a corporation, officers are frequently held personally liable for penalties, damages, and compensation.

The following is a brief state-by-state analysis of workers' compensation laws as they relate to private employment.

Alabama The statute is compulsory. Insurance is required of all employers with five or more employees. Failure to insure is subject to a misdemeanor fine from \$100 to \$1,000. The court may impose civil penalties against an employer in noncompliance in an amount not to exceed \$100 per day. An injured employee may sue the employer and receive double compensation under the statute if the employer is uninsured.

Code of Alabama. Sections 25-5-8(E) and 25-5-50

Workers' Compensation Division
 Department of Industrial Relations
 649 Monroe St.
 Montgomery, AL 36130
 (205)242-2868
 FAX (205)261-3143

Alaska The statute is compulsory. Insurance is required of all employers. The failure to insure is a class B or C felony subject to a fine of up to \$50,000, imprisonment up to ten years, or both. Section 23.30.075(b) of the *Alaska Statutes* provides for a fine up to \$10,000 or imprisonment up to one year, or both. The employer may be enjoined from doing business if the uninsured employer is sued and negligence is presumed. Corporate officers and managers are personally liable.

Alaska Statutes. Section 23.30.005 et seq

Department of Labor
 Division of Workers' Compensation
 P.O. Box 25512
 Juneau, AK 99802-5512
 (907)465-2790
 FAX (907)465-2797

Arizona The statute is compulsory. Insurance is required of all employers. An injured employee may elect to receive compensation under the statute or to pursue legal remedies in tort if the employer is not insured. The employer may be enjoined from doing business if the employer fails to insure. A civil penalty of \$500 may be assessed against an uninsured employer if an award is made to an employee for a noncompensable claim. A civil penalty of \$500 may also be assessed against an employer who is subject to coverage but who fails to secure coverage.

Arizona Revised Statutes. Section 23-901 et seq

Industrial Commission of Arizona
 800 W. Washington
 P.O. Box 19070
 Phoenix, AZ 85005-9070
 (602)542-4661
 FAX (602)542-3373

Arkansas The statute is compulsory. Coverage is required for all employers with three or more employees. Failure to insure is subject to a fine. If the employer has no workers' compensation coverage, an

employee may also elect to receive compensation under the statute or to sue the employer.

Arkansas Statutes. Ark. Code Ann. 1988 11-9-101 et seq

Workers' Compensation Commission
4th and Spring Sts.
P.O. Box 950
Little Rock, AR 72203-0950
(501)682-3930
FAX (501)682-2777

California The statute is compulsory. Insurance is required of all employers. If an employer is enjoined from doing business, there is a penalty of \$1,000 per employee, with \$10,000 for compensable cases (up to \$100,000). Intentional failure to insure is a misdemeanor. Failure to obey a stop order injunction is a misdemeanor, subject to a fine of up to \$10,000, imprisonment for up to sixty days, or both. The injured worker may receive workers' compensation and also sue the employer in civil court.

California Labor Code. Section 3201 et seq

Department of Industrial Relations
Division of Workers' Compensation
45 Fremont St., Ste. 3160
San Francisco, CA 94105
(415)975-0700
FAX (415)975-0732

Colorado The statute is compulsory. Insurance is required of all employers. An employer who fails to insure may be enjoined from doing business or fined. An injured worker may elect to receive compensation plus 50 percent under the statute or to pursue legal remedies if the employer was uninsured at the time of the injury.

Colorado Revised Statutes. Section 8-40-101 et seq

Department of Labor & Employment
Division of Workers' Compensation
Customer Service
1515 Arapahoe St.
Tower 2, Suite 500
Denver, CO 80202-2117
(303)575-8700
FAX (303)575-8882

Connecticut The statute is compulsory. Insurance is required of all employers. Willful failure to insure is subject to a fine up to \$50,000.

An additional penalty of \$100 per day up to \$50,000 may be assessed for noncompliance after a finding of noncompliance.

Connecticut General Statutes. Section 31-275 et seq

Workers' Compensation Commission
21 Oak Street—Capitol Place
Hartford, CT 06106
(860)493-1500
FAX (860)247-1361

Delaware The statute is compulsory. Insurance is required of all employers. Failure to insure is subject to a civil penalty of \$1 per day for each employee in his or her service when the insurance became due, but not less than \$25. The employer may be enjoined from doing business if failure to insure continues for thirty days. Employers who refuse or neglect workers' compensation coverage are subject to penalties. In addition, an injured worker may elect to receive compensation or to sue the employer who fails to insure.

Delaware Code. Section 2374 et seq

Dept. of Labor
Office of Workers' Compensation
Attn: Accounting
4425 N. Market St., 3rd Floor
Wilmington, DE 19802
(302)761-8200
FAX (302)761-6601

Florida The statute is compulsory. Coverage is required of most employers with four or more employees or with any employee involved in the construction industry. Failure to insure may result in the cessation of all business operations, plus a civil penalty of \$100 per day for each day the employer is not in compliance. In addition, a penalty may be assessed equal to twice the amount the employer would have paid for coverage in the preceding three-year period of failed coverage or \$1,000, whichever is greater. A penalty not to exceed \$5,000 per employee may be assessed if an employer willfully fails to insure individuals classified as independent contractors but who are found to be employees by the division. Workers' compensation is the exclusive remedy when the employer is insured for workers' compensation. The uninsured employer may be sued in tort by the injured worker.

Florida Statutes. Sections 440.10 and 440.107

Bureau of Workers' Compensation Compliance
Dept. of Labor & Employment Security
201 Montgomery Building
2562 Executive Ctr. Circle East
Tallahassee, FL 32399-0661
(850)488-2333 or (850)488-2713
FAX (850)922-0226 or (850)488-3377

Georgia The statute is compulsory for all employers with three or more employees. Employers are required to obtain insurance or be approved as self-insurers.

Official Code of Georgia. Section 34-9-1 et seq

State Board of Workers' Compensation
270 Peachtree St., N.W.
Atlanta, GA 30303-1299
(404)656-2048
FAX (404)656-7768

Hawaii Insurance is required of all employers. Failure to insure is subject to a penalty of \$250, or \$10 per day, per employee for every day during which such failure continues, whichever is greater. If the failure lasts for thirty days, the employer may be enjoined from doing business.

Hawaii Revised Statutes. Section 386-123 et seq

Dept. of Labor & Industrial Relations
830 Punchbowl St., Rm. 211,
P.O. Box 3769
Honolulu, HI 96813-3769
(808)586-9151
FAX (808)586-9219

Idaho Coverage is mandatory for all employers unless specifically exempted. Failure to insure is a misdemeanor. Employers who fail to maintain workers' compensation insurance are subject to a penalty of \$2 per day per employee or \$25.00 per day, whichever amount is greater. An employer who is in default can be enjoined from operating the business. In the case of a corporation, any officer or employee of the corporation who has authority to procure insurance and fails to do so is also guilty of a misdemeanor and personally liable for penalties. Injured workers of a noninsured employer are entitled to all statutory

benefits as well as a penalty of 10 percent of the amount of compensation to be paid by the noninsured employer.

Idaho Code. Section 72-101 et seq

Idaho Industrial Commission
P.O. Box 83720
Boise, ID 83720-0041
(208)334-5145
(800)950-2110
FAX (208) 334-2321

Illinois The statute is compulsory. Insurance is required of all employers engaged in the “extra hazardous” activities listed in the statute. Failure to insure is a petty offense. The fine is from \$100 to \$500 per day.

Illinois Statutes. Section 820 ILCS 305/1 et seq

Illinois Industrial Commission
James R. Thompson Center
100 W. Randolph, Ste. 8-200
Chicago, IL 60601
(312)814-6500

Indiana The statute is compulsory. Insurance is required of all employers. Failure to insure is a class A infraction with a fine of up to \$10,000. The employer may be enjoined from doing business. An injured employee may be awarded an amount up to double the compensation provided by the statute plus medical expenses and attorneys' fees.

Indiana Code. Section 22-3-1 et seq

Workers' Compensation Board of Indiana
402 W. Washington St., Rm. W196
Indianapolis, IN 46204
(317)232-3811
FAX (317)233-5493

Iowa The statute is compulsory. Insurance is required of all employers, and may be through private insurers or by self-insurance. An employer who fails to insure may be sued by an injured worker. There is a presumption of negligence. A person who willfully and knowingly fails to insure is guilty of a class “D” felony and may be enjoined from further violation.

Iowa Code. Chapters 85, 85A, 85B, 86, and 87

Division of Industrial Services
1000 E. Grand Ave.
Des Moines, IA 50319
(515)281-5934
FAX (515)281-6501

Kansas The statute is compulsory. Insurance is required of all employers who have or can reasonably anticipate having a gross annual payroll of \$20,000 or more in a calendar year. The intentional failure to insure is a class A misdemeanor. A fine of two times the annual premium or \$25,000, whichever is greater, is imposed for an intentional failure to insure. An injured worker may pursue legal remedies against the employer.

Kansas Statutes. Section 44-501 et seq

Department of Human Resources
DHR Workers' Compensation
800 S.W. Jackson, Ste. 600
Topeka, KS 66612-1227
(913)296-3441
FAX (913)296-0839

Kentucky The statute is compulsory. Insurance is required of all employers with a few exceptions (mainly those who employ agricultural workers). Workers may reject this statute as long as they do so before they are injured and as long as they do so within the limits of statutes. The employer may be enjoined from doing business and fined if it does not have workers' compensation insurance. If an employer fails to insure, the injured worker may file a claim under the statute and pursue legal remedies.

Kentucky Revised Statutes. Section 342.001 et seq

Department of Workers' Claims
Perimeter Park West, Bldg. C
1270 Louisville Rd.
Frankfort, KY 40601
(502)564-5550
FAX (502)564-8250

Louisiana The statute is compulsory. Insurance is required of all employers. An employer who fails to insure is liable for the compensation and subject to penalties of up to \$10,000.

Louisiana Revised Statutes. Section 23.1021 et seq

Office of Workers' Compensation
Department of Labor
P.O. Box 94040
Baton Rouge, LA 70804-9040
(504)342-7555
FAX (504)342-7578

Maine The statute is compulsory. Failure to insure is a class D crime and noncomplying employers may be liable to pay a civil penalty up to \$10,000. Incorporated employers may also have corporate status revoked.

Maine Revised Statutes. 39-A Section 101 et seq

Workers' Compensation Board
27 State House Station
Augusta, ME 04333-0027
(207)287-3751
FAX (207)287-7198
TDD (207)287-6119

Maryland The statute is compulsory. Insurance is required of all employers. Failure to insure is a misdemeanor subject to a fine of from \$500 to \$5,000, imprisonment for up to one year, or both. The employer may be assessed a penalty equal to six months' premiums due to the state fund if the employer fails to become insured within ten days after being ordered to do so. An employee may elect compensation under the statute or file suit against the employer.

Annotated Code of Maryland. Title 9, Labor & Employment Article

Workers' Compensation Commission
6 N. Liberty St., Room 940
Baltimore, MD 21201
(410)767-0900
FAX (410)333-8122

Massachusetts The statute is compulsory. Insurance is required of all employers. Failure to insure is subject to a fine of up to \$1,500, imprisonment for up to one year, or both. Failure to insure after conviction is a separate offense. For the corporate employer, the president and treasurer are subject to the same penalty. The injured worker may elect to retain common law rights to sue. However, an injured worker of an uninsured employer may both petition for compensation and sue an uninsured employer.

Massachusetts General Laws. C. 152 Sec. 1 et seq; Regs. 452 CMR 1.00 et seq

Department of Industrial Accidents
600 Washington St.
Boston, MA 02111
(617)727-4900, ext. 470
FAX (617)727-6477

Michigan The system is compulsory for all private employers, except agricultural, who regularly employ three or more persons; all private employers, except agricultural, who regularly employ one person for thirty-five or more hours per week for thirteen weeks or longer during a fifty-two week period; all public employers; and all agricultural employers with three or more employees who were employed for thirteen consecutive weeks during the previous fifty-two weeks. Real estate salespersons, under certain conditions, are not considered employees under the statute. Certain stockholders of closely held corporations can choose to be excluded from the act if they are the only employees. Failure to insure is subject to a penalty of \$1,000, imprisonment for from thirty days to six months, or both.

Michigan Compiled Laws. Section 418.161 et seq

Bureau of Workers' Disability Compensation
Department of Consumer and Industry Services
P.O. Box 30016
Lansing, MI 48909
(517)322-1195
FAX (517)322-5944

Minnesota The statute is compulsory for all employers. Failure to insure is subject to a fine of \$1,000 per employee per week during which the employer is not in compliance. The employer has ten working days to contest a penalty assessment.

Minnesota Statutes. Section 176.181 et seq

Special Compensation Fund
Workers' Compensation Division
Department of Labor & Industry
443 Lafayette Rd. North
St. Paul, MN 55155-4317
(612)296-2117
FAX (612)297-7098

Mississippi The statute is compulsory. Insurance is required of all employers with five or more employees. Failure to insure is subject to a fine up to \$1,000, imprisonment up to one year, or both, and a civil penalty not to exceed \$10,000.

Mississippi Code. Section 71-3-1 et seq

Workers' Compensation Commission
1428 Lakeland Dr.
P.O. Box 5300
Jackson, MS 39296-5300
(601)987-4200

Missouri The statute is compulsory. Insurance is required of all employers with five (5) or more employees except in the construction industry where insurance is required for one (1) or more employees. The employee is eligible to receive medical benefits, wage loss replacement, and permanent benefits for a work-related injury. The employer has the right to select medical treatment. Failure to obtain insurance is a class A misdemeanor and subjects the employer to a penalty equal to twice the annual premium it would have paid, or \$25,000, whichever is greater.

Missouri Statutes. Section 287.010 et seq

Department of Labor & Industrial Relations
Division of Workers' Compensation
3315 West Truman Blvd., Box 58
Jefferson City, MO 65102-0058
(573)751-4231
FAX (573)751-2012

Montana The statute is compulsory. Insurance is required of all employers with some exemptions. Failure to insure may be subject to a penalty equal to twice the unpaid premium (not less than \$200). The uninsured employer may also be subject to an injunction. The employee may file a claim under the uninsured employers fund (for which the employer is liable), may sue the employer for damages, and has a separate course of action because the employer was uninsured. The uninsured fund has the right to set off against any funds recovered from the uninsured employer or any third party.

Montana Code Annotated. Section 39-71-501 et seq

Department of Labor & Industry
Employment Relations Division
P.O. Box 8011
Helena, MT 59604-8011
(406)444-6531
FAX (406)444-4140

Nebraska The statute is compulsory. Insurance is required of all employers. Failure to insure is subject to a fine of up to \$1,000, imprisonment for up to one year, or both. The employer may be enjoined from doing business. The employer/insurance carrier may be sued by any injured worker.

Revised Statutes of Nebraska. Section 48-101 et seq

Workers' Compensation Court
 13th Floor, State Capitol
 P.O. Box 98908
 Lincoln, NE 68509-8908
 (402)471-6468 or (800)599-5155 (NE only)
 FAX (402)471-2700 or (402)471-8231

Nevada Workers' compensation insurance is required of all employers with one or more employees with certain exceptions such as independent contractors and excluded persons as defined in NRS 616A.110. Employers failing to secure or maintain proper coverage are guilty of a gross misdemeanor for the first offense and a felony for the second or subsequent offenses within seven years of the previous offense, punishable by imprisonment of one to five years and/or by a fine of up to \$10,000. The employer may be ordered to cease business. An injured employee of an uninsured employer may elect to receive compensation from the Uninsured Employers Claim Fund or pursue legal action against the employer.

Nevada Revised Statutes: NRS 616A.110, 616B.650, 616C.220, 616D.200

Department of Business and Industry
 Division of Industrial Relations
 Industrial Insurance Regulation Section
 2500 W. Washington Ave., Ste. 102
 Las Vegas, NV 89106
 (702)486-5001
 FAX (702)486-5319

New Hampshire The statute is compulsory. Insurance is required of all employers. Failure to insure is subject to a penalty of \$2,500 plus \$100 per day per employee. The employer may be subject to an injunction. The employee may sue if there is no coverage.

New Hampshire Revised Statutes. Section 281-A et seq

Workers' Compensation Division
 Department of Labor
 95 Pleasant St.
 Concord, NH 03301
 (603)271-3176
 FAX (603)271-6149

New Jersey Every employer in the State of New Jersey is required to have workers' compensation insurance with the exception of approved self-insured employers. An employer who fails to provide this protection shall be guilty of a disorderly persons offense; if the failure is willful, the employer shall be guilty of a crime of the fourth degree. Failure to insure may result in an initial fine of \$1,000 with subsequent fines of \$1,000 for every ten-day period thereafter for noncompliance with the statute, forfeiture of corporate charter and/or imprisonment.

Every contract of employment shall be presumed to have been made with reference to the provisions of the New Jersey Workers' Compensation Statute (NJSA 34:15-1 et seq) unless a written contract is in existence which specifically indicates that the provisions of the Statute do not apply.

New Jersey Statutes. Section 34:15-1 et seq

Division of Workers' Compensation
Department of Labor
John Fitch Plaza, CN 381
Trenton, NJ 08625-0381
(609)292-2414
FAX (609)984-2515
Web page: www.state.nj.us/labor/wc/default.htm

New Mexico The statute is compulsory with some numerical and occupational exceptions and qualifications. The employer may be enjoined from doing business for failure to secure insurance. The employee may not sue in common law if the employer has secured workers' compensation insurance.

New Mexico Statutes Annotated. Section 52-1-1 et seq

New Mexico Workers' Compensation Administration
P.O. Box 27198
Albuquerque, NM 87125-7198
(505)841-6000
FAX (505)841-6009

New York The statute is compulsory. Insurance is required of all employers. The first-time offense for failure to insure is subject to a fine of from \$500 to \$2,500, imprisonment of up to one year, or both. Repeated offenses can go up to \$7,500. There is an additional penalty of \$250 for each ten-day period without coverage or 2 percent of the payroll for that period. The employer may be sued by the employee or the employee may apply for workers' compensation benefits. If the employee receives benefits, the employer is liable for the benefits and

for an assessment of \$250 plus 15 percent of the award, such assessment not being less than \$1,500 and not exceeding \$5,000 on each claim.

Consolidated Laws of New York. Workers' compensation law

Workers' Compensation Board
100 Broadway-Menands
Albany, NY 12241
(518)474-6670
FAX (518)473-1415

North Carolina The statute is compulsory. Insurance is required of all employers with three or more employees or whose employees are exposed to radiation where conditions exist that cause said exposure. Failure to insure is subject to a penalty of \$1.00 per day per employee (from \$50 to \$100). It is also a misdemeanor for which an employer may be fined or imprisoned, or both, at the discretion of the court. The employer is liable to injured workers either for compensation under the statute or in a civil action suit if the employer has not provided workers' compensation insurance and if the Industrial Commission makes an award of benefits under the Act.

General Statutes of North Carolina. Section 97-1 et seq

NC Industrial Commission
Dobbs Building
430 N. Salisbury St.
Raleigh, NC 27611
(919)733-4820
FAX (919)715-0282

North Dakota North Dakota is a monopolistic state fund. The North Dakota Workers' Compensation Bureau, with limited exceptions, requires all employers to insure their full-time, part-time, seasonal, or occasional workers. A properly insured employer is protected from legal action by injured workers. Uninsured employers who have an employee injured are required to pay a premium for the period of noncompliance, an additional 25-percent penalty on the premium amount owed, a \$1,000 claim penalty, and penalty interest of 2 percent per month on the past annual premium balances. Uninsured employers with no claims face smaller, but nevertheless substantial, penalties. All employer accounts are experience rated, regardless of size. A 5-percent premium discount is offered to employers who participate in a Bureau-approved risk management program. The employer is subject to an injunction and may be sued by the Bureau.

North Dakota Century Code. Section 65-01 et seq

Workers' Compensation Bureau
 500 East Front Ave.
 Bismarck, ND 58504-5685
 (701)328-3800
 (800)777-5033
 FAX (701)328-3820

Ohio The statute is compulsory, and Ohio is an exclusive jurisdiction state. Coverage is required for all employers. Failure to obtain coverage or to have coverage in effect on the date of injury makes a "non-complying" employer directly liable for all compensation and medical expenses paid out in a claim, and a lien may be filed against the employer's property to secure payment. The employer may be enjoined from doing business. The employer may also be sued to recollect amounts paid to a claimant from the State Surplus Fund or to collect past due premium obligations.

Page's Ohio Revised Code Annotated. Section 4123.01 et seq

Bureau of Workers' Compensation
 William Green Bldg.
 30 West Spring St.
 Columbus, OH 43215-2256
 (800)644-6292
 FAX (614)644-0581

Oklahoma The statute is compulsory. Coverage is required by all employers on all employees, whether full-time or part-time. The civil penalty for failure to insure is not to exceed either \$250 per employee for a first offense or \$1,000 per employee for a second offense, up to a maximum of \$10,000. The \$250 per employee penalty for a first offense may be reduced to \$75 per employee if workers' compensation insurance is obtained within thirty days of receiving notice from the Commissioner of Labor of the violation. A second violation constitutes a prima facie case of willful violation, which could result in the issuance of cease-and-desist orders.

Oklahoma Statutes Annotated. Title 85 O.S. Section 63.1 et seq

Workers' Compensation Court
 1915 North Stiles
 Oklahoma City, OK 73105-4904
 Oklahoma City (405)557-7600 / FAX (405)557-7683
 Tulsa (918)581-2714

Oregon The statute is compulsory. Insurance is required of all employers except those specifically excluded. Failure to insure subjects an

employer to an initial penalty of twice the amount of the premium avoided during noncompliance or \$1,000, whichever is greater. If an employer fails to become insured after being found noncomplying, it may be fined \$250 per day. If an employee is injured while the employer is uninsured, there is an additional penalty of not less than \$100 nor more than \$5,000 (depending on the severity of the injury). The employee may file a claim for compensation under the statute and, if the employer is noncomplying, may also sue the employer in civil court. Claim costs are initially paid out of the Workers' Benefit Fund. These costs include compensation, disputed claim settlements, claim disposition agreements, reasonable administrative costs and claims processing costs, and attorney fees related to compensability issues or awarded to the claimant. These costs are then recovered from the noncomplying employer.

Oregon Revised Statutes. Section 656.001 et seq

Department of Consumer and Business Services
Workers' Compensation Division
350 Winter St. NE
Salem, OR 97310
(503)947-7815
FAX (503)947-7718

Pennsylvania The statute is compulsory. Coverage is required for all employers unless exempt. It is a third-degree misdemeanor offense for an employer not to carry workers' compensation insurance. Fines of up to \$2,500 and/or one year in prison for each day of non-coverage can be imposed for noncompliance with the law. If the failure to insure is intentional, the offense then becomes a felony. Any party may file a criminal complaint against an uninsured party with the county district attorney's office. Uninsured employers are liable for benefits and do not have the protection from civil or criminal actions provided to insured employers. Where the employer does have workers' compensation insurance coverage or has been approved as a self-insured employer by the Bureau of Workers' Compensation, the employee's exclusive remedy is under the statute. If the employer was not insured and not otherwise exempted as a self-insurer as of the date of injury, the employee may file judgment pursuant to the Workers' Compensation Act or file a claim in civil court.

Purdon's Pennsylvania Statutes Annotated. Title 77

Bureau of Workers' Compensation
Department of Labor & Industry
1171 South Cameron St., Room 103
Harrisburg, PA 17104-2501
(717)783-5421

Rhode Island The statute is compulsory. Insurance is required of all employers engaged in occupations as defined under the statute, or with four or more employees. Failure to insure is subject to a fine of not less than \$100 or more than \$500 for each day of noncompliance. An administrative penalty may be imposed and/or civil and criminal action may be filed. In no case may the fine exceed an amount equal to three times the premium as determined by a payroll audit for the period for which the employer failed to secure coverage. Corporate officers are personally liable for compensation while the corporation is uninsured. The employer may be sued. Corporate officers are subject to \$1,000 fine and jail term.

General Laws of Rhode Island. Section 28-29-6 et seq

Department of Labor & Training, Workers' Compensation Unit
610 Manton Ave.
P.O. Box 3500
Providence, RI 02909-0500
(401) 457-1800 or (401) 272-0741
FAX (401) 277-2127 or (401) 273-2272

South Carolina All employers employing four or more persons must provide insurance. Failure to insure is subject to a fine of \$.10 per day per employee (minimum \$1, maximum \$50 per day). Failure to insure may be subject to an injunction. The willful failure to insure is a misdemeanor subject to a fine of up to \$1,000, imprisonment for from thirty days to six months, or both. An uninsured employer may be sued in tort, and his defenses of assumption of the risk, contributory negligence, and fellow servant are denied.

Code of South Carolina. Title 42

Workers' Compensation Commission
P.O. Box 1715
Columbia, SC 29202-1715
(803) 737-5700
FAX (803) 737-5768

State Accident Fund*
800 Dutch Sq. Blvd., Ste. 160
Columbia, SC 29221-5000
(803) 737-8100
FAX (803) 731-1428

*Provides workers' compensation insurance to all state agencies; any county or municipality in the state may elect to purchase workers' compensation coverage from the state fund; no sales to private companies.

South Dakota The statute appears to be elective. Any employer who fails to insure is deemed to have elected not to operate under the statute. The employer may be sued. There is no civil fine or criminal penalty for the failure to insure, but there can be a greater civil liability.

South Dakota Codified Laws. Title 62

Division of Labor and Management
 Department of Labor
 Kneip Bldg., 700 Governor's Dr.
 Pierre, SD 57501-2277
 (605)773-3681
 FAX (605)773-4211

Tennessee The statute is compulsory. Insurance is required of employers with five or more employees, with exceptions specified in the law. All subcontractors and anyone engaged in the construction business, as well as anyone engaged in the mining and production of coal, are required to carry coverage if they have one or more employees. Sole proprietors and partners are not required to carry insurance on themselves. The Workers' Compensation Division has been given the power to assess a fine equal to three times the average yearly workers' compensation insurance premium not to exceed \$100,000. Failure to comply on second or subsequent occasions results in discontinuation of business operations.

Tennessee Code Annotated. Section 50-6-101 et seq

Department of Labor
 710 James Robertson Pkwy.
 Andrew Johnson Tower, 2nd Floor
 Nashville, TN 37243-0661
 (615)741-2395/(800)332-2667
 FAX(615)532-1468

Texas The statute is elective. Insurance is required of employers who accept the statute. There is no penalty for the failure to insure. However, the injured worker may sue the employer.

Vernon's Annotated Civil Statutes. Articles 8306 to 8309

Texas Workers' Compensation Commission
 Southfield Bldg.
 4000 South IH-35
 Austin, TX 78704
 (512)448-7900
 FAX (512)440-3552

Utah The statute is compulsory. Insurance is required of all employers. Any employer, including officers, that fails to insure is guilty of a class B misdemeanor. Each day is a separate offense. The employer is subject to a fine of up to \$1,000 if an individual, up to \$5,000 if a corporation, partnership, association or governmental entity. The employer is also subject to imprisonment for from thirty days to six months. A civil penalty can be assessed against the uninsured employer of the greater of \$1,000 or three times the premium for any time period of noncompliances. The injured worker may elect compensation under the statute or file suit against the employer, when the employer is uninsured. Workers' compensation in the State of Utah is a no-fault insurance. A 15-percent penalty can be added on to an award for an employer's willful neglect in the cause of an injury.

Utah Code Annotated. Section 35-1-1 et seq and
Section 34 A-2 et seq

Industrial Accidents Division
160 E. 300 S., 3rd Fl.
P.O. Box 146610
Salt Lake City, UT 84114-6610
(801)530-6800
FAX (801)530-6804

Vermont The statute is compulsory. Insurance is required of all employers. Failure to insure is subject to a fine of up to \$150 per day if insurance is not provided within five days after notice to the employer.

Vermont Statutes Annotated. Title 21, Sections 601 to 710

Department of Labor and Industry
National Life Bldg., Drawer 20
Montpelier, VT 05620-3401
(802)828-2286
FAX (802)828-2195

Virginia The statute is compulsory. Insurance is required of all employers with three or more employees regularly in service in the same business in the State of Virginia (if the employer is a farm, more than two full-time employees). Failure to insure is subject to a fine from \$500 to \$5,000. The intentional failure is a class 2 misdemeanor. The commission may order the employer to cease and desist all business transactions and operations until found by the commission to be in compliance with the provisions. The injured worker may sue the employer instead of seeking compensation under the statute. If the employer has failed to insure, the traditional common-law defenses are not available.

Code of Virginia. Section 65.2-100 et seq

VA Workers' Compensation Commission
1000 DMV Drive
Richmond, VA 23220
(804)367-8600
FAX (804)367-9740

Washington The statute is mandatory. Insurance is required through the Washington State Fund or, if the employer qualifies, through self-insurance. Employers bringing out-of-state workers into Washington from a state of origin that does not have an extraterritorial agreement with Washington must insure workers through the Washington State Fund.

Failure to insure subjects an employer to a penalty of \$500 or double the amount of unpaid premiums, whichever is greater. If the failure to insure is intentional, the employer is guilty of a Class C felony.

Revised Code of Washington Annotated. Title 51

Department of Labor and Industries
P.O. Box 44150
Olympia, WA 98504-4150
(360)902-4817
FAX (360)902-4721

West Virginia This is a monopolistic state. All employers are required to subscribe, although certain partners and corporate officers may elect not to be covered. Self-insurance is permitted. Failure to subscribe and to maintain good standing deprives the employer of civil immunity and certain defenses in tort proceedings. Employee benefits are paid regardless of employer status. Noncompliance may result in both civil penalties and a felony conviction.

West Virginia Code. Chapter 23

Workers' Compensation Division
Underwriting Unit
P.O. Box 153
Charleston, WV 25321
(304)926-5000
FAX (304)926-1996

Wisconsin The statute is compulsory. Insurance is required of all employers who usually have three or more employees or have paid \$500 or more in wages in any calendar quarter (or for farmers with six or more employees on twenty or more days). Failure to insure is subject to a fine of double the amount of premium evaded while uninsured.

(The minimum fine is \$100 per day for the first seven days and \$750 thereafter.) An uninsured employer is subject to a closure order to cease business until it is in compliance with the insurance requirements. The employer is personally liable for all benefits, if uninsured.

Wisconsin Statutes Annotated. Section 102.01 et seq

Division of Workers' Compensation
 Department of Workforce Development
 P.O. Box 7901
 Madison, WI 53707
 (608)266-1340
 FAX (608)267-0394

Wyoming An exclusive state fund since 1915. Mandatory coverage is required for employments enumerated as extrahazardous by the Wyoming Legislature. Employees not classified as extrahazardous may be covered if the employer elects to obtain coverage through written request. Coverage shall go into effect after receipt of the written request and approval by the Division. An employer electing coverage cannot withdraw for a period of two years.

Wyoming Statutes Annotated. Section 27-14-108(j) et seq

Dept. of Employment
 Wyoming Workers' Safety and Compensation Division
 122 West 25th St., Herschler Bldg.
 Cheyenne, WY 82002-0700
 (307)777-6763
 FAX (307)777-5298

District of Columbia The statute is compulsory. Insurance is required of all employers. Failure to insure is subject to a fine up to \$1,000 or imprisonment up to one year, or both.

District of Columbia Code. Section 36-301 et seq

Office of Workers' Compensation
 P.O. Box 56098
 Washington, DC 20011
 (202)576-6265
 FAX (202)541-3595

American Samoa The statute is compulsory. Insurance is required of all hazardous employment and for all employers with three or more employees. Failure to insure is subject to a fine of up to \$1,000, or imprisonment for up to one year, or both. The employer may also be sued.

Workmen's Compensation Commission
 Department of Human Resources
 Pago Pago, AS 96799
 (684)633-4485
 FAX (684)633-1139

Guam The statute is compulsory. Insurance is required of all employers engaged in a trade, occupation, or profession. Failure to insure is subject to a fine up to \$1,000, imprisonment up to one year, or both.

Worker's Compensation Commission
 Department of Labor
 #108 "E" St.
 Tiyan, GU 96913
 (671)475-0150-2
 FAX (671)475-0153

Puerto Rico The statute is compulsory. Insurance with the State Insurance Fund Corporation is required of all employers with one or more employees. Failure to insure is subject to a fine of from \$25 to \$1,000, imprisonment from fifteen days to six months, or both. There is an additional penalty equal to 30 percent of the compensation paid out (not less than \$10). The noninsured employer may also be sued. Minors employed in violation of the law are entitled to receive from their employers an amount equal to the compensation awarded to them.

Laws of Puerto Rico Annotated. Title 11

Puerto Rico State Insurance Fund
 P.O. Box 365028
 San Juan, PR 00936-5028
 (809)793-5959
 FAX (809)793-7735

Virgin Islands The statute is compulsory. Every employer affected shall file with the Government Insurance Fund not later than February 28 of each year on forms supplied, an Actual Report for the previous year and an Estimated Report for the current year showing the number of workmen employed, and the kind of occupation. The premium shall be computed and paid on \$8,424 for each worker for each year. An employer who fails to comply within the term fix shall be considered an Uninsured Employer, liable for compensation expenses, and a 30-percent penalty of the total. Instead of receiving compensation under this statute, the injured employee of an Uninsured Employer, or the employee's beneficiaries, may elect to bring suit for damages against the employer, just as if this statute were not applicable. An employer having paid premiums of \$1,000 or more during the period of three

consecutive years immediately before the rating date, and having paid premiums in each of these three years, shall be eligible for an Experience Rating. The amount of charges to be considered in such Experience Rating shall consist of the payments actually made by the Government Insurance Fund during such consecutive periods of three years on account of accidents, inclusive of benefits, medical, hospital and funeral costs.

Department of Finance
Government Insurance Fund
2314 Kronprindsens Gade
St. Thomas, VI 00802
(809)774-4750 ext. 2255
FAX (809)776-4028

REFERENCES

- Akabas, Sheila, and Lauren B. Gates. *Planning for Disability Management: An Approach to Controlling Costs While Caring for Employees*. Scottsdale, Ariz.: American Compensation Association, 1995.
- Ball, Christopher A. *How to Handle Your Worker's Compensation Claim: A Complete Guide for Employers*, 2d ed. Berkeley, Calif.: Nolo Press, 1997.
- Bender Tax Staff. *Bender's Payroll Tax Guide*. New York: Matthew Bender and Company, Inc., 1982. Supplemented annually.
- Benedict, Forest C., et al., eds. *Glossary of Compensation Terms*. Washington, D.C.: College & University Personnel Association, 1992.
- BNA's Business and Human Resources Services Staff. *Compensation*. (Policy and Practice Series.) Washington, D.C.: BNA Books, Loose-leaf service.
- Burstein, Philip L. *Benchmarks for Designing Workers' Compensation Medical Fee Schedules: 1995-1996*. Cambridge, Mass.: Workers Compensation Research Institute, 1996.
- Campbell, Robert. *Worker's Compensation Fraud Control & Investigation: A Manual Covering the Whole Spectrum of Conducting Worker's Compensation Claims Investigations*. Austin, Tex.: Thomas Publications, 1997.
- CBC Editorial Staff. *Modern Workers' Compensation*. 3 Vols. St. Paul, Minn.: West Group, 1993.
- Danzon, Patricia A., and Scott Harrington. *Rate Regulation of Workers' Compensation Insurance*. Washington, D.C.: American Enterprise Institute for Public Policy Research, 1997.

- DeLuca, Matthew J. *Handbook of Compensation Management*. Upper Saddle River, N.J.: Prentice Hall General Reference and Travel, 1993.
- DeMey, Dennis L. *Workers Compensation: The Dilemma & Practical Remedies*. Asbury Park, N.J.: Broken Star Press, 1997.
- Durbin, David, and Philip S. Borba, eds. *Workers' Compensation Insurance: Claim Costs, Prices, and Regulation*. Philadelphia: S.S. Huebner Foundation for Insurance Education, 1992.
- Engelmann, Curtis H., and Robert C. Roesch. *Managing Individual Performance: An Approach to Designing an Effective Performance Management System*. Scottsdale, Ariz.: American Compensation Association, 1997.
- Evans, Elaine M. *Compensation Basics for HR Generalists: Understanding the Role of Pay in Human Resources Strategy*. Scottsdale, Ariz.: American Compensation Association, 1997.
- Frasco, Robert J. *Workers' Compensation Filing: An Employer's Guide to Early Intervention and Investigation*. Glendale, Calif.: Griffin Publishing, 1993.
- Gomez-Mejia, Luis R., and David B. Balkin. *Compensation, Organizational Strategy and Firm Performance*. Cincinnati: South-Western Publishing Co., 1992.
- Greenwood, Judith, and Alfred Taricco, eds. *Workers' Compensation Health Care Cost Containment*. Horsham, Penn.: LRP Publications, 1992.
- Hampton, Gwen. *Workers' Compensation Claims Desk Book*. Glendale, Calif.: Workers' Compensation Company, 1993.
- Hill, J. Eldred III, ed. *Highlights of Federal Unemployment Compensation Laws 1997*. Washington, D.C.: National Foundation for Unemployment Compensation & Workers' Compensation, 1997.
- Hirsch, Jeffrey L. *Occupational Safety and Health Handbook*. Charlottesville, VA: LEXIS Law Publishing, 1993.
- Kaye, M. S., ed. *Workers' Compensation & Disability Insurance: A Survivor's Guide*. Kearney, Neb.: Morris Publishing, 1996.
- Larson, Arthur. *Workmen's Compensation for Occupational Injuries and Death: Desk Edition*. New York: Matthew Bender & Company, Inc. Supplemented annually.
- Lewis, Charles B. *Workers' Compensation Guide for Employers: Regulations, Checklists & Forms*. Austin, Tex.: Summers Press, Incorporated, 1997.
- Lundberg, Thomas, and Lynn Tylczak. *Slash Your Workers' Comp Costs*. New York: AMACOM, 1997.

- Markham, James J., Kevin M. Quinley, and Layne S. Thompson. *The Claims Environment*. Malvern, Penn.: Insurance Institute of America, Inc., 1993.
- Matthews, Joseph. *How to Win Your Personal Injury Claim*. Berkeley, Calif.: Nolo Press, 1996.
- Miceli, Thomas J., and Kathleen Segerson. *Compensation for Regulatory Takings: An Economic Analysis with Applications*. Greenwich, Conn.: Jai Press, Incorporated, 1996.
- Milkovich, George T., Jerry M. Newman, and Carolyn Milkovich. *Cases in Compensation*, 6th ed. Ithaca, N.Y.: Compensation, 1997.
- Pimentel, Richard, Christopher G. Bell, and Howard J. Larson. *The Workers' Compensation-ADA Connection: Supervisory Tools for Workers' Compensation Cost Containment That Reduce ADA Liability*. Northridge, Calif.: Milt Wright & Associates, 1993.
- Power, Robert D., and Frederick Y. Fung. *Workers' Compensation Handbook: A Guide to Job-Related Health Problems*. San Diego, Calif.: K-W Publications, 1994.
- Survey of Workers Compensation Laws*. Schaumburg, Ill.: Alliance of American Insurers, 1997.
- Tweedy, David, Brian Casey, and Kevin Quinley. *Workers' Compensation Claims Management*. Boston, Mass.: Standard Publishing Corporation, 1997.
- U.S. Chamber of Commerce Staff. *Analysis of Workers' Compensation Laws*. Washington, D.C.: Chamber of Commerce of the U.S., 1997.
- Walsh, James. *Workers' Comp for Employers: How to Cut Claims, Reduce Premiums, and Stay Out of Trouble*, 3rd ed. Santa Monica, Calif.: Merritt Publishing, 1997.
- Workers' Compensation Manual for Managers & Supervisors: A Guide to Effective Workers' Compensation Management*. 2d ed. Riverwoods, Ill.: CCH, Inc., 1996.

APPENDIX: Occupational Safety— State Agencies and Addresses

(Enforce safety standards for the protection of employees in places of employment.)

ALABAMA

Dept. of Labor
100 N Union St., Ste 620
P O Box 303500
Montgomery, AL 36130-3500
(205)242-3460
FAX (205)240-3417

ALASKA

Dept. of Labor
Labor Standards and Safety
1111 W 8th St., Ste 304
P O Box 21149
Juneau, AK 99802-1149
(907)465-4855
FAX (907)465-3584

ARIZONA

Industrial Comm of Arizona
Occupational Safety & Health
P O Box 19070
Phoenix, AZ 85005-9070
(602)542-5795
FAX (602)542-1614

ARKANSAS

Dept. of Labor
10421 W Markham
Little Rock, AR 72205
(501)682-4522
FAX (501)682-4532

CALIFORNIA

Occupational Safety & Health
Dept. of Industrial Relations
45 Fremont St., Rm. 1200
San Francisco, CA 94105
(415)972-8500
FAX (415)972-8656

CONNECTICUT

State of Connecticut
Dept. of Labor
Division of Occupational
Safety & Health
38 Wolcott Hill Road
Wethersfield, CT 06109-1114
(860)566-4550
FAX (860)566-6916

DELAWARE

Dept. of Labor
Div of Industrial Affairs
OSHA Consultation Services
4425 N. Market St.
Wilmington, DE 19802
(302)761-8219
FAX (302)761-6601

FLORIDA

Dept. of Labor & Employment
Security
Div of Safety
Director's Office
2002 Old St. Augustine Rd.,
Bldg E.
Tallahassee, FL 32301
(904)488-3044
FAX (904)922-4538

GEORGIA

Georgia Dept. of Labor
Safety Engineering
223 Courtland St. NE, Ste 301
Atlanta, GA 30303
(404)656-2966
FAX (404)651-8477

HAWAII

Occupational Safety & Health
Division (HIOSH)
830 Punchbowl St., Room 423
Honolulu, HI 96813
(808)586-9100
FAX (808)586-9104

IDAHO

Division of Building
Industrial Safety Section
277 No. 6th St.
P O Box 83720
Boise, ID 83720-0049
(208)334-2129
FAX (208)334-2683

ILLINOIS

Ill Dept. of Labor
Safety Inspection & Education
Div
#1 West Old State Capitol Plaza,
Rm. 300
Springfield, IL 62701-1217
(217)782-9386
FAX (217)782-0596

INDIANA

Dept. of Labor
402 West Washington St.
Rm W195
Indianapolis, IN 46204
(317)232-2655
FAX (317)233-3790

IOWA

Division of Labor
Occupational Safety & Health
Bureau
1000 East Grand Ave
Des Moines, IA 50319-0209
(515)281-3606
FAX (515)281-7995

KANSAS

Dept. of Human Resources
Industrial Safety & Health
Section
512 SW Sixth St., 1st Fl
Topeka, KS 66603-3150
(913)296-4386
FAX (913)296-1775

KENTUCKY

Kentucky Labor Cabinet
OSH Compliance
1047 US Highway 127 South
Ste. 4
Frankfort, KY 40601
(502)564-3070
FAX (502)564-5723

LOUISIANA

Dept. of Labor
Occupational Safety & Health
P O Box 94094
Baton Rouge, LA 70804-9094
(504)342-9601
FAX (504)342-5158

MAINE

Bur. of Labor Standards
Workplace Safety & Health
Division
State House Station 45
Augusta, ME 04333-0045
(207)624-6400
FAX (207)624-6449

MARYLAND

Department of Labor,
Licensing & Regulation
Div. of Labor & Industry
Occupational Safety & Health
(MOSH)
1100 N Eutaw St., Room 613
Baltimore, MD 21201
(410)767-2213
FAX (410)767-2003

MASSACHUSETTS

Dept. of Labor & Workforce
Development
Division of Occupational Safety
100 Cambridge St., Room 1107
Boston, MA 02202-0003
(617)727-3452
FAX (617)727-8022

MICHIGAN

Bureau of Safety & Regulation
Dept of Consumer & Industry
Services
P O Box 30643
Lansing, MI 48909-8143
(517)322-1814
FAX (517)322-1775

MINNESOTA

Dept of Labor & Industry
Occupational Safety & Health
Division
443 Lafayette Rd
St Paul, MN 55155-4307
(612)296-2116
FAX (612)297-2527

MISSISSIPPI

Mississippi State University
Center of Safety & Health
2906 N State, Ste 201
Jackson, MS 39216
(601)987-3981
FAX (601)987-3890

MISSOURI

Div of Labor Standards
Dept of Labor & Industrial
Relations
P O Box 449
Jefferson City, MO 65102
(573)751-3403
FAX (573)751-3721
E-mail laborstandards@
dohr.state.mo.us

MONTANA

Montana Dept. of Labor &
Industry
Safety Bureau
1805 Prospect Ave
P O Box 1728
Helena, MT 59624-1728
(406)444-6401
FAX (406)444-4140

NEBRASKA

Dept of Labor, Division of
Safety/Labor Standards
P O Box 95024
Lincoln, NE 68509-5024
(402)471-4717
FAX (402)471-5039

NEVADA

Division of Industrial Relations
OSHES
400 W King St., Ste 200
Carson City, NV 89703
(702)687-5240
FAX (702)687-6150

NEW HAMPSHIRE

Dept. of Health & Human
Services
Bureau of Health Risk
Assessment
6 Hazen Drive
Concord, NH 03301-6527
(603)271-4676
FAX (603)271-2667

NEW JERSEY

NJ Dept. of Labor
Div of Public Safety &
Occupational Safety & Health
On-Site Consultation Program
P O Box 953
Trenton, NJ 08625-0953
(609)292-3923
FAX (609)292-4409

NEW MEXICO

Environment Dept
Occupational Health & Safety
Bureau
P O Box 26110
Santa Fe, NM 87502-6110
(505)827-4230
FAX (505)827-4422

NEW YORK

Dept of Labor
Division of Safety & Health
Campus, State Off Bldg 12,
Rm 522
Albany, NY 12240
(518)457-3518
FAX (518)457-1519

NORTH CAROLINA

Dept of Labor
Division of Occupational
Safety & Health
319 Chapanoke Road, Ste 105
Raleigh, NC 27603-3432
(919)662-4575
FAX (919)662-4582

NORTH DAKOTA

Dept of Labor
Occupational Safety & Health
Administration
1640 E. Capitol Ave
Bismarck, ND 58501
(701)250-4521 or (800)473-7419
FAX (701)250-4520

OHIO

Div of Safety & Hygiene
Bureau of Workers'
Compensation
13430 Yarmouth Dr N.W.
P O Box 338
Pickerington, OH 43147-0338
(614)466-3385 / (800)644-6292
FAX (614)644-5707

OKLAHOMA

Occupational Safety & Health
Consultation Division
Dept. of Labor
4001 N. Lincoln Blvd
Oklahoma City, OK 73105-5212
(405)528-1500 X276
FAX (405)528-5751

OREGON

Occupational Safety & Health
Div (OROSHA)
Consumer and Business
Services
350 Winter St NE, Rm 430
Salem, OR 97310-0220
(503)378-3272
FAX (503)947-7461

PENNSYLVANIA

Occupational & Industrial
Safety
Dept of Labor & Industry
1529 Labor & Industry Bldg
7th & Forster Sts.
Harrisburg, PA 17120
(717)787-3323
FAX (717)787-8363

RHODE ISLAND

RI Div of Occupational Safety
Dept of Labor and Training
610 Manton Ave
Providence, RI 02909
(401)457-1826
FAX (401)457-1893

SOUTH CAROLINA

Occupational Safety & Health
Dept of Labor
P O Box 11329-1329
Columbia, SC 29211-1329
(803)734-9644
FAX (803)734-9772

SOUTH DAKOTA

South Dakota Occupational
Safety & Health
Administration
P O Box 2439
Bismarck, ND 58502
(800)473-7419
FAX (701)250-4520

TENNESSEE

Dept of Labor-TOSHHA
Andrew Johnson Tower, 2nd Fl
710 James Robertson Parkway
Nashville, TN 37243-0659
(615)741-2793
FAX (615)741-3325

TEXAS

Texas Workers' Compensation
Commission
4000 S. IH-35
Austin, TX 78704-7491
(512)448-7900

UTAH

Labor Commission
Utah Occupational Safety &
Health Division
P O Box 146650
160 E. 300 So., 3rd Floor
Salt Lake City, UT 84114-6650
(801)530-6901
FAX (801)530-7806
E-mail ucmain@jagley@
state.ut.us

VERMONT

Vermont Occupational & Safety
Health Admin.
National Life Bldg
Drawer 20
Montpelier, VT 05620-3401
(802)828-2765
FAX (802)828-2195

VIRGINIA

Theron J Bell, Commissioner
Dept. of Labor & Industry
13 S. Thirteenth St.
Richmond, VA 23219
(804)786-2377
FAX (804)371-6524

WASHINGTON

WISHA Services Division
Dept. of Labor & Industries
P.O. Box 44600
Olympia, WA 98504-4600
(360)902-5495
FAX (360)902-5529

WEST VIRGINIA

Division of Labor
State Capitol Complex
Bldg 3, Rm. 319
Charleston, WV 25305
(304)558-7890
FAX (304)558-3797

WISCONSIN

Dept. of Commerce
Div. of Safety & Buildings
P.O. Box 7969
Madison, WI 53707
(608)266-3151
FAX (608)267-9566

WYOMING

Workers' Safety and
Compensation
Herschler Building,
2nd Fl. East
Cheyenne, WY 82002
(307)777-7786
FAX (307)777-3646

DISTRICT OF COLUMBIA

Office of Occupational Safety &
Health
Dept. of Employment Services
950 Upshur St., NW, 2nd Floor
Washington, DC 20011
(202)576-6339
FAX (202)576-7579

AMERICAN SAMOA

Occupational Safety & Loss
Prevention
Administrative Services Dept.
Pago Pago, AS 96799
(684)633-4156
FAX (684)633-1841

GUAM

Dept. of Labor
Occupational Safety & Health
Admin.
P.O. Box 9970
Tamuning, GU 96931-9970
(671)475-0140
FAX (671)477-2988

NORTH MARIANA ISLANDS

Dept. of Labor and
Immigration
Caller Box 10007
Saipan, MP 96950
(670)288-8805
FAX (670)234-7787

PUERTO RICO

Occupational Safety & Health
Office
505 Munoz Rivera Ave
Hato Rey, PR 00918
(787)754-2171
FAX (787)767-6051

VIRGIN ISLANDS

Occupational Safety and Health
Dept. of Labor
3012 Golden Rock, Christiansted
St. Croix, VI 00820
(809)772-1315
FAX (809)772-4323

UNEMPLOYMENT INSURANCE

1. INTRODUCTION

- 1.1 Background
- 1.2 Federal-State Interaction

2. DEFINITIONS

3. FEDERAL UNEMPLOYMENT TAX ACT (FUTA)

- 3.1 Purpose
- 3.2 Covered Employment
- 3.3 Successor Employer
- 3.4 Statutory Merger
- 3.5 Credit for Successor Employers
- 3.6 Common Paymaster
- 3.7 Corporations Entitled to Use Common Paymaster
- 3.8 Exemptions
- 3.9 Tax Rate
- 3.10 Covered Earnings
- 3.11 Compliance
 - 3.11.1 Penalties and interest
 - 3.11.2 Levies
- 3.12 Deposit Requirements
 - 3.12.1 Deposit rules
 - 3.12.2 Where and how to deposit
 - 3.12.3 Deposit due dates

4. REPORTING REQUIREMENTS UNDER FUTA

- 4.1 Who Must File
- 4.2 Filing Due Date
- 4.3 Signing Form 940
- 4.4 Where to File Form 940

5. FUTA AND STATE UNEMPLOYMENT INSURANCE

- 5.1 The "Normal" or "90-Percent" Credit
- 5.2 Requirements to Qualify for 90-Percent Credit
- 5.3 Proof of Employer-Claimed Credits
- 5.4 Additional Credit
- 5.5 State Loans and Shortages

6. STATE UNEMPLOYMENT INSURANCE

- 6.1 Experience Rating
- 6.2 Determination of Experience Rating
- 6.3 Reserve-Ratio Formula
- 6.4 Benefit-Ratio Formula
- 6.5 Benefit-Wage-Ratio Formula
- 6.6 Payroll-Decline Formula

7. FACTORS AFFECTING EMPLOYER'S EXPERIENCE RATING

- 7.1 Benefit Charges
 - 7.1.1 Charging most-recent employers
 - 7.1.2 Charging base-period employers in inverse chronological order
 - 7.1.3 Charging proportionate base-period wages
- 7.2 Seasonal Workers
- 7.3 Noncharging of Benefits
- 7.4 Voluntary Contributions
- 7.5 Successor Employers

REFERENCES

APPENDIX: State Unemployment Insurance Agencies

1. INTRODUCTION

1.1 Background

Unemployment insurance provides income to people who have lost their jobs through no fault of their own and who are actively seeking suitable employment—a concept many states apply quite liberally. In theory, unemployment insurance spreads the cost of unemployment equitably among many employers.

Unemployment insurance is designed to provide a means of support to people who have involuntarily left the labor force and are actively attempting to return.

1.2 Federal-State Interaction

The Federal Unemployment Tax Act (FUTA) levies a tax against wages paid to employees and allows a credit to the employer of up to 90 percent of the tax owed. The tax is 6.2 percent of the first \$7,000 of wages paid to each employee in the calendar year. Employer credit for tax paid to state unemployment funds is as much as 5.4 percent (90 percent on a deemed 6-percent federal tax rate) of taxable wages. Amounts paid to unemployment insurance funds are used to fund claims and pay administrative expenses. The federal portion is used to make advances to states that run short of funds in their own unemployment insurance system, advances that states must repay.

2. DEFINITIONS

Employer

- Any person or organization that during the current or preceding year either (a) paid wages of \$1,500 or more in any calendar quarter, or (b) had one or more employees for some part of a day in any twenty different weeks.
- Any agricultural employer who during the current or preceding year either (a) paid cash wages of \$20,000 or more for farm labor in any calendar quarter, or (b) employed ten or more farm workers during some part of a day for at least one day during any twenty different weeks.
- Any household employer who during the current or preceding year paid wages of at least \$1,000 during any calendar quarter for domestic services in a private home, local college club, or fraternity/sorority.

Employee. An individual who performs services under the direction and control of an employer.

Successor employer. One who acquires substantially all the property used in a trade or business of another employer and who immediately after the acquisition employs in the trade or business one or more individuals employed by the preceding employer.

Common paymaster. Any member of a group of related corporations that disburses remuneration to employees of two or more of those corporations and is responsible for keeping books and records for those employees.

Normal or 90-percent credit. Credit that allows an employer to use the state unemployment insurance contribution as an offset against the greater portion (90 percent) of the federal unemployment tax liability.

Additional credit. Credit against an employer's federal unemployment tax liability equal to the difference between the amount of contributions actually paid to the state and the amount that would have been required to be paid if a reduced experience rating had not been obtained.

Experience rating. The method by which employer contributions under the state unemployment compensation laws may be varied on the basis of each individual employer's experience with unemployment. Also called *merit rating*.

Voluntary contribution. Contribution to the state unemployment fund by an employer to achieve a better experience rating. The contribution is allowed as an offset against benefits charged to the employer's account.

3. FEDERAL UNEMPLOYMENT TAX ACT (FUTA)

3.1 Purpose

The FUTA is designed to provide unemployment compensation to workers who have lost their jobs through layoff, reduction in labor force, or other reasons beyond their control.

3.2 Covered Employment

All employment is considered to be covered employment except as described in section 3.8.

3.3 Successor Employer

A successor employer acquires substantially all the property used in another employer's trade or business and continues to employ one or more of the same individuals. The successor employer

- May count the wages paid by the first employer during the current year in figuring the \$7,000 wage limit.
- Is not subject to pass the twenty-weeks or \$1,500-wages-in-a-calendar-quarter test. Since the first employer has already met these tests, the successor employer is automatically liable.

The manner of acquisition is immaterial. All the following situations result in successor employers:

- Purchase of trade or business
- Incorporation of previously unincorporated trade or business
- Continuation of an existing partnership by a new partnership

3.4 Statutory Merger

A statutory merger or consolidation does not result in successor employers. No adverse tax effect results either, since the new entity following the merger or consolidation is considered the same employer and taxpayer as the previous employer. The new employer may thus consider wages paid by the absorbed entity as having been paid by it (the new employer) when computing FUTA tax.

3.5 Credit for Successor Employers

A successor employer may not count wages paid by a predecessor who did not qualify as an employer under the Federal Unemployment Tax Act. However, a credit is allowed against the successor's FUTA tax based on the percentage of employees retained by the successor employer.

Example: Jones Partnership sells to Smith, Inc. all its property before Jones has met employer qualifications under the Federal Unemployment Tax Act. Smith retains 20 percent of Jones' employees, representing 20 percent of total wages paid. Smith cannot count the wages paid by Jones when figuring the \$7,000 wage limit. Instead, Smith is entitled to a credit against its FUTA tax based on the amount of credit Jones could have claimed for the employees retained by Smith if Jones had qualified as an employer. If Jones could have claimed a \$1,000 credit against its FUTA tax liability, Smith is entitled to claim a \$200 credit since it retained 20 percent of Jones' employees.

3.6 Common Paymaster

Related corporations with a common paymaster who have employees working for all the corporations do not have to pay FUTA tax on the

first \$7,000 of wages paid to each employee by each of the related corporations.

Example: Bill Doe works for two related corporations—Red, Inc. and Blue, Inc. Doe earns \$25,000 annually from Red, Inc. and \$25,000 from Blue, Inc. He devotes his time equally between the two corporations. Red, Inc. is the common paymaster, so the corporations are treated as one employer. Therefore, FUTA tax is calculated on only \$7,000 of Doe's wages, not on \$14,000.

3.7 Corporations Entitled to Use Common Paymaster

Three criteria must be met to qualify for this special treatment:

- *Related corporations.* Corporations that meet any one of the following tests are considered related (per Treasury Reg. 31.3121(s)-1(b)(1)):
 - The corporations are members of a “controlled group of corporations” as defined in Internal Revenue Code Section 1563. Generally, a controlled group of corporations are parent–subsidiary, brother–sister, or some other combined group of corporations connected through common stock ownership.
 - In the case of a corporation that does not issue stock, fifty percent or more of the board of directors of one corporation are members of the other corporation's board of directors.
 - Fifty percent or more of one corporation's officers are concurrently officers of the other corporation.
 - Thirty percent or more of one corporation's employees are concurrently employees of the other corporation.
- *Common paymaster.* The common paymaster is not required to pay every one of the employees of the related corporations. But, for the special provision to apply, the particular employees' wages must be disbursed through a common paymaster. The remuneration may be paid by one combined paycheck drawn on one account or by separate paychecks drawn on different accounts.
- *Concurrent employment.* Employees must perform services for the benefit of the employing corporation in exchange for remuneration paid contemporaneously from two or more corporations.

3.8 Exemptions

Treasury Reg. 31.3306(c) generally describe covered and excepted employment for FUTA purposes. Employers described in section 2 are subject to FUTA tax except for:

- Agricultural employment when total cash wages paid by the employer are less than \$20,000 in a quarter or the employer does not employ ten or more employees on twenty days in different weeks.
- Domestic service when the employer pays wages less than \$1,000 in any calendar quarter in the current or preceding year.
- Service not in the course of the employer's trade or business unless wages equal or exceed \$50 and work is performed by an individual regularly employed to perform such services.
- Employment of child or spouse, or child under twenty-one in employ of parent.
- Employment by U.S. government or instrumentality of the United States owned in whole or in part by the United States, or exempt under IRC Section 3301.
- Employment by a state political subdivision or instrumentality owned in whole or in part by the state.
- Service in employ of religious, charitable, educational, or other institution exempt from tax under IRC Section 501(a).
- Employment under the Railroad Unemployment Insurance Act.
- Students enrolled in a college or university employed at same.
- Work study.
- Service performed in hospital by a patient.
- Service performed in the employ of a foreign government or in the employ of an instrumentality wholly owned by a foreign government.
- Student nurses or interns in the employ of a hospital or training school.
- Insurance agents paid wholly by commission.
- Individuals under eighteen with paper routes.
- Employment by an international institution.
- Employment for commercial fishing.
- Nonimmigrants under worker's visas.
- Full-time students employed by a camp.

3.9 Tax Rate

The gross FUTA tax rate is 6.2 percent of the taxable wages paid during a calendar year. Employers receive a credit against their FUTA tax

liability for contributions made to their state fund. The maximum credit is limited to 90 percent of a deemed 6-percent federal tax rate, or 5.4 percent. The net FUTA tax rate for many employers is 0.8 percent.

A reduction in the net federal unemployment rate from 0.8 percent to 0.6 percent was to occur January 1, 1997. However, the 0.8 percent rate has been extended through December 31, 2007, when the rate is scheduled to decrease to 0.6 percent.

3.10 Covered Earnings

Employers are liable for FUTA tax on the first \$7,000 paid to each employee during a calendar year.

3.11 Compliance

Penalties, fines, interest, and levies are imposed upon employers who do not comply with FUTA tax rules.

3.11.1 Penalties and interest

— A four-tier penalty for failure to make timely deposits is imposed under IRC Section 6656 as follows:

- 2% if the failure is for five days or less,
- 5% if the failure is for six days but not more than fifteen days,
- 10% if the failure is sixteen days or more, and
- 15% if the tax is not deposited on or before the earlier of

- The day ten days after the date of the first delinquency notice to the taxpayer under IRC Section 6303, or
- The day on which notice and demand for immediate payment is given under IRC Section 6861 or Section 6862, or the last sentence of IRC Section 6331(a) (dealing with the determination that the collection of tax is in jeopardy). The penalty will not be imposed if it can be shown that failure is due to reasonable cause and not to willful neglect.

— Bad checks result in a penalty of 2 percent of the amount of the check or a flat \$15 if the check is for less than \$750.

— A 5-percent penalty of the net tax to be reported is imposed per month up to a maximum penalty of 25 percent for each month or part of a month that employment tax returns are late.

- A penalty of half of one percent up to 25 percent of the tax due is imposed for each month during which the failure to pay continues.
- Criminal penalties, in addition to the penalties previously listed, of imprisonment and fines of up to \$25,000, will be imposed when a willful attempt is made to evade payment of employment taxes by failing to file the federal unemployment tax form (Form 940 or Form 940-EZ) or by filing a false return.

Taxes due and unpaid will bear interest at the current federal rate, compounded daily.

3.11.2 Levies

The IRS may authorize a levy on, and seize the property and property rights of, an employer if the employer fails to pay any tax liability within ten days after notice and demand for payment.

3.12 Deposit Requirements

Employers must compute their FUTA tax liability quarterly as follows:

$\text{FUTA Taxable Wages} \times \text{Net FUTA Tax Rate} = \text{FUTA Tax Liability}$

3.12.1 Deposit rules

- If the aggregate undeposited FUTA tax liability is more than \$100 at the end of a quarter, a deposit of the tax must be made by the due date.
- If in any of the first three quarters the FUTA tax liability is \$100 or less, the liability is carried over to the next quarter and added to that quarter's liability.
- If fourth-quarter FUTA tax liability is over \$100, the liability must be deposited by January 31 of the following year.
- If the FUTA tax liability for the fourth quarter is under \$100, it may be remitted directly to the IRS with Form 940.
- If the employer wishes to receive a ten-day extension of the due date for Form 940, all FUTA tax must be deposited by January 31 of the following year, even if the liability is less than \$100.

3.12.2 Where and how to deposit

Form 8109, Federal Tax Deposit Coupon, is used to make deposits of FUTA tax. Deposits are to be made at a Federal Reserve bank or an authorized depository. Deposits made by mail should be by check or

money order payable to the depository bank. The date of receipt will determine the timeliness of the deposit. A deposit received after the due date will still be considered timely if the employer can establish that it was mailed on or before the second day before the due date.

The Treasury has developed the Electronic Federal Tax Payment System (EFTPS), an electronic fund transfer system to remit payroll taxes and convey deposit information directly to the Treasury. All employers who deposited more than \$50,000 of payroll taxes in 1995 and 1996 are required to start using EFTPS by January 1, 1999. The system will continue to be phased in over a period of years by increasing the percentage of total taxes subject to the new EFTPS system each year.

3.12.3 Deposit due dates

When a FUTA tax deposit is required, it is due the last day of the month following the end of the quarter (April 30, July 31, October 31, and January 31). If the due date falls on a Saturday, Sunday, or legal holiday, the due date becomes the next business day.

4. REPORTING REQUIREMENTS UNDER FUTA

Employers subject to FUTA tax during a calendar year generally must file an annual return on Form 940 or 940-EZ, "Employer's Annual Federal Unemployment Tax Return." Employers can use Form 940-EZ if all the following apply:

- Unemployment taxes were paid to only one state.
- These taxes were paid by the due date of the Form 940-EZ.
- All wages that were taxable for FUTA were also taxable for state unemployment tax.
- All wages were paid in a state that is not a credit reduction state.

Form 940-EZ is an abbreviated form consisting of a half page, whereas Form 940 is more detailed. Hereafter, all references to Form 940 include Form 940-EZ.

Household employers generally report and pay FUTA tax on Schedule H of Form 1040. However, if the household employer owns a business as a sole proprietor, the FUTA tax for the household employees is included on the business Form 940. See IRS Publication 926 and section 7.1.2 of the Employment Regulations chapter for further information regarding payroll taxes for household employees.

4.1 Who Must File

- If there is a change of ownership or transfer of business during the year, each employer who qualifies as an employer under FUTA requirements must file Form 940 reporting the wages paid during the year.
- If there is a statutory merger or consolidation, the resulting corporation is considered the same employer and only one Form 940 must be filed.

(Text continued on page 11)

- If a successor-predecessor relationship exists and the predecessor was not an employer under FUTA requirements, the successor, if considered an employer under FUTA requirements, must file Form 940 for the portion of the year following acquisition of the business.

4.2 Filing Due Date

Form 940 is due on or before January 31 of the following year. If the employer has made timely deposits and the FUTA liability is paid in full by January 31, Form 940 will permit the employer to receive an automatic ten-day extension until February 10 of the following year. If the due date falls on a Saturday, Sunday, or legal holiday, Form 940 is due the next business day.

A mailed return bearing a postmark indicating that it was mailed on or before the due date will be considered timely filed. The registration date of a return sent by registered mail will be considered the postmark. If a return is sent by certified mail, the postmark date on the employer's receipt is considered the postmark date.

4.3 Signing Form 940

The return should be signed by:

| <u>Type of Entity</u> | <u>Signer</u> |
|--|------------------------------|
| Sole proprietorship | Individual |
| Corporation | Principal officer |
| Partnership or unincorporated organization | Partner or officer |
| Trust or estate | Fiduciary of trust or estate |

An unsigned Form 940 will not be considered a return.

4.4 Where to File Form 940

The completed Form 940 should be sent to the IRS center of the region in which the employer's principal place of business or office or agency is located. Where to file depends on whether or not a payment is included with Form 940. Below is a list of regions, states included within them, and addresses.

| <i>If your principal business, office, or agency is located in:</i> | <i>File with the Internal Revenue Service Center at:</i> |
|---|--|
| Florida, Georgia, South Carolina <i>Return without payment:</i> Atlanta, GA 39901-0006 | <i>Return with payment:</i> P.O. Box 105887 Atlanta, GA 30348-5887 |
| New Jersey, New York (New York City and counties of Nassau, Rockland, Suffolk, and Westchester) <i>Return without payment:</i> Holtsville, NY 00501-0006 | <i>Return with payment:</i> P.O. Box 1365 Newark, NJ 07101-1365 |
| New York (all other counties), Connecticut, Maine, Massachusetts, New Hampshire, Rhode Island, Vermont <i>Return without payment:</i> Andover, MA 05501-0006 | <i>Return with payment:</i> P.O. Box 371307 Pittsburgh, PA 15250-7307 |
| Illinois, Iowa, Minnesota, Missouri, Wisconsin <i>Return without payment:</i> Kansas City, MO 64999-0006 | <i>Return with payment:</i> P.O. Box 970010 St. Louis, MO 63197-0010 |
| Delaware, District of Columbia, Maryland, Pennsylvania, Puerto Rico, Virginia, U.S. Virgin Islands <i>Return without payment:</i> Philadelphia, PA 19255-0006 | <i>Return with payment:</i> P.O. Box 8726 Philadelphia, PA 19162-8726 |
| Indiana, Kentucky, Michigan, Ohio, West Virginia <i>Return without payment:</i> Cincinnati, OH 45999-0006 | <i>Return with payment:</i> P.O. Box 6977 Chicago, IL 60680-6977 |
| Kansas, New Mexico, Oklahoma, Texas <i>Return without payment:</i> Austin, TX 73301-0006 | <i>Return with payment:</i> P.O. Box 970017 St. Louis, MO 63197-0017 |
| Alaska, Arizona, California (counties of Alpine, Amador, Butte, Calaveras, Colusa, Contra Costa, Del Norte, El Dorado, Glenn, Humboldt, Lake, Lassen, Marin, Mendocino, Modoc, Napa, Nevada, Placer, Plumas, Sacramento, San Joaquin, Shasta, Sierra, Siskiyou, Solano, Sonoma, Sutter, Tehama, Trinity, Yolo, and Yuba), Colorado, Idaho, Montana, Nebraska, Nevada, North Dakota, Oregon, South Dakota, Utah, Washington, Wyoming <i>Return without payment:</i> Ogden, UT 84201-0006 | <i>Return with payment:</i> P.O. Box 7024 San Francisco, CA 94120-7024 |
| California (all other counties), Hawaii <i>Return without payment:</i> Fresno, CA 93888-0006 | <i>Return with payment:</i> P.O. Box 60378 Los Angeles, CA 90060-0378 |
| Alabama, Arkansas, Louisiana, Mississippi, North Carolina, Tennessee <i>Return without payment:</i> Memphis, TN 37501-0006 | <i>Return with payment:</i> P.O. Box 1210 Charlotte, NC 28201-1210 |

5. FUTA AND STATE UNEMPLOYMENT INSURANCE

Two types of credit are applicable against the FUTA tax for contributions made to state unemployment agencies—normal (or 90 percent) credit and additional credit.

5.1 The “Normal” or “90-Percent” Credit

The Federal Unemployment Tax Act permits an employer to offset against the FUTA tax liability 90 percent of the FUTA tax. This credit is available only for contributions made to U.S. Department of Labor (DOL) approved state unemployment compensation plans and only if the contributions are actually paid by the employer in the year in which the credit was claimed.

Although the FUTA gross tax rate is 6.2 percent, only 90 percent of a deemed 6-percent federal tax rate is allowed. The 0.2 percent difference will continue in effect until December 31, 2007, when the rate is scheduled to decrease to 6 percent.

Example: An employer is subject to both federal and state unemployment tax. The taxable payroll for both laws is \$50,000. The state contribution rate is 2.9 percent, so the state tax liability is \$1,450 ($\$50,000 \times 2.9\%$). The federal tax liability before deducting the 90-percent credit is \$3,100 ($\$50,000 \times 6.2\%$). The employer may take a credit of \$2,700 ($\$50,000 \times 6\% \times 90\%$) against the federal tax. The net federal tax is \$400 ($\$3,100 - \$2,700$).

5.2 Requirements to Qualify for 90-Percent Credit

The total credit against federal tax for a calendar year may not exceed 90 percent of 6 percent, including the 90-percent credit and the additional credit described in section 5.4, below. The lowest net federal tax rate therefore cannot be lower than .8 percent (6.2 percent less 5.4 percent).

The full 90-percent credit applies only if all state contributions are paid on or before the due date of the federal return. A partial credit is allowed for the amount of state contributions paid after the due date. This partial credit is limited to 90 percent of the amount that would have been allowed if the state contributions had been timely made. The partial credit would be 81 percent (90 percent of 90 percent) of the federal tax.

5.3 Proof of Employer-Claimed Credits

Each state provides to the IRS proof of employer credit claims by certifying certain information. The appropriate officer of the state to which the employer paid required contributions reports to the IRS proof of the normal credit claimed by the employer. Required state contributions paid after the due date of Form 940 are also reported to the IRS.

If an employer wants to use the maximum allowable credit but is unable to pay state contributions by the due date of Form 940, an extension of not more than 90 days may be granted to file Form 940. If the extension is granted, the employer is entitled to the normal credit if the state contributions are paid on or before the extended due date.

5.4 Additional Credit

For an employer who had obtained a good experience rating, the amount paid for state contributions would be considerably less than 90 percent of the deemed federal rate (90 percent \times 6 percent = 5.4 percent; see section 5.2, above). In this case there would not be any benefit in a favorable rating, since the employer would be paying considerably more in FUTA tax.

For this reason an additional credit is allowed. The federal government allows the employer to take an additional credit against the federal tax equal to the difference between the contributions actually paid to the state and the amount that would have been paid if the reduced rate had not been in effect.

5.5 State Loans and Shortages

Title XII of the Social Security Act allows a state to borrow funds from the federal unemployment account to enable the state to pay unemployment benefits. This allows a state to continue to pay benefits when its funds run low because of poor economic conditions. Repayment of this loan, without interest, may occur in three ways:

1. A reduction of the state's share of the amount of any excess in the employment security administration account that would have been transferred to the state's account in the unemployment trust fund.
2. A transfer of funds from the state's account in the unemployment trust fund to the federal unemployment account.
3. A reduction in the total credit otherwise allowed an employer.

This reduction of the credit against federal tax is computed on Part 1 of Form 940. Each quarter the employer should compute the federal tax liability, using the net FUTA rate. The credit reduction is not computed and paid until Form 940 is filed.

Example: Blake, Inc. has a net FUTA rate of .8 percent. Taxable wages for the calendar year were \$100,000, or \$25,000 per quarter. For the first three quarters, Blake should deposit \$200 ($\$25,000 \times .8\%$) each quarter. The state Blake resides in has borrowed funds from the federal government because its unemployment funds have run low. The IRS has enforced a credit reduction of .9 percent on this state in order to collect the loan repayment. Blake's fourth-quarter FUTA deposit is calculated as follows:

Fourth-Quarter Taxable Wages \$25,000
 Net FUTA Rate .8%
 Fourth-Quarter FUTA Tax ($\$25,000 \times .8\%$) \$200

Credit Reduction:
 Total Taxable Wages for the Year \$100,000
 Credit Reduction Rate .9%
 Additional FUTA Tax ($\$100,000 \times .9\%$) \$900
 Deposit Due January 31 ($\$200 + \900) \$1,100

6. STATE UNEMPLOYMENT INSURANCE

All states have unemployment compensation laws that require contributions from employers. Some states require contributions from employees. Each state is responsible for the content and development of its unemployment insurance laws.

Each state governs

- Amount and duration of benefits, with minor limitations.
- Coverage and contribution rates.
- Eligibility requirements and disqualification provisions.
- Direct administration of the laws, including collecting contributions, maintaining wage records, taking claims, determining eligibility, and paying benefits.

6.1 Experience Rating

Experience ratings allow employer state contribution rates to vary based on the employer's experience with unemployment. Experience ratings

permit the cost of unemployment compensation to vary depending on an employer's rate of involuntary unemployment. As a result of experience ratings, state contribution rates range from the lowest rate allowed of zero to rates that exceed 5.4 percent. All states are required to provide for experience ratings up to at least 5.4 percent because of the federal credit of 5.4 percent ($6\% \times 90\%$).

6.2 Determination of Experience Rating

All formulas for calculating an experience rating are devised to determine the experience of each employer with unemployment or benefit costs. This list indicates the type of plan used to determine experience ratings as of July 1, 1998:

Experience Rating

| | |
|----------------------|-----------------------------|
| Alabama | Benefit ratio |
| Alaska | Payroll decline |
| Arizona | Reserve ratio |
| Arkansas | Reserve ratio |
| California | Reserve ratio |
| Colorado | Reserve ratio |
| Connecticut | Benefit ratio |
| Delaware | Benefit-wage ratio |
| District of Columbia | Reserve ratio |
| Florida | Benefit ratio |
| Georgia | Statewide reserve ratio |
| Guam | None |
| Hawaii | Reserve ratio |
| Idaho | Reserve ratio |
| Illinois | Benefit-wage ratio |
| Indiana | Reserve ratio |
| Iowa | Benefit ratio |
| Kansas | Reserve ratio |
| Kentucky | Reserve ratio |
| Louisiana | Reserve ratio |
| Maine | Reserve ratio |
| Maryland | Benefit ratio |
| Massachusetts | Reserve ratio |
| Michigan | Benefit ratio/reserve ratio |
| Minnesota | Benefit ratio |
| Mississippi | Benefit ratio |
| Missouri | Reserve ratio |

Experience Rating (*continued*)

| | |
|----------------|-----------------------------|
| Montana | Reserve ratio |
| Nebraska | Reserve ratio |
| Nevada | Reserve ratio |
| New Hampshire | Reserve ratio |
| New Jersey | Reserve ratio |
| New Mexico | Reserve ratio |
| New York | Reserve ratio |
| North Carolina | Reserve ratio |
| North Dakota | Reserve ratio |
| Ohio | Reserve ratio |
| Oklahoma | Benefit-wage ratio |
| Oregon | Benefit ratio |
| Pennsylvania | Benefit ratio/reserve ratio |
| Puerto Rico | Reserve ratio |
| Rhode Island | Reserve ratio |
| South Carolina | Reserve ratio |
| South Dakota | Reserve ratio |
| Tennessee | Reserve ratio |
| Texas | Benefit ratio |
| Utah | Benefit ratio |
| Vermont | Benefit ratio* |
| Virgin Islands | Reserve ratio |
| Virginia | Benefit ratio |
| Washington | Benefit ratio |
| West Virginia | Reserve ratio |
| Wisconsin | Reserve ratio |
| Wyoming | Benefit ratio |

*Benefit ratio is used for experienced employers only. New employer rates are assigned by industry classification.

6.3 Reserve-Ratio Formula

An account for each employer shows total payroll, employer contributions, and benefits paid to workers. Benefits are subtracted from contributions. The net amount is then divided by total payroll to determine the size of the balance in terms of potential liability. While a balance of \$5,000 may be adequate for a total payroll of \$50,000, it would be low for a total payroll of \$200,000.

The size of an employer's reserve ratio determines the experience rating. The larger the reserve ratio, the lower the experience rating. The formula is designed to give a better experience rating to those employers who have contributed more than benefits paid out.

6.4 Benefit-Ratio Formula

This formula compares benefits to payrolls. The basis for this formula is the fact that if each employer pays a rate that meets the benefit ratio, the program will be adequately funded.

6.5 Benefit-Wage-Ratio Formula

This experience rating is measured by separations of workers that result in the payment of benefits; the duration of their benefits is not considered. The separations are weighted with the workers' wages earned from each base-period employer and are recorded on each employer's experience record. These wages are termed *benefit wages*. For any one employer, only one separation per beneficiary per benefit year is recorded on the record.

The experience factor of each employer is determined by dividing the total benefit wages into the total taxable wages. This experience factor is then multiplied by the state's experience factor. A table is then used to determine the experience rating.

6.6 Payroll-Divide Formula

This experience rating formula is measured by the decline in an employer's payrolls from year to year or quarter to quarter. No benefit or contribution amounts are considered. This formula operates on the assumption that if an employer's payroll declines, the employer is not offering as much employment and is therefore considered a source of potential unemployment.

7. FACTORS AFFECTING EMPLOYER'S EXPERIENCE RATING

Certain factors affect an employer's experience rating. Among these are benefit charges, seasonal workers, voluntary contributions and successor employer situations.

7.1 Benefit Charges

When an employee receives unemployment benefits, those benefits either have to be charged to the state's fund or to the employer or

employers who had paid wages to the employee for which the benefits were received. In reserve-ratio and benefit-ratio states, a claimant's benefits need to be charged. In benefit-wage states the benefit wages need to be charged. There is no charging of benefits in payroll-decline states.

There are three methods of charging benefits to employers.

7.1.1 Charging most-recent employers

A few states charge the most-recent employer on the theory that this particular employer is primarily responsible for the unemployment. In most of these states the charges are limited to the most-recent employer who employed the employee for a certain number of weeks. Other states do not charge an employer unless a specified amount of wages was paid.

7.1.2 Charging base-period employers in inverse chronological order

Some states charge base-period employers but limit the amount for each employer. The charge first is applied to the most-recent employer, then in inverse chronological order to previous employers. This method is based on the assumption that responsibility lessens for unemployment as time goes by.

A limit is placed on the amount any one employer may be charged. When the limit is reached, the next-previous employer is charged with the remainder. The limit is determined as either a fraction of the wages paid by the employer or as a specified amount in the base period or quarter, or both.

If the last employer in a base period employed a claimant for a considerable part of the base period or the claimant's unemployment is short, this method of charging base-period employers in inverse chronological order has the same effect as charging the most recent employer. If the claimant's unemployment is long, this method results in charging all base-period employers proportionately.

7.1.3 Charging proportionate base-period wages

Most states charge benefits to all base-period employers based on the wages earned from each employer by the claimant. This method is based on the assumption that unemployment is a result of the general conditions of the labor market rather than separation from a given employer.

7.2 Seasonal Workers

Several states have specific guidelines for identifying the employers of seasonal workers and charging them with benefits paid to these seasonal

employees. Seasonal employers are generally charged only for benefits paid for unemployment during the seasonal period. Nonseasonal employers are charged for benefits for all periods.

7.3 Noncharging of Benefits

Depending on the particular state, some benefits are not charged to employers

- If the duration of unemployment is very short.
- If benefits are paid on the basis of a determination in a case that is appealed and later reversed.
- If benefits are paid following a period of disqualification for voluntary quitting, misconduct, or refusal of suitable employment.
- If the employer who employs a claimant part time in the base period continues to provide that claimant with equal part-time employment.
- If the benefits are being paid to a claimant who is taking approved training.

7.4 Voluntary Contributions

About half of the states allow employers to make voluntary contributions. The voluntary contribution increases the balance in the employer's reserve so the employer is assigned a lower rate. An employer who will be increasing the number of employees in the coming year, for example, may benefit from making a voluntary contribution. This may result in a lower experience rating being applied to the larger wage base.

State agencies usually do not supply employers the amount of the voluntary contribution necessary to lower the experience rating, but worksheets are available to compute it. It is important to make the payment large enough to result in a lower rate since the voluntary contribution is often not refunded if it does not result in a reduced rate.

Voluntary contributions cannot be credited against the federal unemployment tax.

7.5 Successor Employers

Although laws vary from state to state, most states provide that the predecessor's experience rating be transferred to a successor employer. In order to receive this transfer of rating, certain conditions must be met, depending on the particular state:

- Successor assumes responsibility for contributions of predecessor.
- No substantial reduction of personnel takes place after the transfer.
- There is continuity of ownership or management.
- Successor continues same type of trade or business.
- Predecessor has ceased to do business.

If the successor employer was not subject to unemployment laws before the transfer, the successor will normally be required to use the predecessor's rate for the remainder of the year. If the successor was subject to unemployment laws prior to the transfer, the successor usually must continue to use that same rate for the remainder of the year, although some states recompute the successor's rate at the time of transfer.

When a business transfer occurs, both the predecessor and the successor should notify the appropriate state agencies. Most states provide special forms for this purpose and require filing within a limited time period.

REFERENCES

- Avrutis, Raymond. *How to Maximize Your Unemployment Benefits: Complete Information for All Fifty States*. Garden City Park, N.Y.: Avery Publishing Group, 1994.
- Blaustein, Saul J. *Unemployment Insurance in the United States: The First Half Century*. Kalamazoo, Mich.: W. E. Upjohn Institute for Employment Research, 1993.
- Bourdeau, Pierre-Yves, and Claudine Roy. *Unemployment Insurance Act & Regulations*. Annual Edition. Charlottesville, Vir.: LEXIS Law Publishing, 1993.
- Donnadieu, Gabe, and Robert A. Schuler. *Controlling Unemployment Insurance Costs: The Employer's Comprehensive Guide to the UIC System*. Westport, Conn.: Greenwood Publishing Group, 1994.
- Frick Company Staff. *Unemployment Compensation: A Cost You Can Cut*. Chicago: American Chamber of Commerce Publishers, 1995.
- History of Unemployment Insurance Legislation in the United States and New York State (1935-1989)*. Upland, Pa.: DIANE Publishing Company, 1994.
- Korn, Anthony. *Compensation for Dismissal, 1997*, 2d ed. Holmes Beach, Fla.: Gaunt, Inc., 1997.

- Nye, Sandra G. *Employee Assistance Law Answer Book*. New York: Panel Publishers, Inc., 1991.
- O'Leary, Christopher, and Stephen A. Wandner, eds. *Unemployment Insurance in the United States: Analyses of Policy Issues*. Kalamazoo, Mich.: W. E. Upjohn Institute for Employment Research, 1997.
- Science & Life Consultants Association Staff. *Work, Injuries & Compensation: Index of New Information (With Authors & Subjects)*. Annandale, Va.: ABBE Publishers Association of Washington, D.C., 1992.
- Smith, Barry D., and Eric A. Wienen. *How Insurance Works*, 2d ed. Malvern, Pa.: Insurance Institute of America, Inc., 1994.
- Social Security Programs in the United States & Throughout the World*. New York: Gordon Press Publishers, 1996.
- Tax Guide for Small Business*. Income, Excise, and Employment Taxes for Individuals, Partnerships, and Corporations. Publication 334. Washington, D.C.: Department of the Treasury—Internal Revenue Service. Annual.

APPENDIX: State Unemployment Insurance Agencies

The following list contains addresses and telephone numbers of state unemployment insurance agencies as of July 1, 1998.

ALABAMA

Dept. of Ind. Relations
Unemployment Compensation
Agency
649 Monroe St.
Montgomery, AL 36131
(334)242-8888
FAX (334)242-2068

ALASKA

Dept. of Labor
Employment Security Div
P O Box 25509
Juneau, AK 99802-5509
(907)465-2711
FAX (907)465-4537

ARIZONA

Dept. of Economic Security
P O Box 6028
Phoenix, AZ 85005
(602)248-9354
FAX (602)650-1610

ARKANSAS

Employment Security Dept.
P O Box 2981, #2 Capital Mall
Little Rock, AR 72203-2981
(501)682-3100
FAX (501)682-2394

CALIFORNIA

Employment Development Dept
P O Box 826880, MIC40
Sacramento, CA 94280-0001
(916)654-7401
FAX (916)654-8599/(916)654-8117

COLORADO

Dept. of Labor & Employment
Div. of Employment & Training
UI Tax Administration
1515 Arapahoe St.
Tower 3, Suite 400
Denver, CO 80202-2117
(303)603-8254
FAX (303)620-4988

CONNECTICUT

Employment Security Div
200 Folly Brook Blvd.
Wethersfield, CT 06109-1114
(860)566-5304
FAX (860)566-7697

DELAWARE

Dept. of Labor
Div. of Unemployment Insurance
P O Box 9953
Wilmington, DE 19809-0953
(302)761-8482
FAX (302)761-6638

FLORIDA

Dept. of Labor & Employment
Security
102 Caldwell Bldg
Tallahassee, FL 32399-0211
(904)921-3421/(800)482-8293
FAX (904)921-3564

GEORGIA

Dept. of Labor
Adjudication Secuon
148 International Blvd., NE, Ste 850
Atlanta, GA 30303-1751
(404)656-3069
FAX (404)657-4124

HAWAII

Unemployment Insurance Division
Unemployment Insurance
Administration
830 Punchbowl St., Room 325
Honolulu, HI 96813
(808)586-9071
FAX (808)586-9077

IDAHO

Dept. of Labor
317 Main St.
Boise, ID 83735-0001
(208)334-6318
FAX (208)334-6301

ILLINOIS

Dept. of Employment Security
401 S. State St.
Chicago, IL 60605
(312)793-4880
FAX (312)793-6296

INDIANA

Dept. of Training & Employment
Services/UI Tax Administration
10 N. Senate Ave., Room 104
Indianapolis, IN 46204-2277
(317)232-7698
FAX (317)232-6950

IOWA

Iowa Workforce Development
Bureau of Job Insurance
1000 E. Grand Ave
Des Moines, IA 50319-0209
(515)281-4986
FAX (515)242-6301

KANSAS

Dept. of Human Resources
Division of Employment Security
Contributions Branch
401 SW Topeka Blvd
Topeka, KS 66603-3182
(785)296-5025
FAX (785)291-3425

KENTUCKY

Div. of Unemployment Insurance
P O Box 948
Frankfort, KY 40602-0948
(502)564-2272
FAX (502)564-5442

LOUISIANA

Dept. of Labor
P O Box 94186
Baton Rouge, LA 70804-9186
(504)342-2992
FAX (504)342-5965

MAINE

Maine Dept. of Labor
Bureau of Unemployment
Compensation
P O Box 309
Augusta, ME 04332-0309
(207)287-3176
FAX (207)287-3733

MARYLAND

Office of Unemployment Insurance
Dept. of Labor, Licensing and
Regulation
1100 N Eutaw St.
Rm. 414
Baltimore, MD 21201
(410)767-2414
FAX (410)767-2501

MASSACHUSETTS

Dept. of Employment & Training
Charles F. Hurley Bldg
19 Stanford St.
Boston, MA 02114
(617)626-5075

MICHIGAN

Unemployment Agency—Tax Office
7310 Woodward Ave
Detroit, MI 48202
(313)876-5146
FAX (313)876-5678

MINNESOTA

Job Service & Unemployment
Insurance Div
Dept. of Jobs & Training
390 N. Robert St.
St. Paul, MN 55101
(612)296-6141
FAX (612)297-5283

MISSISSIPPI

Employment Security Comm
Unemployment Insurance Div
Attn: C&S Dept.
P O Box 1699
Jackson, MS 39215-1699
(601)961-7755
FAX (601)961-7784

MISSOURI

Div. of Employment Security
421 E. Dunklin, Box 59
Jefferson City, MO 65104-0059
(573)751-3215
FAX (573)751-4945

MONTANA

Unemployment Insurance Div
Dept. of Labor & Industry
Box 1728
Helena, MT 59604-1728
(406)444-3783
FAX (406)444-2699

NEBRASKA

Unemployment Insurance
Dept. of Labor
P O Box 94600
Lincoln, NE 68509-4600
(402)471-9000
FAX (402)471-9994

NEVADA

Dept. of Employment Training and
Rehabilitation
500 E. Third St
Carson City, NV 89713-0030
(702)687-4540
FAX (702)687-3186

NEW HAMPSHIRE

New Hampshire Employment
Security
32 S. Main St
Concord, NH 03301-4857
(603)224-3311
FAX (603)228-4145

NEW JERSEY

NJ Dept. of Labor
U-DI Financing
P O Box 947
Trenton, NJ 08625-0947
(609)984-3041
FAX (609)777-4951

NEW MEXICO

Unemployment Insurance Bur
NM Dept. of Labor-4085
P O Box 1928
Albuquerque, NM 87103
(505)841-8431
FAX (505) 841-9053

NEW YORK

Office of Director
Unemployment Insurance Div
N Y State Dept. of Labor
Governor W Averell Harriman
State Office Building Campus,
Rm 554
Albany, NY 12240-0001
(518)457-2878
FAX (518)485-8604

NORTH CAROLINA

Employment Security Comm.
P O Box 26504
Raleigh NC 27611-6504
(919)733-7395
FAX (919)733-1255

NORTH DAKOTA

Customer Service Area V—
Centralized Services
Job Service
P O Box 5507
Bismarck, ND 58506-5507
(701)328-2814
FAX (701)224-2414

OHIO

Bur. of Employment Services
145 S. Front St., P O Box 923
Columbus, OH 43216-0923
(614)466-2319
FAX (614)752-4811

OKLAHOMA

Unemployment Insurance Div
Employment Security Comm.
P O Box 52003
Oklahoma City, OK 73152
(405)557 7190
FAX (405)557-5350

OREGON

Employment Department
875 NE Union St
Salem, OR 97311-0030
(503)947-1488
FAX (503)947-1487

PENNSYLVANIA

Dept. of Labor & Industry
Bureau of Employer Tax Operations
Room 915, Labor & Industry Bldg
Seventh & Forster Sts.
Harrisburg, PA 17121
(717)787-2179
FAX (717)787-8373

RHODE ISLAND

Division of Taxation
Employer Tax Section
One Capitol Hill
Providence, RI 02908-5829
(401)222-3696
FAX (401)222-3694

SOUTH CAROLINA

Employment Security Comm
1550 Ladsden St
P O Box 995
Columbia, SC 29202
(803)737-3080
FAX (803)737-2659

SOUTH DAKOTA

Div. of Unemployment Insurance
Dept. of Labor
420 S. Roosevelt
P O Box 4730
Aberdeen, SD 57402-4730
(605)626-2312
FAX (605)626-2322

TENNESSEE

Employer Services
Dept. of Employment Security
8th Floor, 500 James Robt Pkwy
Nashville, TN 37245-3555
(615)741-2486
FAX (615)741-7214

TEXAS

Texas Workforce Comm
101 F 15th St
Austin, TX 78778-0001
(512)463-2222
FAX (512)475-1221

UTAH

Dept. of Workforce Services
140 E. 300 South
P O Box 45288
Salt Lake City, UT 84145-0288
(801)536-7749
FAX (801)536-7700

VERMONT

Unemployment Compensation Div
Dept. of Employment & Training
5 Green Mountain Dr
P O Box 488
Montpelier, VT 05601-0488
(802)828-4000
FAX (802)828-4046

VIRGINIA

Employment Comm
P O Box 1358
Richmond, VA 23218
(804)786-7159
FAX (804)786-5890

WASHINGTON

Employment Security Dept
Experience Rating Unit
P O Box 9046
Olympia, WA 98507-9046
(360)902-9670
FAX (360)902-9202

WEST VIRGINIA

Bureau of Employment Programs
Unemployment Compensation Div
112 California Ave
Charleston, WV 25305-0112
(304)558-2675
FAX (304)558-1324

WISCONSIN

Div. of Unemployment Insurance
Dept. of Workforce Development
P O Box 7942
Madison, WI 53707
(608)261-6700
FAX (608)267-1400

WYOMING

Dept. of Employment
Employment Resources Division
P O Box 2760
Casper, WY 82602
(307)235-3201
FAX (307)235-3278

DISTRICT OF COLUMBIA

Off. of Unemployment
Compensation
Dept. of Employment Services
500 C St., NW, Rm 501
Washington, DC 20001
(202)724-7457
FAX (202)724-7474

GUAM

Dept of Labor
P O Box 9970
Tamuning, GU 96911-2970
(671)473-0102
FAX (671)477-2788

PUERTO RICO

Labor & Human Resources Dept
Bur of Employment Security
505 Munoz Rivera Ave
Hato Rey, PR 00918
(787)754-5375
FAX (787)763-2227

VIRGIN ISLANDS

Employment Security Agcy
Unemployment Insurance Div
P O Box 789
Sunny Isles Shopping Center
Store #7
Christiansted, VI 00821-0789
(340)773-1440
FAX (340)773-1515

HIRING FOREIGN NATIONALS

1. BASIC PREMISES

- 1.1 Source and Scope of the Federal Power to Regulate Immigration
- 1.2 Government Agencies and Their Functions
 - 1.2.1 Immigration and Naturalization Service (INS)
 - 1.2.2 State Department
 - 1.2.3 Department of Labor (DOL)

2. NONIMMIGRANT VISAS

- 2.1 Presumption of Immigrant Intent
- 2.2 Evidence That Alien Will Depart
- 2.3 Nonimmigrant Categories (Generally)
 - 2.3.1 B-1 business visitors
 - 2.3.2 B-2 visitors for pleasure
 - 2.3.3 E-1 treaty traders
 - 2.3.4 E-2 treaty investors
 - 2.3.5 F students
 - 2.3.6 H-1A registered nurses; H-1B aliens with specialty occupations
 - 2.3.7 H-2 temporary workers; H-2A agricultural workers; H-2B nonagricultural workers
 - 2.3.8 H-3 trainees
 - 2.3.9 J exchange visitors
 - 2.3.10 L intracompany transferees
 - 2.3.11 M nonacademic or vocational students
 - 2.3.12 O temporary workers of extraordinary ability in sciences, education, and business
 - 2.3.13 P performing artists and athletes
 - 2.3.14 Q international cultural exchange visitors
 - 2.3.15 R-1 religious workers

3. LAWFUL PERMANENT RESIDENCE

- 3.1 Based Upon Immediate Relative
 - 3.1.1 Definition
 - 3.1.2 Procedure
- 3.2 Based Upon Special Immigrant Status
- 3.3 Based Upon Family Preferences
- 3.4 Based Upon Employment
 - 3.4.1 Categories of employment-based immigrants
 - 3.4.2 Labor certification
 - 3.4.3 Petitioning procedure for employment-based aliens

- 3.5 Final Application for Immigrant (Permanent Resident) Status
 - 3.5.1 Adjustment of status
- 3.6 The Immigration Reform and Control Act of 1986
 - 3.6.1 Legalization (amnesty)
 - 3.6.1.1 Special agricultural workers (SAWs)
 - 3.6.1.2 Unity for families of legalized aliens

4. LABOR CERTIFICATION

- 4.1 Employment Classifications
 - 4.1.1 Schedule A—professional
 - 4.1.2 Schedule B—low level/entry level
 - 4.1.3 Occupations on neither schedule
- 4.2 Application for Labor Certification
 - 4.2.1 Who files
 - 4.2.2 What must be filed
 - 4.2.3 Basic certification process
 - 4.2.4 Schedule A
 - 4.2.4.1 Schedule A—special handling
 - 4.2.5 Schedule B
 - 4.2.5.1 Temporary agricultural workers
 - 4.2.5.2 Live-in domestic workers
 - 4.2.6 Where to file for labor certification
- 4.3 Labor Certification Decision and Administrative Review
 - 4.3.1 When to file for review
 - 4.3.2 Scope of filing
 - 4.3.3 Hearings
- 4.4 Refiling After Denial
- 4.5 Validity of Labor Certification
 - 4.5.1 Duration and effective date
 - 4.5.2 Geographic and occupational scope

5. INELIGIBILITY FOR VISAS—EXCLUSION

- 5.1 Determination of Excludability
- 5.2 Grounds for Exclusion

6. APPLYING FOR U.S. CITIZENSHIP

- 6.1 Requirements
- 6.2 Procedure

7. EMPLOYER RESPONSIBILITIES

- 7.1 Employment Verification System
- 7.2 Prohibition of Discrimination

8. PENALTIES

- 8.1 Employer Responsibilities

**9. ILLEGAL IMMIGRATION REFORM AND
IMMIGRANT RESPONSIBILITY ACT OF 1996**

REFERENCES

APPENDIX 1: Addresses of Government Offices
Department of Labor Regional Offices
Immigration and Naturalization Service Offices

APPENDIX 2: Visa Symbols

APPENDIX 3: Immigration and Naturalization Form I-9

**APPENDIX 4: Summary of Changes in Immigration Law After the
Illegal Immigration Reform and Immigrant
Responsibility Act of September 30, 1996**

1. BASIC PREMISES

1.1 Source and Scope of the Federal Power to Regulate Immigration

The right of a foreign national to enter or stay in the United States is set by Congress.* The principal statute governing the status of non-United States citizens (aliens) in this country is the Immigration and Nationality Act. The act's goal, relative to aliens working in the United States, is that jobs should go first to United States citizens. The act presumes that any person who wants to enter the United States is seeking to stay permanently, and that the person is or will become an immigrant. The burden is on the alien to prove that he or she is entitled to temporary admission by showing that he or she falls within one of the nonimmigration visa categories.

A visa is permission to apply to enter the country. It is issued by a United States consulate and is presented to an officer of the Immigration and Naturalization Service (INS) at the port of entry. A visa permits the alien to travel only to seek entry at a United States entry port; the INS then admits the alien to the United States.

1.2 Government Agencies and Their Functions

1.2.1 Immigration and Naturalization Service (INS)

The INS has jurisdiction over the alien from the time of entry to departure. It has both a service and an enforcement function. Service consists primarily of acting upon applications and petitions for benefits under the law; examples would include certain categories that involve employment (H and L visas) when the INS gives preliminary approval before the United States consulate will consider issuing the visa. For immigrant visas, the INS determines into which category, for preference purposes and so forth, the application falls.

At the United States border, the INS has the final say on whether to admit the alien. The INS will determine whether the alien is excludable under any of the nine major grounds of exclusion set out in the act. Most of the time, however, the alien is routinely admitted, since the United States consulate has already passed on those questions.

*For the organization and development of this chapter, we are indebted to the *Immigration Handbook: Employment of Foreign Nationals*, 2d ed., rev., American Council on International Personnel, Inc., New York, 1985.

1.2.2 State Department

The U.S. State Department operates United States consulates in foreign countries. The United States consulate is the office that actually issues both nonimmigrant and immigrant visas. It determines whether the alien qualifies for a nonimmigrant visa, rules on the alien's intent to leave the United States at the expiration of his or her visit, and determines whether the alien is ineligible for a visa under the nine major grounds of exclusion.

The appropriate United States consulate receives the approved petition from the INS, makes the final determination (including whether any of the nine major grounds of excludability apply), and interviews the petitioner.

1.2.3 Department of Labor (DOL)

Certain categories of immigrant visas are granted based upon an offer of permanent employment. Department of Labor approval is necessary only if the offer of employment is itself the basis for eligibility for immigration.

The DOL must certify to the INS that

- There are not sufficient U.S. workers who are able, willing, qualified, and available to perform the work.
- The employment of a foreign national in the position offered will not adversely affect the wages and work conditions of United States workers similarly employed.

For nonimmigrant visas, the DOL certification is limited to temporary labor certification for certain visa petitions and is advisory only.

2. NONIMMIGRANT VISAS

2.1 Presumption of Immigrant Intent

Unlike immigrant visas, nonimmigrant visas are not subject to numerical limitations and, thus, have a simplified application process. The alien applies to the United States consulate of his or her country of residence or citizenship. Temporary workers, trainees, or intracompany transferees, or fiance(e)s of United States citizens must first apply for INS approval before submitting the visa application to the United States consulate.

As noted above, the Immigration and Nationality Act presumes that every alien applying for a visa to enter the United States intends to stay,

and it is up to the alien to prove that he or she qualifies under one of the nonimmigrant categories, and that the stay will be a temporary one. The act, however, recognizes that certain employment-based non-immigrants may legitimately intend to depart the United States at the end of their authorized stay or seek to become permanent residents. This concept is known as *dual intent*.

The alien's passport must be valid for at least six months beyond the expiration of his intended stay in the United States. If not, the United States consulate will not issue the visa.

Canadian nationals and Canadian landed immigrants (permanent residents) with common nationality (British Commonwealth citizenship) do not need nonimmigrant visas to enter the United States for temporary periods. They can simply go to the port of entry with the supporting documentation; that is, they skip going to the United States consulate and go directly to the INS at the border.

When a nonimmigrant alien enters the United States, a small white card, known as an I-94, is stapled to the alien's passport by the immigration officer. The I-94 indicates how long the alien may legally stay in the United States. The I-94 is important because it serves as proof of the alien's legal status in the United States. A nonimmigrant visa may be issued for one or more entries into the United States. Most common are visas for "one," "two," or "multiple" entries. Thus, an alien with a visa that allows for more than one entry can depart and re-enter the United States as many times as the visa allows and as long as the visa itself has not expired. It is important to note that a visa only allows an alien to make an *application* for entry. Entry is not guaranteed, and an alien may be refused entry if she or he does not have a proper visa or proper documentation, or is otherwise determined to be inadmissible. The visa is used only for the initial entrance into the United States; once the alien has been inspected and admitted, it has served its primary purpose.

2.2 Evidence That Alien Will Depart

An alien must show that he or she has a residence in a foreign country and has no intention of abandoning it.

The United States consulate will consider the following factors to show that the alien intends to return to a home in a foreign country:

- Employment
- Property ownership
- Substantial assets outside the United States
- Membership in religious, social, political, or cultural organizations
- Family ties

2.3 Nonimmigrant Categories (Generally)

The following list includes those nonimmigrant categories of most interest to prospective employers. Omitted, for example, are visas for diplomats or crews of foreign vessels passing through United States ports.

2.3.1 B-1 business visitors

B-1 is the category for aliens visiting the United States temporarily for business purposes.

A visitor for business purposes may be intending to negotiate a contract, consult with business associates, engage in litigation, attend a business convention, or perform independent research. If the alien receives any payment, other than reimbursed expenses, from a United States source, he or she cannot qualify under this category. He may, however, qualify as a temporary worker under another nonimmigrant category.

B-1 visas can be granted for up to one year, with six-month extensions. The reciprocity granted by the alien's country to United States visitors is considered in setting the term of stay.

The initial application is made at the United States consulate in the country where the alien resides. It should include a letter from the employer explaining the business purpose for traveling to the United States and proof of financial arrangements to demonstrate that the alien does not need to accept local employment for support while in the United States. The alien must also prove intention to return to the foreign residence. Extensions may be obtained by filing INS Form I-539 with the INS district office having jurisdiction over the alien's location in the United States and should be accompanied by a letter from the alien's employer explaining why the extension is needed and providing further proof of financial support.

2.3.2 B-2 visitors for pleasure

The B-2 category includes tourists, those coming to the United States for medical treatment, attendees at nonbusiness conventions, and amateur entertainers and athletes. The visa is generally granted on a reciprocity basis. For most European countries that do not require United States citizens to have visas to visit, visas are granted to nationals of those countries for indefinite duration. At the point of entry, the INS generally admits visitors for periods of six months. Extensions can be obtained if the alien can demonstrate sufficient ties to the home country and the financial resources to accommodate a long visit without the need to accept local employment.

As with category B-1, the B-2 visitor applies at his or her local United States consulate and submits proof of financial arrangements and intent to return to the foreign residence. To ease the application process, a B-2 visitor may submit an affidavit or letter of invitation from a friend or relative in the United States. Proof of financial arrangements can be facilitated by submitting a completed *Affidavit of support* (Form I-134) from a U.S. sponsor, friend, or relative, with supporting documentation on the income and assets of the sponsor, friend, or relative.

Visitors for business or pleasure may be eligible to have the B-visa requirement waived under a program known as the *Visa Waiver Pilot Program*. This program allows aliens from certain countries (mostly Western European but also including Argentina, Australia, Brunei, Japan, and New Zealand) to enter the United States as visitors for up to ninety days without first obtaining a visa. Visitors who enter the United States under this program must depart within ninety days and are not eligible to extend their stay, change their visa status, or apply for permanent residence, other than as an immediate relative of a U.S. citizen.

2.3.3 E-1 treaty traders

If an alien is a national of one of the approximately sixty countries that have a trading treaty with the United States, he or she may enter the United States solely to carry on substantial trade principally between the United States and the country of which he or she is a national.

The enterprise must be majority owned by the nationals of the treaty country. The alien must be employed in a supervisory or executive capacity or in a position involving skills essential to the enterprise's operation. The volume of trade must be substantial.

Trade means the exchange, purchase, or sale of goods and services. It includes international banking, insurance, transportation, communication and data processing, advertising, accounting, design and engineering, management, consulting, tourism, and technology transfer.

An E-1 visa gives unlimited entry for a total period of four or five years, depending on the alien's country. The INS generally admits treaty nationals for one year, with extensions in increments of up to two years. Every time treaty traders travel, they are given a new one-year admission, so extensions are rarely needed.

Changes from another non-immigrant status and extensions are applied for on INS Form I-129, plus Supplement E, "Petition for Nonimmigrant Worker." Treaty traders are usually permitted to stay as long as they are employed by the treaty enterprise, which can be ten or even twenty years, as long as they manifest an intention to return home eventually.

A treaty trader applies for an E-1 visa at a United States consulate located outside the United States. No preliminary INS application is needed. The application is made on State Department Form OF-156, submitted with evidence that

- The trading enterprise is majority owned by treaty country nationals.
- The enterprise is engaged in substantial trade principally between the United States and a treaty country.
- The alien is a citizen of that country.
- The alien will be employed in a qualifying position with the treaty enterprise.

A dependent of the treaty trader will not receive INS authorization for local employment in the United States, but accepting employment is not a violation of status that will lead to deportation. Employment is, however, a violation that prohibits adjustment of status to permanent residence—which only means that application for a change of visa to an immigrant visa must be made outside the United States.

2.3.4 E-2 treaty investors

The E-2 visa category is for the benefit of nationals of treaty countries who make a substantial investment in the United States or who are executives, managers, or key employees of a treaty investor enterprise. The enterprise must be majority owned by the treaty country national.

The investment must be an active one, that is, not a passive one, such as one in equities or real estate. The amount invested must be at risk, and must be substantial—the enterprise cannot be a marginal one.

In other respects, the E-2 classification is like the E-1 category.

Treaty trader or investor countries include Argentina, Australia, Austria, Bangladesh, Belgium, Bolivia, Brunei, Cameroon, Canada, China (Taiwan), Colombia, Costa Rica, Czech Republic, Denmark, Egypt, Estonia, Ethiopia, Finland, France, Germany, Greece, Grenada, Honduras, Iran, Ireland, Israel, Italy, Japan, Korea, Latvia, Liberia, Luxembourg, Morocco, Oman, Netherlands, Norway, Pakistan, Panama, Paraguay, the Philippines, Senegal, Slovak Republic, Spain, Sri Lanka, Suriname, Sweden, Switzerland, Thailand, Togo, Turkey, Tunisia, the United Kingdom, Vietnam, and Zaire. The treaty with Vietnam is not currently in force, but the treaty with Iran is. United Kingdom nationals who are nonresidents in the United Kingdom proper or Gibraltar are not considered treaty nationals.

2.3.5 F students

An F-1 visa is granted to students who have no intention of abandoning their foreign residences and who enter the United States temporarily in order to attend an academic program.

- The school must be approved for F-visa purposes by the United States Attorney General.
- The student must be enrolled in a full course of study.
- The student must be proficient in English or enrolled in English-proficiency courses.
- The student must have sufficient funds for the expenses for the full course of study.

The F-2 visa is for the family of an F-1 student. INS Form I-20 is issued by the school to the student. Application for entry is made at the United States consulate abroad; no advance INS permission is needed. Form OF-156 is used, accompanied by the I-20 from the school. The student must also submit financial documentation and evidence that he or she will depart at the end of his or her course of study.

The student's visa is generally granted for the duration of status—that is, the time necessary to finish the course of study. Transfer from one school to another during the course of study does not require INS approval. A change of academic program is applied for on the student-extension form, INS Form I-539. A student may not study for longer than eight years in the United States on an F visa without first obtaining permission from the INS.

The Immigration Act of 1990 established for F-1 students a pilot program that liberalizes the rules for students seeking employment authorization off-campus. Under this program, an F-1 student may be granted employment authorization to work off-campus in a job unrelated to the alien's field of study. To be eligible, a student must

- Have been in legal F-1 student status for at least one academic year; and
- Be in good academic standing.

A prospective employer under this program must, on Form ETA-9034, be able to provide the school and the Department of Labor with an attestation that the employer

- Has recruited for the position for at least sixty days (*recruitment* means filing a job order with the local state employment office and posting at the place of work);

- Will afford the student the greater of the prevailing wage rate or the same wages and working conditions afforded U.S. workers similarly employed in the same occupation; and
- Will not employ the student for more than twenty hours per week during the academic term.

Employers must show that they were unsuccessful in recruiting U.S. workers and, if challenged, must provide evidence to substantiate recruitment efforts. Employers can hire F-1 students for up to ninety days after the last day of recruitment.

2.3.6 H-1A registered nurses; H-1B aliens with specialty occupations

The H-1 visa category was substantially changed by the Immigration Act of 1990. Current H-1 visas are divided into two categories.

The H-1A visa is for aliens who are coming to the United States temporarily to perform *services as registered nurses*. To qualify as an H-1A nurse, the alien must be licensed to practice nursing in the country where he or she was educated or must have received a U.S. nursing education; must have passed an exam for graduates of foreign nursing schools or be licensed to practice nursing in the state of intended employment; and must be fully qualified to practice nursing in the state of intended employment upon admission.

To bring an H-1A nurse to the United States, an employer must file an attestation with the Department of Labor showing that certain wage and labor conditions are met. Attestations are filed under penalty of perjury. The Department of Labor will provide notice of acceptance of the attestation on Form ETA 9029.

The employer can file a petition for a temporary nurse on Form I-129, "Petition for Nonimmigrant Worker," with the INS Service Center that has jurisdiction over the place of intended employment. The petition must be accompanied by Form ETA-9029 and a statement that the employer will comply with all conditions of the attestation and employ nurses only at the facility for which the attestation is filed. The employer must also show that the H-1A nurse meets the qualifications required by the statute. An H-1A nurse can be approved for an initial period of up to three years, with extensions to a maximum of five years and, in certain extraordinary circumstances, six years.

The H-1B category includes several classes of aliens, including aliens engaged in specialty occupations; aliens with exceptional merit and ability related to a project administered by the Department of Defense; fashion models; and accompanying aliens.

An H-1B *specialty occupation* requires the theoretical and practical application of highly specialized knowledge. To qualify, an alien must

have a minimum of a bachelor's or higher degree (or the equivalent in experience) as an entry-level requirement. Specialty occupations include, but are not limited to, architecture, engineering, mathematics, physical and social sciences, medicine and health, education, business, accounting, law, theology, and the arts.

To qualify, an alien must have the required U.S. degree or foreign equivalent (or the equivalent in experience) and be licensed to practice in the specialty occupation. A petitioner must obtain a labor condition application for the position involving a specialty occupation.

A second H-1B visa category is designated for *aliens who will perform services of an exceptional nature related to a cooperative Department of Defense (DOD) research and development project*. The DOD H-1B alien must have the minimum of a bachelor's or higher degree in the area in which he or she will be providing services. The employer must show that the alien will be working for a DOD project and describe the alien's duties and projected dates of employment. The employer is also required to provide the names of aliens who are currently employed on the project and whose employment on the project ended within the past year. A labor certification is not required for DOD aliens.

The third H-1B category includes *aliens of distinguished merit and ability* in the arts, entertainment, athletics, and fashion modeling and "accompanying" aliens (see below). To qualify as an alien of distinguished merit and ability, the alien must have documented prominence in his or her chosen field, demonstrated by, but not limited to, sustained national or international acclaim, lead or starring roles in events of distinguished reputation, national or international recognition for achievements or successes, or receipt of significant national or international prizes. The work that the alien is coming to perform must require the services of such a prominent alien or group.

If an employer has not established clear eligibility or ineligibility for the approval or denial of an H-1B petition involving an alien of distinguished merit and ability, the INS must obtain an advisory opinion regarding the alien's qualifications and the nature of the services to be performed. The advisory opinion is obtained from an appropriate union, management organization, critic, or expert in the appropriate field.

A petition for an accompanying alien must be filed in conjunction with the petition for the primary alien. The employer must demonstrate that the accompanying alien is highly skilled and an essential and integral part of the services or performances to be provided. The employer must also demonstrate that such services cannot be performed by U.S. workers. A labor certification is required for aliens coming to the United States to provide the services of a fashion model.

A petition for an H-1B worker is made on Form I-129, “Petition for Nonimmigrant Worker.” It must be accompanied by an approved labor certification, on Form ETA-9035, if required. The petitioner must also submit evidence that the alien and petitioner meet the requirements of the statute.

An H-1B alien with a specialty occupation or of distinguished merit and ability (and accompanying aliens) may be admitted for an initial period of up to three years (maximum six years). A DOD alien may be admitted for an initial period of up to five years (maximum ten years). H-1 aliens who wish to extend their stay, or to be readmitted as H-1s longer than the time limits allow, must first have resided outside the United States for the immediate preceding year.

2.3.7 H-2 temporary workers; H-2A agricultural workers; H-2B nonagricultural workers

The H-2B visa category is for skilled or unskilled workers excluding foreign medical school graduates, on a temporary basis, if United States workers cannot be found to fill the positions. H-2A is for nonseasonal, nonregular agricultural workers. The employer must show that

- There is a temporary need for the type of services or skills to be rendered by the alien.
- There are no United States workers available who are unemployed and qualified to fill the position.

The employer shows that the need is temporary through such factors as the lack of an ongoing or continuous need in the employer’s organization for the skills possessed by the alien—for example, in connection with a special project or the need for an instructor or for technicians to install a new system—or work that recurs according to cyclical need, such as in agriculture (laborers are needed during harvest times) or in resort hotels (a larger staff is needed during vacation months).

The employer demonstrates that there are no U.S. workers by getting a temporary labor certificate from the Department of Labor. This differs from the labor certificate needed for permanent residence in that it is advisory only. The INS makes the final decision.

Note that it is extremely difficult to move from H-2 to permanent resident status while the foreign employee is in the same position. It would be contradictory for the employer to say that the position, which was temporary, is now permanent.

The employer first obtains a temporary labor certificate from the DOL by filing DOL Form ETA 750, Part A. Once the certificate is

obtained, or the DOL declines to certify, the employer files the nonimmigrant visa petition, INS Form I-129, "Petition for Nonimmigrant Worker," with the INS. Form I-129 must be accompanied by the DOL certificate or evidence rebutting the DOL determination that U.S. workers are available. The employer can file for more than one employee at a time.

Once the INS approves the petition, the alien must obtain the H-2 visa at the consulate outside the United States, and be admitted to the United States under that visa. The alien does so by filing State Department Form OF-156, accompanied by the INS approval notice to the employer, plus evidence of intention to leave the United States upon expiration of the stay.

The visa is for a maximum initial period of one year. Extensions are available each year, up to a maximum of three years. The extension is obtained by having the employer obtain a temporary certification from the DOL, and then filing extension requests on INS Form I-129 with the INS office covering the employer's location.

The family of an H-2 alien comes under the H-4 category.

2.3.8 H-3 trainees

The H-3 category is for aliens coming temporarily to the United States as trainees, other than for graduate medical education or training. It generally applies to employers who bring aliens to the United States for a temporary period of training in an established program. The program can be in a classroom and/or on the job, but it cannot displace any U.S. workers. The employer must show that

- The training is pursuant to an established training program run by the employer.
- The training is not available in the home country of the alien employee.
- Any productive employment is incidental to the training program and does not displace U.S. workers.

For the last requirement, a rule of thumb applies: If the alien were not filling the position, would the employer need to fill the position as part of normal operations? If yes, then there is displacement.

The employment must be for a temporary period, and the alien must intend to be in the United States temporarily. The training does not have to be for the employer's foreign branch, but cannot be for a U.S. branch.

The employer files INS Form I-129 "Petition for Nonimmigrant Worker," including documentation on the training program. If similar training is available in the alien's home country, the employer must

explain why training in the United States is necessary. The INS approves it on INS Form I-797. The alien trainee then submits the nonimmigrant visa application, State Department Form OF-156, to the U.S. consulate together with evidence that he or she will depart at the expiration of his or her stay.

The visa is granted for the full length of the training program—generally no more than two years. Extensions are difficult to obtain, but to do so, the employer must file Form I-129.

As with H-1 and H-2, family members of H-3 aliens are category H-4.

2.3.9 J exchange visitors

The J-1 category is for a student, scholar, trainee, teacher, or other who is coming temporarily to the United States to participate in a program designated by the U.S. Information Agency (USIA). The USIA has the authority to designate program sponsors and the terms of the exchange visitor program. Some programs permit employment, some require it, and some prohibit it.

An alien selected to participate in a sponsor's program receives a certificate of eligibility from the sponsor on USIA Form IAP-66. The alien then takes the form to the U.S. consulate abroad together with evidence of intent to leave the United States upon completion of participation in the program. No preliminary INS approval is needed before the alien applies for a nonimmigrant visa on State Department Form OF-156, and is issued a J-1 visa by the U.S. consulate.

A principal disadvantage of a J visa is that many J-visa holders have a two-year foreign residency requirement in their home countries upon completing their program. Such visa holders may not apply for any immigrant visa or for most nonimmigrant visas until they first return to and physically remain in their home country for two years.

J-visa holders are subject to the two-year requirement if:

- The program the alien is attending is financed in any way by the United States or the alien's home country;
- The alien's skills appear on a "skills list," published by the Secretary of State, for the alien's country; or
- The alien came to the United States to get graduate medical training or education.

A waiver of the two-year foreign residency requirement can be obtained if certain conditions are met. It is also advised that J-visa holders verify with the USIA that the two-year foreign residence requirement applies (or still applies) to them, regardless of what the IAP-66 indicates.

Exchange visitors are generally admitted for the duration of their programs, as indicated on their IAP-66 forms. Extensions of stay may be necessary when a program is extended beyond the period initially anticipated or when the specific program admits participants for only limited time increments. The extension application is made on Form I-539 to the regional INS office with jurisdiction over the applicant's residence in the United States.

An exchange-visitor student may be employed if:

- An urgent financial need arose since acquiring exchange-visitor status.
- The employment does not interfere with school.
- The alien obtains written approval of the exchange program's sponsor.

Full time employment is permitted only during school vacations. No specific permission from the INS is required. For teenage students, employment is only permitted up to ten hours per week, and only in noncompetitive jobs such as tutoring, grass cutting, babysitting, and newspaper delivery.

The family of a J-1 alien comes under category J-2. Spouses can obtain permission to work from the INS. The spouse must show that the income derived from employment is not used to support the J-1.

2.3.10 L intracompany transferees

The L-1 category is for an alien who, for one year within the preceding three years, has been employed full time by a company that seeks to transfer the alien temporarily to a U.S. branch of the same company to render managerial or executive services, or services that require specialized knowledge.

The foreign and the U.S. employer must be related as a parent, subsidiary, or affiliate. To be a parent, subsidiary, or affiliate, one company must have effective control of the other, or, a third company, individual, or group of individuals must have effective control over both the foreign and the U.S. employer. Less than 50 percent control is permissible if the party with less than 50 percent has authority to name top managers, make important corporate decisions, and direct the day-to-day operations—for example, the control group owns a substantial block of stock and the rest of the stock is widely dispersed.

Certain accounting firms may qualify to bring aliens to the United States on L-visas. If two or more international accounting partnerships market their services under an internationally recognized name, the U.S. affiliates can apply to bring aliens working for affiliates to the United States on an L-visa. The accounting firms must be working or

organized through an agreement with an international jointly owned coordinating organization.

Managerial duties means that the employee directs the organization or a recognized department subdivision, function, or component of the organization; controls the work of supervisory, professional, or managerial employees; and has authority to hire and fire or recommend the hiring or firing of personnel. Managerial duties also include the exercise of discretion over day-to-day activities over which the employee has authority. They don't include first-line supervisors, unless the employees supervised are professionals. *Executive duties* means that the employee primarily directs the management of the organization, or, as a major component or function of the organization, establishes goals and policies, and has a wide latitude of discretionary decision making, and is supervised generally by higher-level executives, a board of directors, or stockholders.

Specialized knowledge means that an employee has special knowledge of the company, product, service, research, equipment, techniques, management, and their application to international markets, or an advanced level of expertise in the company's processes and procedures.

The employer files INS Form I-129, "Petition for Nonimmigrant Worker," with supporting evidence, and the INS approves it on Form I-797. The employee then goes to the U.S. consulate abroad to apply for the nonimmigrant visa. The alien may show intent to depart at the expiration of his or her stay by showing that he or she was employed by the petitioning company for over a year and is subject to its policy of international transfers.

The INS usually grants permission for three years; the U.S. consulate issues the visa for the same period; and the alien is then admitted at the border for the same period. Extensions of up to two years are available, with each extension more difficult to gain than the last. Extensions may be obtained for up to five years for a worker with specialized knowledge and seven years for other L-visa holders. No extensions beyond these limits are allowed unless the alien has resided outside the United States for the immediate prior year. To get an extension, the employer files Form I-129.

If employers transfer ten or more managerial or executive employees in the preceding year, they can get blanket approval from the INS for intracompany transfers of managers and executives. There is no blanket approval available for specialized-knowledge employees. The employer applies for blanket approval on Form I-129S, "Certificate of Eligibility," with a copy of Form I-797 attached. The employer gives evidence of affiliated relationship of all offices, and designates all positions to or from which transfers may be made. The INS then issues an approval notice that names the company divisions and transferee

positions that qualify. The approved blanket petition is forwarded to the U.S. consulate. The employee then only has to prove to the consulate that he or she has one-year employment in a managerial or executive role with the appropriate division of the organization and intends to leave the United States at the expiration of the employment. The filing of a permanent labor certification or preference petition is not a basis for denying an L-visa petition, nor for an application to extend or change status. An L-visa holder may legitimately have a dual intent to depart the United States at the end of an authorized stay or seek to become a permanent resident.

Family members of L-1 aliens come under category L-2. They have no authority to work unless they separately qualify for some other status.

2.3.11 M nonacademic or vocational students

An M-1 visa is granted to students who have no intention of abandoning their foreign residences, and who enter the United States temporarily in order to attend vocational or nonacademic training programs. This category is similar to F-1, except for the nonacademic nature of the program.

The U.S. Attorney General must recognize the school as a qualified institution. Then the school issues a certificate of eligibility on INS Form I-20M-N to the student. The student brings the form to the U.S. consulate abroad to obtain the M-1 visa. The student must present proof of financial resources to cover expenses without employment in the United States, proof of proficiency in English, and proof of intent to depart the United States at the expiration of the stay. The student must also prove that the training to be received can be used in the home country and that it is unavailable at comparable quality and cost in the home country.

The visa is granted for a maximum of one year. Extensions are requested on INS Form I-539, "Application to Extend—Change Nonimmigrant Status."

Vocational/nonacademic students may not accept employment outside of the training program while in the United States. However, as part of the training program, the INS may authorize one month of practical training for every four months of education, up to a maximum of six months. The student applies for permission to take practical training on INS Form I-539. Training must be related to the course of study and be unavailable in the home country.

2.3.12 O temporary workers of extraordinary ability in sciences, education, and business

The O visa was created by the Immigration Act of 1990 to replace the prior H-visa category of aliens with extraordinary ability in the sciences,

arts, athletics, entertainment, education, and business. An alien of extraordinary ability is one whose ability has garnered national or international acclaim or has met a standard of distinction. The alien's entry must substantially benefit the United States, must be temporary, and must be for work in the alien's area of ability.

To bring an alien in the O-visa classification to the United States, an employer or agent must file with the INS Form I-129 plus Supplement O, "Petition for Nonimmigrant Worker." The petition must be filed within six months of the date that the alien's services will be needed. The petition should include documentation in support of the petitioner's need for a person of the alien's extraordinary ability and the alien's itinerary, if appropriate. The petitioner must also submit an advisory opinion evidencing consultation with an appropriate peer group regarding the services to be performed, whether the position requires a person of extraordinary ability, and the alien's qualifications to perform the services.

Notice of approval will be made on Form I-797. The petition will be approved for the time determined by the INS to be necessary to perform the services in question, but not to exceed three years. The alien's stay can be extended in increments of up to one year to permit the alien to complete the activity for which the alien was initially admitted.

If a strike or other work stoppage is in effect at the place where the alien will be employed, the petition will be denied. The filing of a permanent labor certification or preference petition cannot be a basis for denying an O-visa petition, nor for an extension of a change of status. An O-visa holder may legitimately have a dual intent to depart the United States at the end of an authorized stay or to seek to become a permanent resident.

An O-2 visa may be issued to an alien seeking entry solely for the purpose of accompanying and assisting an O-1 alien. The family of an O-1 alien may come to the United States on an O-3 visa but cannot work, unless granted authorization under some other category.

2.3.13 P performing artists and athletes

The P visa category was created by the Immigration Act of 1990. It allows aliens to come to the United States to perform as athletes, artists, or entertainers. P-1 visas are for athletes who compete at a demonstrated internationally recognized level or pursuant to contract and for entertainment groups that have received international recognition or an appropriate prize or award. A P-1 athlete can enter as an individual or as a part of a group. The athlete must have either a tendered contract to perform services or be able to demonstrate the required level of

performance. A P-1 entertainer can enter only as part of a group. Seventy-five percent of the group's members must have been involved with the group for at least a year and must perform an integral function for the group. A P-2 visa is for artists and entertainers entering under a reciprocal exchange agreement between a U.S. and a foreign organization that provides for the temporary exchange of entertainers and artists. A P-2 visa can be accorded to an alien individually or as a part of a group. The P-3 visa is for artists and entertainers who enter the United States to perform under a program that is culturally unique. The P-3 category requires that the group be prominent and that members of the group or aliens entering as individuals be of distinguished merit and ability.

To bring an athlete, artist, or entertainer, a sponsoring organization or employer must file Form I-129 plus Supplement O, "Petition for Nonimmigrant Worker," within six months of the time that the alien's services will be needed. The petition must be accompanied by documentation of the reciprocal agreement between participating organizations, evidence that an appropriate labor organization was involved in negotiating the agreement, and an advisory opinion from the labor organization that certifies the existence of a viable exchange agreement. The petitioner must show that the performers under the agreement have comparable skill levels, and must show terms and conditions of employment.

Essential support personnel may accompany the athlete, artist, or entertainer. When this is the case, the petitioner must obtain an advisory petition that evaluates the necessity of such support staff and whether there are available U.S. workers who could perform the support services.

Approval of a petition is made on Form I-797. The petition will be approved for the period determined by the INS to be necessary to complete the performance in question, but not to exceed one year. An extension of stay, in increments of one year, may be obtained for an additional period determined by the INS to be necessary to complete the event or performance for which the performer was admitted.

If a strike or other work stoppage is in effect at the place where the alien will be employed, the petition may be denied. The filing of a permanent labor certification or preference petition shall not be a basis for denying a P-visa petition, nor for an extension or change of status. A P-visa holder may legitimately have a dual intent to depart the United States at the end of an authorized stay or seek to become a permanent resident.

Family members of a P-visa athlete, entertainer, or artist may accompany the alien as P-4 nonimmigrants and may not work. (Discussion of P-1 and P-3 visas is based upon proposed regulations.)

2.3.14 Q international cultural exchange visitors

The Q-visa category was created by the Immigration Act of 1990 for international cultural exchange visitors. Its purpose is to provide practical training or employment that involves the sharing and learning of cultural history and traditions between the United States and a participant country. This visa category is similar to the J-visa category.

To bring a Q-visa category exchange visitor to the United States, the employer must apply for exchange program approval and petition for the visitor on Form I-129, "Petition for Nonimmigrant Worker." The employer exchange program must have a cultural component designed primarily to share or explain the alien's culture and history through the alien's employment or training. The employment or training must take place in a public place such as a museum, school, or business. The employer must also pay a wage and provide working conditions comparable to those provided to similarly situated U.S. workers.

To bring a cultural exchange visitor to the United States, an employer must be in business in the United States and must maintain an established international cultural exchange program. The employer must also designate an employee to be responsible for administering the exchange program and act as a liaison with the Immigration Service. Wages paid to the exchange visitor must be comparable to those paid to similarly employed U.S. workers. To qualify as a participant as a cultural exchange visitor an alien must be at least eighteen years old, have English skills sufficient to communicate, must be qualified to perform the work involved, and must not have been in the United States in Q-visa status during the preceding year.

A cultural exchange visitor can stay for a maximum of fifteen months.

2.3.15 R-1 religious workers

The Immigration Act of 1990 established a nonimmigrant visa category that allows religious workers to enter the United States to carry out activities of a religious nature.

To qualify as a nonimmigrant religious worker, an alien must, for at least two years immediately preceding admission to the United States, have been a member of a religious denomination having a bona fide nonprofit religious status in the United States. The alien must be coming to the United States solely to work as a minister, to work in a professional capacity for a religious organization, or to work in some other religious occupation or vocation. A petitioning organization for which the alien will be working must have a bona fide nonprofit status under IRC Section 501(c)(3).

The employer must file for a religious worker on Form I-129, "Petition for Nonimmigrant Worker." The employer must submit evidence that documents that the employer is a qualifying organization and the alien's qualifications meet the requirements of the statute. The employer must also certify that the alien will be compensated for the duties to be performed and in what manner.

An approved religious worker will be authorized for an initial period not to exceed three years. This initial period may be extended for up to two years.

A religious worker's family may be admitted on an R-2 visa and may not accept U.S. employment.

3. LAWFUL PERMANENT RESIDENCE

A *permanent resident* is an alien who has received indefinite permission to live and work in the United States. A permanent resident is sometimes referred to as a "green card" holder, but today, the card is printed on white paper and laminated with a photo similar to many types of driver's licenses. Permanent residence (and therefore, immigration) is confined to

- Special immigrants.
- Immediate relatives of United States citizens.
- Close relatives of citizens and permanent residents.
- Persons with offers of permanent employment in the United States when U.S. workers are in short supply.

An alien qualifies for permanent residence by applying for an immigrant visa while abroad or by adjustment to permanent residence status. Before 1994, only certain aliens who maintained lawful status before application for permanent residence were eligible to adjust their status. In October 1994, the law changed, allowing previously ineligible applicants to apply for residence in the United States by paying a substantial penalty fee in addition to the standard filing fee, along with filing Form I-485, Supplement A. That change had particular impact on aliens who were immediate relatives of U.S. citizens but who had entered the United States illegally and on other applicants who had resided illegally in the United States after an initial lawful entry. Under a concomitant provision, applicants who are eligible to adjust for a visa overseas, are subject to a 90-day exclusionary period; that is, they are barred from readmission to the United States for 90 days. This provision was due to sunset on September 30, 1997.

In 1996, Congress amended the law to make aliens who have worked without authorization, entered illegally, or resided unlawfully in the

United States ineligible to adjust their status in the United States. The penalty provision described above has been deemed by non-IRS practitioners to protect an alien's right to apply for adjustment of status, at least until the provision sunsets. Only implementing regulation will determine for certain how the penalty provision interacts with the 1996 changes in the law.

The law sets no limit on the number of immediate relatives who may obtain permanent residence status, but it sets a yearly limit on all others, with a maximum number in each preference category and a maximum number from each foreign state and dependent area.

Within the yearly limit, 480,000 are allocated to family-sponsored immigrants and 140,000 to employment-based immigrants. Visa numbers are also allocated to other visa categories as prescribed by law. Visas given to immediate relatives, although not subject to numerical limitation, will count against the worldwide totals, potentially limiting the number of visas available to preference immigrants.

3.1 Based Upon Immediate Relative

3.1.1 Definition

Immediate relatives of a United States citizen include

- Children (under the age of twenty-one).
- Spouses.
- Parents (provided the citizen is over twenty-one).
- Widows and widowers who were married to the U.S. citizen for at least two years before the spouse's death.

The term *spouse* means legally married, even if currently separated, as long as the marriage was bona fide and there has been no legal separation agreement or divorce. Marriages entered into for immigration purposes are not bona fide.

Children means unmarried sons and daughters under age twenty-one. A stepchild is considered a child if the step relationship was formed before the child turned eighteen. An adopted child is considered a child if adopted before age sixteen, together with other requirements. An illegitimate child is considered a child of the mother or of a father who has or who has had a bona fide parent-child relationship with the illegitimate child. For sons and daughters married or over twenty-one, see section 3.2.

Parents of a U.S. citizen (if the U.S. citizen is over twenty-one)—The age requirement is designed to discourage foreign nationals from coming to the United States to give birth to their children in order to

have them immediately sponsor the parent for permanent residence. Natural fathers will be entitled to receive or petition for benefits if they have or had a bona fide parent-child relationship.

Widow and widower of U.S. citizen (married at least two years at the time of the U.S. spouse's death)—To qualify as an immediate relative, an immigrant petition must be filed on the alien's behalf within two years after the spouse's death, and the alien relative must not have remarried.

3.1.2 Procedure

The U.S. relative is the *petitioner* and the alien is the *beneficiary*. The petition is filed on INS Form I-130, "Petition for Alien Relative," or I-360, "Petition for Amerasian, Widow(er) or Special Immigrant," with the INS office covering the U.S. relative's residence, unless the alien is in the United States and eligible for adjustment of status. The alien's place of U.S. residence would determine the INS office for filing purposes. If both petitioner and beneficiary are located in the same consular district abroad at the time of petition filing, the petition must be submitted to the INS office covering the U.S. relative's residence. The petition is filed together with

- Evidence of U.S. citizenship of the petitioner, such as a birth certificate, certificate of naturalization, or unexpired U.S. passport.
- Birth certificate of the beneficiary, showing the names of the parents.
- If the beneficiary is the petitioner's spouse, the marriage certificate of the parties, plus evidence of termination of all prior marriages.
- If the petitioner is the father of the beneficiary, the parent's marriage certificate and evidence of termination of all prior marriages.
- If the petitioner is the child of a male beneficiary, the birth certificate of the petitioner and the parents' marriage certificate and evidence of termination of all prior marriages. If the petitioner is the child of a female beneficiary, simply the child's birth certificate showing the mother's full name is sufficient.
- If the petitioner is the brother or sister of the beneficiary through a common mother, the birth certificates of both parties. If the relationship is through a common father and different mothers, the parents' marriage certificates and evidence of termination of all prior marriages.
- If the parent-child relationship is based on adoption or legitimation, a certified copy of the adoption decree or evidence of legitimation.
- If either the petitioner or beneficiary is a married woman, her marriage certificate, to show change of natal surname.

It is recommended that the petitioner and applicant submit only certified copies of all required documents to the INS, rather than originals, unless originals must be submitted, as in the case of applications themselves and naturalization certificates. Documents may be certified by an attorney or an INS official who is shown the original to prove that the copy is an exact duplicate. Applicants and petitioners may also certify their own documents by completing a half-page form provided by the INS.

The INS may investigate when documents cannot be produced. If a marriage has attributes typical of a sham, an investigation, lasting years, is likely. To expedite the approval process and limit potential investigation, it is suggested that married applicants submit documentation in support of the *bona fides* of their marriage. Such documentation could include, but is not limited to, wedding invitations or announcements; wedding photos; evidence of correspondence or other communication before marriage; sworn affidavits from friends, family, and others documenting the genuineness of the relationship; joint leases, mortgages, bills, credit cards, bank accounts, loans, or major purchases; evidence of designation of a spouse as beneficiary under health, life insurance, or other benefits; and birth certificates or adoption decrees for any children.

If the alien's relationship is based upon a marriage that occurred less than twenty-four months previously, he or she is conditionally admitted. The alien beneficiary and the petitioner must file a joint petition within the ninety days just before the second anniversary of the conditional admission to prove that the marriage was *bona fide*. The petitioner and beneficiary may also be required to appear at an INS interview. If no petition is filed, if the petitioner or beneficiary fail to appear for a scheduled interview, or if the petition is denied, the alien may be deported.

The INS can waive the joint petitioning requirement and remove the condition if the alien spouse files a waiver. The alien must prove that the *qualifying* marriage was entered into in good faith by the alien spouse and that the alien is not at fault for failing to file a joint petition, and that

- Extreme hardship (based upon circumstances that arose during the period that the spouse was a conditional resident) would result if the alien were deported;
- The marriage has been terminated by the alien; or
- During the marriage the alien spouse or child was battered or subjected to extreme cruelty by the U.S. citizen spouse or parent.

To be eligible the alien must file for the waiver before the second anniversary of obtaining permanent residence. However, if a joint petition has been timely filed but, for some reason, a U.S. spouse fails to follow through, a waiver may be filed even after the second anniversary.

If a marriage is determined to have been entered into solely for the purpose of evading immigration laws, both the alien and the petitioning spouse are subject to being charged with marriage fraud, carrying penalties of up to five years in prison and \$250,000 in fines.

If an immigrant relative petition is denied, the denial can be appealed to the Board of Immigration Appeals in Washington, D.C. After administration appeals are exhausted, the denial can be subject to review in the federal district courts. The denial of a joint petition or waiver thereof can be reviewed, *de novo*, by an immigration judge in deportation proceedings.

3.2 Based Upon Special Immigrant Status

Special immigrants include

- Permanent residents returning from temporary visits abroad.
- Former U.S. citizens reapplying for citizenship.
- Ministers of religious orders and religious workers (accompanied by their spouses and children) who have been engaged in their religious vocations for at least two years and whose denominations have a bona fide U.S. organization.
- Certain U.S. consular employees from Hong Kong.
- Certain employees of the U.S. government or the Panama Canal Company.
- Doctors and their families who have been licensed to practice in a state on or before January 8, 1978, were practicing in a state on that date, entered the United States on an H or a J visa before January 10, 1978, and were continuously present and practicing or studying medicine in the United States since their date of entry.
- Certain officers of international organizations and their families who have lived in the United States for a lengthy period.
- Certain juveniles declared dependent upon a court in the United States.
- Immigrants who served honorably on active duty in the U.S. military during certain conflicts.

Practically viewed, very few persons qualify as special immigrants.

3.3 Based Upon Family Preferences

With the exception of immediate relatives of U.S. citizens and special immigrants, all other classes of immigrants are subject to numerical limitations. There is a worldwide ceiling of 480,000 family-based immigrant visas per fiscal year (55,000 are allocated to family members of legalized aliens for the years 1991–1994). (The federal government's fiscal year ends September 30.)

There is a per-country ceiling of approximately 25,620 visas per year. Dependents from independent countries receive a maximum of approximately 7,320 immigrant visas per year. Presently most countries do not come close to their maximum, but certain countries have long waiting lists.

An alien is charged to the country of his or her birth, not the country of residence. However, there are some exceptions:

- A spouse is charged to the other spouse's place of birth when a visa is not available from the spouse's country.
- Minor children (under twenty-one) are charged to the place of birth of the parent whom they are accompanying to the United States.
- Former U.S. citizens by birth are charged to the country of citizenship: if stateless, to their country of residence.
- A person born in a country in which neither parent was born may be charged to either parent's place of birth if the parents did not have a residence and they had no intention to remain indefinitely in the country of the child's birth at the time of birth. This was considered the missionary clause: Children of missionaries on temporary assignment in a populous foreign state could receive more beneficial visa chargeability from the parents' native country. It has proved most useful, however, for Hong Kong-born Chinese whose parents were in Hong Kong temporarily while fleeing either the Japanese during World War II or the communist forces following the war.

The 480,000 family-based annual visas are apportioned among four preference categories. It is possible that a country will not have used its maximum, but that no visas are available to it in a particular preference category. The family-based preference visas include:

- *First Preference*: Unmarried sons and daughters of U.S. citizens. This means sons and daughters over twenty-one, since children under twenty-one are immediate relatives (no numerical limit).

- *Second Preference*: Spouses and unmarried sons and daughters of permanent residents. This means all unmarried children of residents, over or under age twenty-one. Usually, family members of permanent residents will become residents at the same time, but children over age twenty-one cannot qualify for derivative status. “Unmarried children” includes divorced or widowed persons.
- *Third Preference*: Married sons and daughters of U.S. citizens. This includes all married offspring, whether over or under age twenty-one. The spouse and child of a qualifying son or daughter are also included.
- *Fourth Preference*: Brothers and sisters of U.S. citizens. The U.S. citizen must be twenty-one or over and must have a common parent. The spouse and child of a qualified sibling are included.

The procedure to be followed is essentially the same as that for immediate relatives.

3.4 Based Upon Employment

3.4.1 Categories of employment-based immigrants

1. Priority workers

Aliens with extraordinary ability. These aliens are defined as that small percentage of individuals who have risen to the very top of their fields in the arts, sciences, education, athletics, and business. They must have sustained national or international acclaim and documented, recognized achievements. They enter the United States to work in areas of ability and to perform work that would substantially benefit the United States.

Outstanding professors and researchers. These aliens must have international recognition as outstanding in their chosen field and a minimum of three years of teaching or research in that field. They enter to work in a tenured or tenure-track teaching or research position.

Certain multinational executives and managers. These aliens must have at least one year of employment with the petitioner within the last three years preceding petition and intend to continue work for the employer. The employer must be a multinational company or its subsidiary or affiliate. This classification includes international accounting firms, as discussed in section 2.3.10, herein.

2. Professionals holding advanced degrees

The minimum entry requirement is a U.S. degree or foreign equivalent higher than a bachelor’s degree or equivalent experience.

Aliens of exceptional ability. This immigration category covers the sciences, arts, or business. It requires a degree of expertise significantly above that ordinarily encountered in the applicable field. Work must substantially benefit the United States and the alien must have more than a mere degree or license. These positions require labor certification.

3. Skilled workers

These immigration categories require at least two years of training or experience that is not seasonal or temporary.

Professionals with basic degrees. This immigration category requires a U.S. bachelor's degree or foreign equivalent as an entry-level requirement.

Other workers. This immigration category includes skilled and unskilled workers with less than two years of training or experience that are not seasonal or temporary.

All Category 3 jobs require labor certification.

4. Certain special immigrants

Religious workers. The alien must have been a member of a religious denomination that has a nonprofit status as a religious organization in the United States for at least two years immediately preceding the filing of the petition. The alien must be coming to the United States to work as a minister, religious professional, or in some other religious capacity, such as in a religious occupation or vocation.

Certain employees of the U.S. embassy in Hong Kong. The alien must have been an employee, or family member thereof, of the embassy for at least three years. The employee must be subject to a threat because of employment by the U.S. government and there must be a recommendation that the alien is in exceptional circumstances.

5. Investors

This category includes aliens who invest at least \$1 million in capital in a new enterprise and employ at least ten U.S. workers full time or who invest \$500,000 in a targeted area such as a rural or high-unemployment area. An alien can also qualify if he or she: (1) invests capital in an existing enterprise that results in an increase in net worth or employees of at least 40 percent; or (2) takes over a troubled business and saves existing jobs for at least two years. Immigrant investors are subject to a two-year conditional residence.

This allocation is 10,000 visas per year, with 3,000 reserved for targeted areas.

3.4.2 Labor certification

Jobs can be separated into three broad categories: (1) those that are in chronic short supply, which have been precertified (see Appendix

2 of this chapter); (2) those for which there are surplus workers and thus cannot be used for employment-based petitions, unless a waiver is obtained; and (3) those that require individual certification. The labor certification procedure is discussed in detail in section 4, herein.

3.4.3 Petitioning procedure for employment-based aliens

When an employer files a petition on behalf of an immigrant worker, the employer is the “petitioner” and the alien is the “beneficiary.” The immigrant visa petition is filed on Form I-140, “Immigration Petition for Foreign Worker,” or in the case of a special immigrant, on Form I-360, “Petition for Amerasian, Widow(er), or Special Immigrant.” The petition is filed with the INS service center that has jurisdiction over the place of employment.

The employer must submit evidence that it can pay the employee the proffered wage and that the employee meets the qualifications for the immigrant classification under which the alien is seeking to immigrate.

The petition might have to be accompanied by an approved labor certification. If a labor certification is required, the “priority date” for the petition is established as of the date that the application for labor certification is filed with the Department of Labor. All other priority dates are established as of the date of filing the immigrant visa petition.

Once a petition is approved, the beneficiary can apply for adjustment of status in the United States, if eligible, on Form I-485, “Application for Permanent Residence.” If not eligible to adjust, the beneficiary can apply for an immigrant visa at a U.S. consular post outside the United States.

3.5 Final Application for Immigrant (Permanent Resident) Status

Once the INS has approved an alien person for a preference, the alien makes the final application for residence. Two methods are used: If the alien is already in the United States, status in certain circumstances may be adjusted at the INS district office with jurisdiction where the alien resides, or the alien may submit an immigrant visa application at the U.S. consulate where the alien resides or last resided abroad.

When the alien is ineligible to apply for resident status while in the United States or is not in the United States, the petition is decided by the INS and sent to a national visa “clearinghouse” known as the National Visa Center (NVC). The NVC then sends it to the appropriate U.S. consulate abroad. At the consulate, the final decision is made,

including consideration of the nine major grounds of exclusion. Consular officers are generally concerned with financial means, medical infirmities, criminal convictions, and political affiliations. The consulate notifies the applicant when the approved petition is received. If a visa number is currently available under the numerical limitation system, the consulate sends Packet Three, which includes a biographical form, State Department Form OF-169. The applicant gathers all documents and notifies the consulate that he or she is ready for the final interview. At the interview, the applicant takes a medical exam, presents all supporting documents, and two completed copies of State Department Form OF-230, the immigrant visa application. The usual supporting documents submitted are

- Applicant's passport.
- Birth and marriage certificates.
- Police certificates from each place of residence of six months or more.
- Any court and prison records.
- Military service records.
- Photos.
- Evidence of financial support in the United States, such as a letter from a prospective employer or an affidavit of support from a relative. All documents must be in English or be presented along with English translations.

3.5.1 Adjustment of status

When aliens are located in the United States, they may be eligible to have their status changed from nonimmigrant to immigrant without having to apply to the U.S. consulate abroad. This process is called *adjustment of status*.

An alien present in the United States may have status adjusted to that of permanent resident if—

- The alien is eligible to receive an immigrant visa.
- A visa is immediately available. (This means that either the alien is applying under a category without a numerical limit, or the backlog for his or her preference class has caught up to the priority date.)
- The alien is a preference immigrant who has maintained continuous legal immigration status in the United States to the date of the adjustment application or is the immediate relative of a U.S. citizen.

Certain aliens who have a visa immediately available to them but do not meet all of the other requirements listed above may be able to

adjust status in the United States upon submitting a penalty fee and Form I-485, Supplement A. Because of a change in the law in 1994, certain aliens who were previously ineligible may apply for adjustment of status. These aliens include, but are not limited to: (1) immediate relatives of U.S. citizens who entered the United States illegally or (2) preference immigrants who have not maintained lawful status before an application for adjustment of status. The legal provision that allows for adjustment under these circumstances sunset on September 30, 1997.

An alien is *not* eligible for adjustment of status if he or she has been—

- Admitted as a crewman.
- Admitted in transit without a visa.
- Admitted on a finance visa, unless married to the citizen who initially filed the finance petition.
- Admitted on the Visa Waiver Program, unless the immediate relative of a U.S. citizen.
- Admitted on an S nonimmigrant visa.
- Engaged in unauthorized employment or otherwise violated the terms of a nonimmigrant visa and is not an immediate relative of a U.S. citizen or certain special immigrants.

Aliens who obtain immigrant status through marriage to a U.S. citizen or lawful permanent residence are granted conditional residence (unless already married for two years at the time resident status is granted) and technically are not “adjusted” to lawful permanent residence. They are, however, accorded the same rights as other permanent residents, except that their conditional residence is valid for only two years.

The advantage to adjustment of status is that the alien may remain in the United States while his or her application is processed in the United States. An alien precluded from applying for adjustment of status may apply to a U.S. consul abroad.

The availability of an immigrant visa depends upon the “priority date” the alien has established. The length of time a beneficiary will have to wait for a given visa can be determined by consulting a timetable of visa availability published monthly by the State Department. The dates given on the table are the dates at which beneficiaries now getting their visas initially got their priority dates.

The priority date is established at the time of filing first papers, that is, the immigrant relative preference petition for close family members and certain employment-based immigrants, the labor certificate

application for job offer immigrants, or the preference petition for job offer immigrants pre-certified under DOL Schedule A.

Since there is no limit on the number of persons who can become permanent residents as immediate relatives of citizens, visas are always immediately available, and the adjustment application can be filed by eligible applicants simultaneously with the immediate relative petition. For other family-based preference categories with no backlog, the same holds true. For family preferences with a backlog and employment-based petitions, the adjustment application cannot be filed with the petition. Such concurrent filings for employment-based immigrants were eliminated by the Immigration Act of 1990. The application for adjustment/residence must be filed after a petition is approved.

The adjustment application is filed on INS Form I-485, "Application for Permanent Residence" (or I-360 in the case of a petition for a special immigrant or widow[er]), at the INS office with jurisdiction over the alien's U.S. residence. If the immediate relative or family-based preference petition is filed simultaneously with the adjustment application, both forms are filed together where the foreigner lives, even if the petition alone would have been filed in a different INS office.

The application is filed with a biographical information form, Form G-325A, fingerprints on FBI Form FD-258, and two identical photos. The same forms are required for each family member, except that there is no need to file separate Forms G-325A and FD-258 for family members under fourteen years of age. However, documents must establish the family relationship.

The medical exam and the interview are next. The INS determines whether any of the nine major grounds for exclusion apply. At the interview, the applicant presents his or her passport, INS Form I-94 (arrival/departure card), and medical exam report, together with evidence of financial support, such as a letter from a current employer.

3.6 The Immigration Reform and Control Act of 1986

On November 6, 1986, heated debate over U.S. immigration policy was brought to a close with the Immigration Reform and Control Act of 1986 (IRCA). The history of the IRCA can be traced back to the establishment in 1978 of a select commission that presented its findings in the *Final Report of the Select Commission on Immigration and Refugee Policy* in early 1981. The two key conclusions drawn by the commission and reflected in the IRCA were that legal immigration is beneficial to the

United States and that employer sanctions are the most effective means of reducing illegal immigration.

3.6.1 Legalization (amnesty)

One of the major provisions of IRCA granted legalization, and temporary and eventually permanent residence, to approximately three to six million illegal aliens. Until May 4, 1988, qualified illegal aliens were eligible to apply for amnesty.

3.6.1.1 Special agricultural workers (SAWs)

Certain agricultural workers were eligible to apply for temporary residence if they performed qualifying agricultural work in the United States.

Qualifying SAWs who applied for and were granted temporary residence and were adjusted to permanent residence almost automatically as of December 1, 1989 (group 1), or December 1, 1990 (group 2). SAWs were required to apply between June 1, 1987, and November 30, 1988.

Most aliens who obtained lawful status through the legalization or special agricultural worker programs have adjusted their status to that of lawful permanent residence. Many are eligible to become U.S. citizens. Although a number of class action suits have yet to be resolved, the initial goal of IRCA has been accomplished. A remaining issue is the status of family members of aliens who were granted legalization of SAW status.

3.6.1.2 Unity for families of legalized aliens

Spouses and unmarried children under the age of twenty-one of legalized aliens are eligible to apply for a temporary stay of deportation and work authorization until they are eligible to obtain immigrant status.

To qualify for the family unity program the applicant

- Must have entered the United States and continuously resided in the United States since May 5, 1988; and
- Must be the spouse or unmarried child (under twenty-one) of a legalized alien as of May 5, 1988.

Application for the family unity program is made on Form I-817 and should include evidence of the legalized alien's status; evidence of the family relationship and continuous residence in the United States since May 5, 1988; and a Request for Employment Authorization (Form I-765), if desired.

Aliens who have been convicted of a felony or three or more misdemeanors, who are a threat to national security, or who have

engaged in the persecution of others, are disqualified from applying for family unity.

Aliens who are granted family unity are placed in a “voluntary departure” status and are identified as deportable. They are also ineligible to receive certain forms of public assistance.

4. LABOR CERTIFICATION

The Immigration and Nationality Act specifies that an alien is ineligible for a visa if he or she is seeking to enter the United States for the purpose of employment *unless* the Secretary of Labor certifies to the Secretary of State and the Attorney General that

- There are not enough workers who are able, willing, qualified (or equally qualified if the alien is a teacher or has exceptional ability in the arts or sciences), and available at the time of the application and the place for the job.
- The employment of the alien will not adversely affect the wages and working conditions of similar U.S. workers.

Thus, for aliens seeking visas under the third and sixth preference classes, certification is first required that will meet the foregoing standards. The certification is made by the Department of Labor.

4.1 Employment Classifications

The Secretary of Labor has established two schedules of occupations. Schedule A includes those occupations for which a predetermined shortage exists, and Schedule B includes those occupations for which an ample supply of U.S. workers exists.

4.1.1 Schedule A—professional

The occupations that are listed in Schedule A include the following groups:

Group I.

- Physical therapists qualified to take the licensing examination in the state in which they will practice.
- Nurses who are licensed in the state in which they will practice or have passed the Commission on Graduates of Foreign Nursing Schools (CGFNS) examination.

Group II. Artists and scientists of exceptional ability (excluding performing artists), including college and university teachers who have been practicing their profession for at least a year and intend to practice the same art or science in the United States.

Note: Groups III and IV of Schedule A have been tentatively removed by interim regulations implementing the Immigration Act of 1990.

4.1.2 Schedule B—low level/entry level

Schedule B includes forty-nine occupations such as clerks, cleaners, receptionists, typists, laborers, and taxi drivers. These are generally low-skill-level or entry-level jobs. An employer may petition for a waiver for any particular job.

4.1.3 Occupations on neither schedule

For Schedule A, there is a predetermined shortage and for Schedule B, a predetermined surplus of U.S. workers. Applications for occupations falling on neither schedule are considered on a job-by-job basis. Most applications fall into this category.

(Text continued on page 39)

4.2 Application for Labor Certification

4.2.1 Who files

The employer files the application for labor certification. The application may be filed on the employer's behalf by an agent, who need not be an attorney. Since a labor certification is a complex process subject to denial if not done in a certain way, it is recommended that an inexperienced employer seek the assistance of an immigration lawyer or other representative with experience in filing labor certifications. The employer is called the *petitioner* and the alien employee is called the *beneficiary*.

Labor certifications are not required for Schedule A employees. Appropriate documentation to demonstrate Schedule A eligibility is filed together with the preference petition with the INS. Other labor certifications are determined by the Department of Labor.

4.2.2 What must be filed

All employers must show the following:

- The employer has the funds to pay the employee's salary.
- The wage to be paid to the alien equals or exceeds the prevailing wage.
- The wage is based on regular payments, not extras or bonuses.
- The employer is not discriminating on the basis of race, creed, sex, age, or handicap.
- The job is not vacant due to a strike or labor dispute.
- The job opportunity does not violate any laws.
- The job has been open to United States workers.
- The application is sworn or affirmed.
- All documents are in English or contain English translations.

4.2.3 Basic certification process

The employer files the application in duplicate on Form ETA 750, "Application for Alien Employment Certification." The statement of the alien's qualifications is signed by the alien and the description of the job offer is signed by the employer. The employer also must show that, except for Schedule A occupations, good-faith efforts were made to hire United States workers and must show who was interviewed and, for what job-related reason, not hired.

As part of the labor certification process, the employer must provide notice of the filing to

- The bargaining representative for the employees in the occupation or area for which the alien is sought; or if no bargaining representative exists,
- Employees themselves by posting a notification of the filing in a conspicuous place in the workplace.

Any third party has the right to comment or submit evidence that bears on the application for labor certification. Such information is likely to consist of, but not be limited to, information on current wages or working conditions in the workplace, failure of the employer to meet those conditions, or documentation of available United States workers for the job sought by the alien.

The local job service office will calculate the prevailing wage for the job. If the wage offered by the employer is less, the employer must increase it or the application will be denied.

After receiving the application, the local job service office will attempt for thirty days to recruit a United States worker to fill the job, and, during that time, the employer must place advertisements in general circulation newspapers, professional journals, or ethnic publications. However, if the employer documents all previous attempts to recruit a United States worker, the job service office may reduce or eliminate further recruitment efforts for all jobs except Schedule B occupations.

4.2.4 Schedule A

Applications for Schedule A occupations are filed with an employment-based preference petition with the INS office in the United States, not with the Department of Labor or state job service office. The alien must show prearranged employment by having the employer complete and sign the job offer description portion of the application.

The INS or Department of State determination whether or not an alien qualifies under Schedule A is final and not subject to review.

4.2.4.1 Schedule A—*special handling*

Applications for a college or university teacher or an exceptional performing artist are designated by special handling.

Teacher. The employer must submit documentation to show competitive recruitment, why the alien is better qualified than other applicants, the faculty report evaluating the alien applicant, and copies of the advertisements in professional journals concerning the job opening.

Performer. The employer must show documents attesting to the artist's current widespread acclaim and receipt of prizes or awards, published critical reviews, evidence of earnings commensurate with the claimed level of ability, and playbills from performances.

For the following Schedule A groups, certain specific kinds of evidence or demonstrations must accompany applications.

Group I. The alien must submit proof of license. In addition, if the alien is a doctor seeking work in an understaffed part of the United States, the alien must submit a statement signed by the Department of Health and Human Services attesting to the doctor shortage in that particular specialty for that particular geographic area. The alien obtains this by written request to the appropriate HHS Regional Health Administrator.

Group II. The alien must submit documentary evidence of international recognition, such as

- Prizes and awards.
- Memberships in international organizations.
- Published material about the alien.
- Evidence of work on panel, as a judge of the work of others in the same or an allied field.
- Original significant contributions to the alien's field.
- Scholarly publications.
- Evidence of artistic exhibitions in more than one country.

4.2.5 Schedule B

The Secretary of Labor has determined that allowing aliens to fill Schedule B occupations adversely affects United States workers, and thus aliens are generally proscribed from filling Schedule B occupations. Nevertheless, the employer or the employer's agent or attorney may petition for a waiver for a certain job in a specified geographic area.

To obtain a waiver, the employer must show documentary verification that he could not fill the job during thirty-day recruitment efforts with the state job service office.

4.2.5.1 Temporary agricultural workers

Due to the nature of the business, employers of agricultural workers have an expedited application procedure.

The employer must show that there are not sufficient United States workers able, willing, and qualified, and that employment of the alien will not adversely affect United States workers' wages and conditions. Under regulations, the Secretary of Labor may set a deadline for ap-

plications up to sixty days before the job is to start. The Secretary will give notice within seven days to the employer if there are deficiencies in the application, and will issue the labor certifications at least twenty days before the job begins. Agricultural associations may apply on behalf of groups of employers, and expedited administrative appeal procedures apply.

An employer's application will be denied if

- There is a strike or lockout.
- During the previous two years, the employer hired temporary agricultural alien workers in violation of the law.
- The employer does not prove provision of workers' compensation.
- The employer does not prove an attempt to recruit U.S. workers.

Any alien violating the condition of a labor certification granted under this provision (for example, working without employment authorization) is disqualified for five years.

4.2.5.2 Live-in domestic workers

For a live-in domestic worker, the employer must submit a statement describing the living accommodations and two copies of the employment contract showing

- Hourly and weekly wages.
- Hours of employment per week and exact hours per day.
- That the alien may leave the premises during off-hours, except if paid overtime.
- That the alien will reside on the premises.
- Duties to be performed.
- Advances made by employer, with details.
- That the alien need not give more than two weeks' notice to resign and that the employer will give at least two weeks' notice of termination.
- That a copy of the contract was given to the alien.
- That private room and board will be provided to the alien at no charge.
- Any other terms or conditions of employment.

Additionally, the application must document the alien's past work experience, showing at least the equivalent of one year of full-time employment as a domestic worker.

4.2.6 Where to file for labor certification

Schedule A. The Application for Alien Employment and the visa petition are submitted to the INS district director at the location of the intended employment.

All others. The Department of Labor Application for Employment Certification is submitted to the local state job service office at the location of the intended employment.

4.3 Labor Certification Decision and Administrative Review

When a decision has been reached on the labor certification application, the Department of Labor notifies the employer in writing, with a copy to the alien.

If the labor certification is not granted, then a Notice of Findings is issued to the employer and the alien, showing the date and the specific reasons for the Notice of Findings.

4.3.1 When to file for review

The employer has thirty-five days from the date of the Notice of Findings to submit evidence to correct defects or rebut the findings. If a response is not mailed by certified mail by the thirty-fifth day, then the decision is final. The failure to file a rebuttal will be deemed a refusal to exhaust administrative remedies, which means that the employer cannot request judicial review of the adverse decision.

4.3.2 Scope of filing

Rebuttals and additional evidence may be submitted by the employer or by the alien if the employer also makes a submission. All findings not rebutted are deemed admitted.

The request for review should contain only legal argument and evidence that was in the record; new lines of argument cannot be opened on review.

4.3.3 Hearings

The certifying officer prepares an appeal file after receiving the request for review. Copies are sent to the administrative law judge or Board of Alien Labor Certification Appeals (BALCA) and Solicitor of Labor in Washington, D.C., and to the employer and the alien. The employer and alien may examine the record and suggest additions. The suggestions are sent to the administrative law judge, with copies to the Solicitor of Labor.

An administrative law judge is designated to hear the case and direct the submission of briefs. The judge then can affirm the denial, direct that the certification be granted, remand the case to the certifying officer for further consideration or fact-finding, or order a hearing.

At a hearing, the Solicitor of Labor represents the Department of Labor. The administrative law judge, while able to question witnesses, is not an advocate for either party. The parties can present, examine, and cross-examine witnesses, but technical rules of evidence do not apply.

The administrative law judge decides issues of fact and law, but cannot consider any arguments that the immigration law may be invalid or unconstitutional. The judge issues a written decision, sending copies to the alien, the employer, the certifying officer, and the solicitor.

An adverse decision of the administrative law judge is subject to review by the federal courts. This should be handled by an attorney experienced in immigration cases.

4.4 Refiling After Denial

If an application for labor certification has been denied, it may be refiled six months after the denial. If the denial was solely because the wage offered was less than the prevailing wage, it may be refiled immediately. For Schedule A occupations, it may be refiled at any time.

4.5 Validity of Labor Certification

4.5.1 Duration and effective date

Once granted, a labor certification continues indefinitely. For Schedule A, it is effective as of the date stamped by the INS; for all others, it is effective as of the date the local job service office date-stamped the application. The effective date determines the priority date for a visa application.

A labor certification may be invalidated for fraud.

4.5.2 Geographic and occupational scope

For Schedule A occupations, the labor certification is valid for the occupation. It is limited in area only if the certification so specifies.

For other occupations, the labor certification is valid only for the particular job offer.

5. INELIGIBILITY FOR VISAS— EXCLUSION

5.1 Determination of Excludability

As described above, the determination of excludability is made by the U.S. consul before a visa is issued, and may be redetermined by the INS at a port of entry to the United States.

5.2 Grounds for Exclusion

The Immigration and Nationality Act sets forth nine major grounds of inadmissibility to the United States. Applicants for adjustment of status are also subject to grounds of inadmissibility. The list includes

Medical grounds—Aliens with contagious disease, physical or mental disorders that pose a threat to the alien or others, drug addiction, and failure to present proof of certain vaccinations.

Criminal grounds—Aliens with crimes of moral turpitude, drug convictions, multiple criminal convictions, prostitution, domestic violence, stalking, and felony convictions.

Security or related grounds—Aliens engaged in espionage, or who are seeking to overthrow the government, who threaten U.S. foreign policy, who have present, voluntary membership in a totalitarian party, are Nazis, or are terrorists.

Public charge—Aliens who are likely to become a public charge.

Employment—Aliens seeking to enter on the basis of employment without a labor certification, if required, and certain foreign medical graduates.

Immigration violations—Aliens who have been deported or excluded, who have sought or obtained a visa by fraud; who have made a false claim to U.S. citizenship after September 30, 1996; certain aliens who have resided unlawfully in the United States for six months or more for an aggregate of twelve or more months after April 1, 1997; certain aliens who have entered the United States illegally; and stowaways and smugglers.

Documentation—Aliens who seek entry without proper documentation.

Citizenship—Aliens determined to be ineligible for citizenship (draft evaders and most who obtain exemption or discharge from military service on the grounds of being an alien).

Other—Aliens who are practicing polygamists, who are accompanying an excludable alien, who withhold or retain custody outside the United States of a child of a U.S. citizen who has been granted custody by a U.S. court, certain aliens who have voted unlawfully in a U.S. election, and U.S. citizens who have renounced U.S. citizenship to avoid U.S. taxation.

Certain classes of excludable aliens may be eligible for a waiver of excludability. To qualify for a waiver, an alien must generally have a close U.S. citizen or permanent resident family tie (spouse, parent, or child) in the United States or have resided in the United States for at least seven consecutive years.

6. APPLYING FOR U.S. CITIZENSHIP

6.1 Requirements

The process of applying for U.S. citizenship is called *naturalization*. The requirements are

- Lawful admission as a permanent resident of the United States.
- Continuous residence (not necessarily physical presence) in the United States for at least five years immediately preceding the filing of the petition for naturalization (three years for spouses of U.S. citizens).
- Physical presence within the United States for an aggregate total of at least one-half of the period of residence (two and one-half years; one and one-half years for spouses of U.S. citizens).
- Residence for at least three months in the state in which petition for naturalization is filed.
- Ability to read, write, and speak ordinary English (waived for persons over fifty years of age who have lived in the United States for at least twenty years as a permanent resident or over fifty-five years of age with at least fifteen years in the United States as a permanent resident); knowledge and understanding of the fundamentals of U.S. history and government.
- Good moral character, attachment to the principles of the Constitution, and proper disposition to the good order and happiness of the United States.
- Continuous residence (not necessarily physical presence) in the United States from the date the naturalization petition was filed until

actual admission to citizenship; intention to reside permanently in the United States.

6.2 Procedure

If an applicant satisfies the requirements, then he or she files an application to petition for naturalization on INS Form N-400, "Application for Naturalization"—this is preliminary to filing the actual petition. It is filed with the INS office with jurisdiction over the applicant's residence.

After a fingerprint check is completed (generally taking three to four months) the applicant is scheduled for an interview by the INS. Applicants must establish that they satisfy the physical presence requirement and that they are of good moral character. The examiner will then test for English and knowledge of U.S. government history, unless the applicant has already successfully passed the citizenship test administered by a designated testing facility. Certain designated agencies or facilities are authorized to provide a testing site for the administration of a standardized citizenship test. Applicants who pass the test can provide the results to the INS and will not be required to take the test during the naturalization interview. Applicants can also take the test several times if they do not pass the first time. This opportunity is particularly advantageous, since the applicants who fail a test during the interview must wait several months before they can take the test again. The test results are good for one year. The examiner completes the petition at the interview and makes a positive or negative recommendation.

Applicants who have certain disabilities may be exempt from the English language requirement and, in some cases, the "knowledge and history of government" requirement. To obtain an exemption an applicant must obtain a letter or statement from a physician certified by INS, indicating that the alien has a medical condition that prevents him or her from reasonably complying with either the language requirement or both requirements. The applicant might also have to complete an INS waiver form. Applicants who receive an exemption are entitled to have an interpreter in their native language present at the interview.

The naturalization process and swearing in will be completed by either the federal court or the INS itself. The Immigration Act of 1990 established administrative naturalization, which allows the INS to carry out the naturalization hearing and ceremony. Before the provision for administrative naturalization was enacted only the federal court could conduct a naturalization hearing and ceremony. If the federal court fails to conduct a hearing within forty-five days of an examiner's positive

recommendation, the petition will be returned to the INS for an administrative naturalization hearing.

No waiting period is required, but the hearing is scheduled according to the court's or the INS's backlog, unless expedited treatment is requested and granted. At the hearing, the applicant is sworn in and the certificate of naturalization is issued.

7. EMPLOYER RESPONSIBILITIES

Under the Immigration Reform and Control Act of 1986, an employer is liable and subject to penalties if he or she

- Knowingly hires after November 6, 1986, or knowingly retains, if hired after November 6, 1986, an employee who is unauthorized to work (or whose work authorization has expired) in the United States, that is, who is not a U.S. citizen, legal permanent, conditional, or temporary resident, or who does not have authorization from the INS to work.
- Fails to verify employment authorization or incorrectly verifies on Form I-9 upon hiring any employee hired after November 6, 1986.
- Discriminates in hiring decisions based on an applicant's national origin or citizenship status.

Each area creates separate liabilities for the employer. Violations are punishable with fines that range from \$250 to \$10,000 per alien, depending upon the employer's practice and history of violations. Egregious violations are punishable by imprisonment. Employers who knowingly accept false documents or documents belonging to someone other than the applicant are also subject to penalties. Until June 1, 1988, the INS issued citations and warnings advising the employer of possible violations. After June 1, 1988, implementation of full enforcement began. An employer's good faith attempt to comply, however, is sufficient, and employers may rely on the representations of an alien's status made by a state employment agency or job service office.

Certain independent contractors, "casual hires," and "sporadic, irregular, and intermittent" household workers are excluded from these provisions. Employees hired before November 7, 1986, who were unauthorized, or who later became unauthorized, are "grandfathered," and their employers are not liable as long as the employee has been continuously employed since the date of hire.

Employees are exempt from liability under these provisions unless they knowingly make false statements or give false information to an

employer regarding their employment status. Employees who work illegally, however, are violating U.S. immigration law and may be deportable or unqualified for immigration benefits.

7.1 Employment Verification System

For each new employee, an employer (except for recruiters and referers), must verify both the employee's identity and work authorization by filling out Form I-9. Form I-9 includes detailed instructions on how to complete the form. By completing the I-9, the employer is stating, under penalty of perjury, that the employer has examined the appropriate document(s) to establish work authorization. The reverse of Form I-9 (see Appendix 3) lists single documents that can be used to establish both identity and work authorization, or documents that establish either only identity or work authorization. In the latter case, the employer must review two documents as listed on the I-9.

The employee must also attest to being either a citizen, a permanent resident, or one who is lawfully entitled to the employment by cosigning Form I-9. The employer must comply with these provisions within three business days of commencement of employment. The employer must retain Form I-9 for the later of three years after hiring the employee or one year after the employee terminated employment, whichever is later.

It is recommended that employers keep an "I-9 File" separate from other employee records and that the employer not copy any employment authorization or identity documents presented. It is also recommended that employers allow the employee to decide which documents to present and accept them as long as they fulfill I-9 requirements and appear to be facially valid.

The employer should accept only original documents and should be sure to fully complete the I-9. An employer may be subject to a claim of discrimination if he or she requires more than the minimum documents required by the I-9.

The Attorney General, Secretary of Labor, and the Secretary of Health and Human Services are to jointly establish a system for validating social security numbers. Currently, employers are given three days' notice before being required to present Form I-9 to an inspector.

7.2 Prohibition of Discrimination

An employer may not discriminate against applicants on the basis of national origin or status as a citizen. Protected classes include an alien who is a permanent resident, a temporary permanent resident admitted

under the legalization program, a refugee, or an asylee. Employers are also prohibited from retaliating against an employee who asserts a discrimination claim against the employer.

An employer is exempt (or may claim a defense) from this provision if

- He or she has three or fewer employees.
- Title VII of the 1964 Civil Rights Act covers the claim instead.
- He or she is complying with a government contract (for example, security provisions on defense contracts).
- English language skill is a bona fide job requirement.
- The applicant is not within a protected class.

Attorney's fees are recoverable by the prevailing party in any suit brought for discrimination.

This provision of the IRCA places employers in a delicate position. Employers must be careful not to hire illegal aliens, yet they are prohibited from discriminating against applicants who may *appear* to be illegal aliens. Thus, employers must consider all potential applicants and be certain to inspect the required documents of any person having been given employment. Employers may also face a discrimination claim or be committing an unfair employment practice by refusing to accept an I-9 document that appears to be facially genuine or requiring that the applicant provide more documentation than that required by the I-9. Note that applicants are required to complete Form I-9 only after having been offered employment, not when initially applying. It is a good idea to store the forms away from other personnel documents; the fewer people who have access to I-9s, the less likelihood of the documents being used to sustain a claim that the employer discriminated on the basis of age, citizenship, or national origin.¹

8. PENALTIES

8.1 Employer Responsibilities

Under the employer's responsibilities discussed in section 7, an employer who violates the provisions is subject to civil and criminal penalties.

An employer is entitled to notice and a hearing, if accused of violating the provisions. For a first offense, employers are subject to a

¹Marsia Manley, "Coping with the New Immigration Law," *Inc Magazine* (August 1987), 91-94.

civil penalty of not less than \$250 and not more than \$2,000 for each unauthorized alien employee. For a repeat offense, the civil penalties range from \$2,000 to \$5,000 for each unauthorized alien employee. Employers who show a pattern of violations may be subject to civil penalties ranging from \$3,000 to \$10,000 per alien, and to criminal penalties of up to \$3,000 per alien and up to six months' imprisonment. Additionally, the U.S. Attorney General is empowered to seek an injunction against an employer.

If the violations are merely paperwork violations, for example, failure to complete an I-9 or completing it inaccurately, the fines drop down to \$100 to \$1,000 for each employee.

With the passage of the Immigration Act of 1990, employers became subject to additional fines based upon a finding that the employer engaged in discriminatory conduct. The new fines parallel those already in place for hiring undocumented, unauthorized workers. The employer is now subject to fines either for overdocumenting or refusing to accept valid I-9 documents. These new fines can be imposed in addition to the antidiscrimination remedies already available, such as reinstatement, back pay, and attorney's fees.

In addition, an employer found to have engaged in discriminatory conduct may be required to

- Post notices in the workplace about employees' rights and employer obligations under the act.
- Educate appropriate personnel about the requirements of the anti-discrimination provisions.
- Remove false performance reviews or warnings from an employee's file.
- Lift any restrictions on an employee's working conditions.

Hearings are to be held by an administrative law judge, with at least thirty days' notice. Either party may appeal an adverse decision to the U.S. Court of Appeals within sixty days.

Civil penalties are collected by the U.S. Attorney General by civil suit in federal district court.

An employer cannot require an employee to post a bond or indemnify the employer from any violations of these provisions. If an employer attempts to gain employee indemnification, the employer is subject to a civil penalty of \$1,000 plus reimbursement of the indemnification or bond expenses.

9. ILLEGAL IMMIGRATION REFORM AND IMMIGRANT RESPONSIBILITY ACT OF 1996

The Illegal Immigration Reform and Immigrant Responsibility Act of 1996 radically changed the immigration law in the United States.

Although the new law deals in great part with changes in deportation law and criminal aliens, other aliens who violate the immigration laws through the simple overstay of a visa or through unlawful employment will be subject to new sanctions. For employers and others who deal with foreign nationals, navigating the immigration law will be more precarious (see appendix 4, "Summary of Changes in Immigration Law After the Illegal Immigration Reform and Immigrant Responsibility Act of September 30, 1996").

Regulations will help to define the extent of the changes, and litigation is expected as certain aspects of the new law are challenged.

REFERENCES

- American Immigration Lawyers Association, *Immigration and Nationality Law Handbook*. Washington, D.C.
- Backer, Karen. *Immigration: Then and Now*. New York: Scholastic, 1997.
- Chase, Bari, Marcy Chynsky, and Susan Colman, eds. *Immigration Labor Certification Reporter*. New York: Matthew Bender, 1984. Looseleaf Service.
- Chiswick, Barry R. *Illegal Aliens: Their Employment and Employers*. Kalamazoo, MI: W.E. Upjohn, Institute for Employment Research, 1988.
- , Ed. *Immigrations, Language, Ethnicity: Canada and the United States*. Washington: American Enterprise Institute, 1992.
- Devine, Robert C. *Immigration Law and Procedure*. Charlottesville, VA: MICHIE, 1994.
- Fragomen, Jr., Austin T., and Stephen C. Bell. New York: Clark Boardman Callaghan, 1995.
- . *Immigration Fundamentals: A Guide to Law and Practice*, 4th ed. New York: Practising Law Institute, 1996.
- . *Immigration Employment Compliance Handbook*. New York: Clark Boardman Callaghan, 1991.
- . *Immigration Procedures Handbook*. New York: Clark Boardman, 1988.
- , Alfred Del Rey, and Sam Bersen. *Immigration Law and Business*. New York: Clark Boardman, 1983. Loose-leaf.
- Goger, Thomas J., ed. *Immigration Law Service*. Rochester, N.Y.: Lawyer's Co-op Publishing Co., 1985. Loose-leaf service.

- Gordon, Charles, and Ellen Bittel Gordon. *Immigration Law and Procedure: Desk Edition*. New York: Matthew Bender, 1981. Looseleaf Service.
- Ignatius, Sarah, Elizabeth S. Stickey, and the National Immigration Project. *Immigration Law and the Family*. New York: Clark Boardman Callaghan, 1994.
- Immigration and Naturalization Act. 8 U.S.C. §1101 et seq.
- Kurzban, Ira J. *Kurzban's Immigration Law Sourcebook*. Washington: American Immigration Law Sourcebook. Latest edition.
- Legomsky, Stephen H. *Immigration Law and Policy*. Westbury, NY: Foundation Press, 1994.
- Liebman, Henry G. *The Immigration Handbook: For Work, Investment, Study and Retirement in the U.S.A.* Seattle: Fairgreens Media, 1996.
- MacDonald, Ian A., and Nicholas J. Blake. *Immigration Law and Practice*. Charlottesville, VA: 1994.
- Plender, Richard, Ed. *Basic Documents on International Migration Law*. Norwell, MA: Kluwer Academic, 1996.
- Steel, Richard D. *Steel on Immigration Law*. 2nd ed. New York: Clark Boardman Callaghan, 1992. Loose-leaf service.
- Wernick, Alan. *U.S. Immigration and Citizenship—Your Complete Guide: Everything You Need to Know About Visiting, Working and Staying in the United States*. Rocklin, CA: Prima, 1997.
- West Publishing. *Federal Immigration Laws, Rules and Regulations*. St. Paul, MN: 1997.

(Text continued on page 53)

APPENDIX 1: Addresses of Government Offices

Department of Labor Regional Offices

| <u>Region</u> | <u>Jurisdiction</u> | <u>Address</u> |
|---------------|-----------------------------------|---|
| I | CT, ME, MA, NH, RI, VT | Room 1707, JFK Federal Building, Government Center Boston, MA 02203 |
| II | NY, NJ, PR | Room 3713, 1515 Broadway New York, NY 10036 |
| III | DE, MD, PA, VA, WV, DC | P.O. Box 8796 Philadelphia, PA 19101 (street address, not for mailing purposes: 3535 Market Street) |
| IV | AL, FL, GA, KY, MS, NC, SC, TN | Room 405, 1371 Peachtree Street, NE Atlanta, GA 30309 |
| V | IL, IN, MI, MN, OH, WI | 230 S. Dearborn St. Chicago, IL 60604 |
| VI | AR, LA, NM, OK, TX | Room 317, 555 Griffin Square Building Griffin & Young Sts. Dallas, TX 75202 |
| VII | IA, KS, MO, NE | Room 1000, Federal Building 911 Walnut St. Kansas City, MO 64106 |
| VIII | CO, MT, ND, SD, UT, WY | 1961 Stout St. Denver, CO 80202 |
| IX | AZ, CA, GU, HI, NV | Box 36084, Federal Office Building 450 Golden Gate Avenue San Francisco, CA 94102 |
| X | AK, ID, OR, WA | Room 1145 Fed Office Building 909 First Avenue Seattle, WA 98174 |
| — | VI | First National City Bank Building Veterans Drive St. Thomas, VI 00801 |

Source: 20 CFR # 656.60.

Immigration and Naturalization Service Offices

You may obtain information from one of the following local INS offices. Direct your letter to the attention of the *Employer and Labor Relations Officer*.

ALABAMA
77 Forsyth St. S.W., Rm. G-85
Atlanta, GA 30303

ALASKA
620 East 10th Ave., Suite 102
Anchorage, AK 99501

ARIZONA
2035 N. Central Ave.
Phoenix, AZ 85004

ARKANSAS
701 Loyola Ave., Rm. T-8005
New Orleans, LA 70113

CALIFORNIA
300 N. Los Angeles St.
Los Angeles, CA 90012

880 Front St.
San Diego, CA 92188

630 Sansome St.
San Francisco, CA 94111-2280

COLORADO
4730 Paris St., Albrook Center
Denver, CO 80239-2804

CONNECTICUT
JFK Federal Building
Government Center
Boston, MA 02203

DELAWARE
1600 Callowhill St.
Philadelphia, PA 19130

DISTRICT OF COLUMBIA
4420 N. Fairfax Dr
Arlington, VA 22203

FLORIDA
7880 Biscayne Blvd.
Miami, FL 33138

GEORGIA
77 Forsyth St. S.W., Rm. G-85
Atlanta, GA 30303

GUAM
595 Ala Moana Blvd.
Honolulu, HI 96813

HAWAII
595 Ala Moana Blvd.
Honolulu, HI 96813

IDAHO
900 N. Montana Ave.
Helena, MT 59601

ILLINOIS
10 W. Jackson Blvd., Rm. 533
Chicago, IL 60604

INDIANA
10 W. Jackson Blvd., Rm. 533
Chicago, IL 60604

IOWA
3736 S. 132nd St.
Omaha, NE 68144

KANSAS
9747 N. Conant Ave.
Kansas City, MO 64153

KENTUCKY
701 Loyola Ave., Rm. T-8005
New Orleans, LA 70113

LOUISIANA
701 Loyola Ave. Rm. T.8005
New Orleans, LA 70113

MAINE
739 Warren Ave.
Portland, ME 04103

MARYLAND
1530 Calton Center Dr., Bldg. D, Suite M
Baltimore, MD 21227

MASSACHUSETTS
JFK Federal Building
Government Center
Boston, MA 02203

MICHIGAN
Federal Building, 333 Mt. Elliott St.
Detroit, MI 48207

MINNESOTA
2901 Metro Dr., Suite 100
Bloomington, MN 55425

MISSISSIPPI
701 Loyola Ave., Rm. T-8005
New Orleans, LA 70113

MISSOURI
9747 N. Conant Ave.
Kansas City, MO 64153

MONTANA
900 N. Montana Ave.
Helena, MT 59601

NEBRASKA
3736 S. 132nd St.
Omaha, NE 68114

NEVADA
2035 N. Central Ave.
Phoenix, AZ 85004

NEW HAMPSHIRE
JFK Federal Building
Government Center
Boston, MA 02203

NEW JERSEY
Federal Building, 970 Broad St.
Newark, NJ 07102

NEW MEXICO
343 U.S. Courthouse, P.O. Box 9388
El Paso, TX 79984

NEW YORK
68 Court St.
Buffalo, NY 14202

26 Federal Plaza
New York, NY 10278

NORTH CAROLINA
77 Forsyth St. S.W., Rm. G-85
Atlanta, GA 30303

NORTH DAKOTA
2901 Metro Dr., Suite 100
Bloomington, MN 55425

OHIO
1240 E. 9th St., Room 1917
Cleveland, OH 44199

OKLAHOMA
4149 Highline Blvd., #300
Oklahoma City, OK 73108

OREGON
511 N.W. Broadway
Portland, OR 97209

PENNSYLVANIA
1600 Callowhill St.
Philadelphia, PA 19130

PUERTO RICO
P.O. Box 365068
San Juan, PR 00936

RHODE ISLAND
JFK Federal Building
Government Center
Boston, MA 02203

SOUTH CAROLINA
Room 110 Federal Building
334 Meeting St.
Charleston, SC 29403

SOUTH DAKOTA
2901 Metro Dr., Suite 100
Bloomington, MN 55425

TENNESSEE
701 Loyola Ave., Rm. T-8005
New Orleans, LA 70113

TEXAS
8101 N. Stemmons Freeway
Dallas, TX 75247

P.O. Box 9398
El Paso, TX 79984

805 No. T St.
Harlingen, TX 78550

509 N. Belt
Houston, TX 77060

727 E. Durango, Suite A301
San Antonio, TX 78206

UTAH
4730 Paris St., Albrook Center
Denver, CO 80239-2804

VERMONT
739 Warren Ave.
Portland, ME 04103

VIRGINIA
4420 N. Fairfax Dr
Arlington, VA 22203

VIRGIN ISLANDS
PO Box 610, Charlotte Amalie
St. Thomas, VI 00801

Po Box 1270, Kingshill, Christiansted
St. Croix, VI 00850

WASHINGTON
815 Airport Way South
Seattle, WA 98134

WEST VIRGINIA
1600 Callowhill St.
Philadelphia, PA 19130

WISCONSIN
10 W. Jackson Blvd., Rm. 533
Chicago, IL 60604

WYOMING
4730 Paris St., Albrook Center
Denver, CO 80239-2804

APPENDIX 2: Visa Symbols

| <u>Visa Symbol</u> | <u>Class</u> |
|--------------------|--|
| A-1 | Ambassador, public minister, career diplomat or consular officer, and members of immediate family |
| A-2 | Other foreign government official or employee, and members of immediate family |
| A-3 | Attendant, servant, or personal employee of A-1 and A-2 classes, and members of immediate family |
| B-1 | Temporary visitor for business |
| B-2 | Temporary visitor for pleasure |
| C-1 | Alien in transit |
| C-2 | Alien in transit to United Nations Headquarters district under § 11 (3), (4), or (5) of the Headquarters Agreement |
| C-3 | Foreign government official, members of immediate family, attendant, servant, or personal employee, in transit |
| D | Crewman (seaman or airman) |
| E-1 | Treaty trader, spouse and children |
| E-2 | Treaty investor, spouse and children |
| F-1 | Student |
| F-2 | Spouse or child of student |
| G-1 | Principal resident representative of recognized foreign member government to international organization, his staff, and member of immediate family |
| G-2 | Other representative of recognized foreign member government to international organization, and members of immediate family |
| G-3 | Representative of nonrecognized or nonmember foreign government to international organization, and members of immediate family |
| G-4 | International organization officer or employee, and members of immediate family |
| G-5 | Attendant, servant, or personal employee of G-1, G-2, G-3, and G-4 classes, and members of immediate family |
| H-1A | Temporary registered nurse |
| H-1B | Temporary worker of distinguished merit and ability, DOD employees, specialty occupations |
| H-2 | Temporary worker performing services unavailable in the United States |
| H-2A | Agricultural worker |
| H-3 | Trainee |
| H-4 | Spouse or child of alien classified H-1, H-2, or H-3 |
| I | Representative of foreign information media, spouse, and children |
| J-1 | Exchange visitor |

(continued)

| <u>Visa Symbol</u> | <u>Class</u> |
|--------------------|---|
| J-2 | Spouse or child of exchange visitor |
| K-1 | Fiance(e) of U.S. citizen |
| K-2 | Minor child of fiance(e) of U.S. citizen |
| L-1 | Intracompany transferee (executive, managerial, and specialized personnel continuing employment with international firm or corporation) |
| L-2 | Spouse or minor child of alien classified L-1 |
| M-1 | Vocational student |
| M-2 | Spouse or child of student |
| NATO-1 | Principal permanent representative of member state to NATO (including any of its subsidiary bodies) resident in the United States and resident members of his official staff; Secretary General, Deputy |
| O-1 | Temporary worker of extraordinary ability in the sciences, business, and education |
| O-2 | Accompany aliens to O-1 aliens |
| O-3 | Family members of O-1 aliens |
| P-1 | Internationally recognized athletes and entertainment groups |
| P-2 | Artists and entertainers under a reciprocal exchange agreement |
| P-3 | Artists, athletes, entertainers to perform in a culturally unique program |
| P-4 | Family members of P-1 to P-3 aliens |
| Q | Cultural exchange visitor |
| R-1 | Religious workers |
| R-2 | Family members of R-1 aliens |

Source: Wernick, Allan H., *The Guide to Immigration Counseling*. (New York, Center for Immigrant Rights, 1985), appendix B; 8 U.S.C. 1101(a)(15), PL 99-603.

APPENDIX 3: Immigration and Naturalization Form I-9

U.S. Department of Justice
Immigration and Naturalization Service

OMB No. 1115-0136

Employment Eligibility Verification

Please read instructions carefully before completing this form. The instructions must be available during completion of this form. **ANTI-DISCRIMINATION NOTICE:** It is illegal to discriminate against work eligible individuals. Employers CANNOT specify which document(s) they will accept from an employee. The refusal to hire an individual because of a future expiration date may also constitute illegal discrimination.

Section 1. Employee Information and Verification. To be completed and signed by employee at the time employment begins

| | | | |
|---|-------|--|--------------------------------|
| Print Name: Last | First | Middle Initial | Maiden Name |
| Address (Street Name and Number) | | Apt. # | Date of Birth (month/day/year) |
| City | State | Zip Code | Social Security # |
| I am aware that federal law provides for imprisonment and/or fines for false statements or use of false documents in connection with the completion of this form. | | I attest, under penalty of perjury, that I am (check one of the following): <input type="checkbox"/> A citizen or national of the United States <input type="checkbox"/> A Lawful Permanent Resident (Alien # A _____) <input type="checkbox"/> An alien authorized to work until ____/____/____ (Alien # or Admission # _____) | |
| Employee's Signature | | | Date (month/day/year) |

Preparer and/or Translator Certification. (To be completed and signed if Section 1 is prepared by a person other than the employee.) I attest, under penalty of perjury, that I have assisted in the completion of this form and that to the best of my knowledge the information is true and correct.

| | |
|---|------------|
| Preparer's/Translator's Signature | Print Name |
| Address (Street Name and Number, City, State, Zip Code) | |
| Date (month/day/year) | |

Section 2. Employer Review and Verification. To be completed and signed by employer. Examine one document from List A OR examine one document from List B and one from List C as listed on the reverse of this form and record the title, number and expiration date, if any, of the document(s)

| List A | OR | List B | AND | List C |
|--|----|----------------|-----|----------------|
| Document title: _____ | | _____ | | _____ |
| Issuing authority: _____ | | _____ | | _____ |
| Document #: _____ | | _____ | | _____ |
| Expiration Date (if any): ____/____/____ | | ____/____/____ | | ____/____/____ |
| Document #: _____ | | _____ | | _____ |
| Expiration Date (if any): ____/____/____ | | _____ | | _____ |

CERTIFICATION - I attest, under penalty of perjury, that I have examined the document(s) presented by the above-named employee, that the above-listed document(s) appear to be genuine and to relate to the employee named, that the employee began employment on (month/day/year) ____/____/____ and that to the best of my knowledge the employee is eligible to work in the United States. (State employment agencies may omit the date the employee began employment).

| | | |
|---|------------|-----------------------|
| Signature of Employer or Authorized Representative | Print Name | Title |
| Business or Organization Name | | Date (month/day/year) |
| Address (Street Name and Number, City, State, Zip Code) | | |

Section 3. Updating and Reverification. To be completed and signed by employer

| | |
|--|--|
| A. New Name (if applicable) | B. Date of rehire (month/day/year) (if applicable) |
| C. If employee's previous grant of work authorization has expired, provide the information below for the document that establishes current employment eligibility. Document Title: _____ Document #: _____ Expiration Date (if any): ____/____/____ | |

I attest, under penalty of perjury, that to the best of my knowledge, this employee is eligible to work in the United States, and if the employee presented document(s), the document(s) I have examined appear to be genuine and to relate to the individual.

| | |
|--|-----------------------|
| Signature of Employer or Authorized Representative | Date (month/day/year) |
|--|-----------------------|

LISTS OF ACCEPTABLE DOCUMENTS

| LIST A | OR | LIST B | AND | LIST C |
|---|----|--|-----|--|
| <p style="text-align: center;">Documents that Establish Both Identity and Employment Eligibility</p> <ol style="list-style-type: none"> 1. U.S. Passport (unexpired or expired) 2. Certificate of U.S. Citizenship (<i>INS Form N-560 or N-561</i>) 3. Certificate of Naturalization (<i>INS Form N-560 or N-570</i>) 4. Unexpired foreign passport, with <i>I-551</i> stamp or attached <i>INS Form I-94</i> indicating unexpired employment authorization 5. Alien Registration Receipt Card with photograph (<i>INS Form I-151 or I-551</i>) 6. Unexpired Temporary Resident Card (<i>INS Form I-688</i>) 7. Unexpired Employment Authorization Card (<i>INS Form I-688A</i>) 8. Unexpired Reentry Permit (<i>INS Form I-327</i>) 9. Unexpired Refugee Travel Document (<i>INS Form I-571</i>) 10. Unexpired Employment Authorization Document issued by the INS which contains a photograph (<i>INS Form I-688B</i>) | OR | <p style="text-align: center;">Documents that Establish Identity</p> <ol style="list-style-type: none"> 1. Driver's license or ID card issued by a state or outlying possession of the United States provided it contains a photograph or information such as name, date of birth, sex, height, eye color, and address 2. ID card issued by federal, state, or local government agencies or entities provided it contains a photograph or information such as name, date of birth, sex, height, eye color, and address 3. School ID card with a photograph 4. Voter's registration card 5. U.S. Military card or draft record 6. Military dependant's ID card 7. U.S. Coast Guard Merchant Mariner Card 8. Native American tribal document 9. Driver's license issued by a Canadian government authority For persons under age 18 who are unable to present a document listed above: 10. School record or report card 11. Clinic, doctor, or hospital record 12. Day-care or nursery school record | AND | <p style="text-align: center;">Documents that Establish Employment Eligibility</p> <ol style="list-style-type: none"> 1. U.S. social security card issued by the Social Security Administration (<i>other than a card stating it is not valid for employment</i>) 2. Certification of Birth Abroad issued by the Department of State (<i>Form FS-545 or Form DS-1350</i>) 3. Original or certified copy of a birth certificate issued by a state, county, municipal authority or outlying possession of the United States bearing an official seal 4. Native American tribal document 5. U.S. Citizen ID Card (<i>INS Form I-197</i>) 6. ID Card for use of Resident Citizen in the United States (<i>INS Form I-179</i>) 7. Unexpired employment authorization document issued by the INS (<i>other than those listed under List A</i>) |

Illustrations of many of these documents appear in Part 8 of the Handbook for Employers (M-274)

APPENDIX 4: Summary of Changes in Immigration Law After the Illegal Immigration Reform and Immigrant Responsibility Act of September 30, 1996

The law affects primarily illegal immigration and the political asylum application process. This summary does not cover issues related specifically to changes in deportation procedures. Provisions are effective April 1, 1997, unless otherwise noted.

Before the Act

Adjustment of Status

("Green card application")

Aliens who violate nonimmigrant visas or work without authorization are still eligible to adjust their status.

Aliens who entered without inspection (came illegally without a visa) are not necessarily ineligible to adjust their status.

Affidavit of Support

Affidavit of support is currently not enforceable.

Affidavits of support are generally applicable for three years.

Sponsor must show income at or above 100 percent of the poverty guideline. Nearly anyone can fill out Affidavit of Support.

Sponsor need not keep INS informed of address.

Political Asylum

Aliens can apply anytime.

After the Act

Adjustment of Status

Violations of nonimmigrant status makes aliens ineligible for adjustment of status unless they are in lawful status at the time of application or are immediate relatives or certain special immigrants.

Aliens who entered without inspection are arguably not eligible to apply for adjustment of status.

Affidavit of Support

Affidavits of support are legally enforceable contracts by federal and subdivision of state governments.

Affidavits of support are enforceable until an alien becomes a citizen or is credited with forty qualifying quarters of work.

Sponsor must show income at or above 125 percent of poverty guideline.

Affidavits of support must be filled out by petitioner, unless petitioner's income is not high enough. In that case, an affidavit of support can be filled out by someone else but he or she is also liable.

Sponsor must keep INS informed of address or face possible fines.

Political Asylum

Aliens must apply within one year of entry to United States.

Before the Act**Political Asylum**

Aliens can apply twice—once before Immigration Service and once before immigration judge.

Aliens are entitled to work permit 150 days after application.

There is no filing fee.

Aliens at port of entry without proper visa or other documents can be allowed in to apply for asylum.

Unlawful Presence

There is no comparable provision.

Visa Issues

There is no comparable provision.

There is no impact on the validity of the visa as a result of overstaying a non-immigrant visa period.

After the Act**Political Asylum**

Aliens can only apply once.

INS can decide whether or not to grant work permit after waiting period has passed.

INS can impose a filing fee in new regulations.

Aliens at port of entry without proper documents with asylum claims are subject to "summary exclusion."

Unlawful Presence

Aliens who, after April 1, 1997, (1) have resided unlawfully in the United States for more than six months are subject to a three-year bar upon entry; or (2) have resided unlawfully for a year or more are subject to a ten-year bar. Requires a departure from the United States.

Visa Issues

Immigrants need to show proof of certain vaccinations before being allowed to enter (includes people applying for green card in the United States).

Visa overstays result in cancellation of the visa by operation of law, whether expired or not, and the alien is forever barred from obtaining another visa except in the country of nationality, unless there are extraordinary circumstances.

Note: U.S. citizens who renounce citizenship to avoid payment of taxes are inadmissible.

INSURANCE

1. BACKGROUND

- 1.1 Spreading Risk
- 1.2 Law of Large Numbers
- 1.3 Regulation of Insurance Companies
 - 1.3.1 Rate control
 - 1.3.2 Prevention of unfair practices
 - 1.3.3 Protection of the stability and solvency of the insurer

2. TYPES OF INSURERS

- 2.1 Primary or Direct Insurers
 - 2.1.1 Stock companies
 - 2.1.2 Mutual companies
 - 2.1.2.1 Assessment insurers
 - 2.1.2.2 Fraternal
 - 2.1.3 Stock/mutual companies
 - 2.1.4 Reciprocals
 - 2.1.5 Lloyd's associations
 - 2.1.6 Service insurers
 - 2.1.7 Government insurers
- 2.2 Reinsurance Companies

3. AGENTS AND BROKERS

- 3.1 Agents
 - 3.1.1 Authority
 - 3.1.2 General and local agents
 - 3.1.3 Exclusive and independent agents
 - 3.1.4 Statutory employees
- 3.2 Brokers
- 3.3 Other Marketing Methods

4. HEALTH INSURANCE

- 4.1 Individual Medical-Expense Insurance
- 4.2 Underwriting Factors
- 4.3 Typical Policy Coverages and Provisions
 - 4.3.1 Basic expense
 - 4.3.2 Major medical
 - 4.3.3 Comprehensive
 - 4.3.4 Special health
- 4.4 Group Health Plans
 - 4.4.1 Underwriting group policies
 - 4.4.2 Special provisions

- 4.4.3 Benefits and services
- 4.4.4 Health maintenance organizations (HMOs)
- 4.4.5 Preferred provider organizations (PPOs)
- 4.4.6 Franchise health insurance
- 4.5 Disability Insurance
 - 4.5.1 Total disability
 - 4.5.2 Partial disability
 - 4.5.3 Benefits and waiting period
 - 4.5.4 Renewable and noncancelable
 - 4.5.5 Obtaining coverage
- 4.6 Long-Term Care Insurance
 - 4.6.1 Types of policies
 - 4.6.2 Choosing the right policy
- 4.7 Insurance Continuation
 - 4.7.1 Consolidated Omnibus Budget Reconciliation Act
 - 4.7.2 Family and Medical Leave Act

5. LIFE INSURANCE

- 5.1 Term Insurance
 - 5.1.1 Select and ultimate pricing
 - 5.1.2 Death benefits
 - 5.1.3 Term policy features
- 5.2 Whole Life Insurance
 - 5.2.1 Whole life premiums
 - 5.2.2 Cash value
 - 5.2.3 Dividends
 - 5.2.4 Tax benefits
- 5.3 Universal Life Insurance
 - 5.3.1 Basic features
 - 5.3.2 Options
 - 5.3.3 Unique features
 - 5.3.4 Variable universal life
- 5.4 Key Person Insurance
- 5.5 Group Term Plans
 - 5.5.1 Basic characteristics
 - 5.5.2 Group permanent life
 - 5.5.3 Noncontributory plans
 - 5.5.4 Contributory plans
 - 5.5.5 Amount of coverage
- 5.6 Single-Premium Policies
- 5.7 Split Dollar/Reverse Split Dollar Policies
- 5.8 Second-to-Die Life Insurance
- 5.9 Living Benefits Insurance
- 5.10 Annuities

6. PROPERTY INSURANCE

- 6.1 Perils/Property Commonly Insured
 - 6.1.1 Named-peril policies
 - 6.1.2 Broad-form policies
 - 6.1.3 Comprehensive perils
 - 6.1.4 Automobile liability coverage
 - 6.1.5 Nonowned and hired cars automobile liability
 - 6.1.6 Drive other car endorsement (DOC)
 - 6.1.7 Commercial inland marine
- 6.2 Amount of Insurance
 - 6.2.1 Actual cash value
 - 6.2.2 Replacement cost
 - 6.2.3 Co-insurance
 - 6.2.4 Agreed-value endorsement
 - 6.2.5 Inflation guard coverage
- 6.3 Deductibles
- 6.4 Insurable Interest
- 6.5 Increase in Risk

7. LIABILITY INSURANCE

- 7.1 Occurrence Policies
- 7.2 Claims-Made Policies
- 7.3 General Liability Policies
- 7.4 Excess-Liability Policies

8. EMPLOYEE BONDING

- 8.1 Fidelity Bonds
 - 8.1.1 Individual bonds
 - 8.1.2 Blanket bonds
 - 8.1.3 Bonding coverage
 - 8.1.4 Exclusions
- 8.2 Combination Crime Policies

9. SOCIAL SECURITY

REFERENCES

1. BACKGROUND

1.1 Spreading Risk

Insurance is an important method through which one can protect against future losses. An insurance policy provides that an insured will be compensated for a stated loss by the insurer. The risk to the insurer is “spread” over the pool of all those insured for similar losses since, barring catastrophe, not all insureds will suffer a loss in any given period. Furthermore, actuaries can predict, with reasonable accuracy, the number of covered losses that will occur in any given year. Thus, insurers can charge a premium that will provide for sufficient funds to cover losses and expenses while allowing for profit.

An individual purchasing an insurance policy is spreading the potential loss over the group of other people who are purchasing similar coverage. Thus, to the individual, the potential for a disastrous financial loss is reduced. All insureds pay relatively small premiums so that the few who sustain losses can receive large returns. If the insured suffers a covered loss, especially a large loss, the insured gets a return on his or her investment. If the insured is in a large pool that incurs very small or no losses, the insured still receives a valuable product: peace of mind.

1.2 Law of Large Numbers

Insurance companies predict losses in a group by the law of large numbers, the basic premise of which is that the larger the number of separate risks combined within a given group, the easier it becomes to predict a future loss within the group. They then base their premiums on the expected cost of these future losses as well as expenses and profit. Actual losses may vary from these expected losses because of

- Chance fluctuations around the expected losses.
- Errors in predicting the expected losses.
- Court interpretations.

Since the relative difference between the actual losses and the true expected losses tends to decrease as the pool of insureds increases, insurers want to cover as many insureds as possible to make future losses “more predictable.”

1.3 Regulation of Insurance Companies

Insurance companies that sell property and liability insurance are regulated, for the most part, by state statute. Insurance regulation within

individual states is governed by an official commonly known as the commissioner of insurance. Typically, the commissioner of insurance is appointed by the governor and is responsible for the administration of insurance laws and supervision of the insurance industry within the state.

Other matters regulated by state statutes include

- Rate control.
- Prevention of unfair practices.
- Protection of the stability and solvency of the insurer.

States require every insurer who intends to write policies in a state, as well as all agents and brokers, to be licensed by the state. Under this licensing power, states can monitor and regulate levels of

- Competence and ethics.
- The economic stability and method of operations.
- The types of investments of each insurer.

State statutes for some types of insurance also prescribe a standard form for policies governing language, required and prohibited clauses, and readability.

1.3.1 Rate control

The goal of rate regulation is to keep rates high enough to cover claims adequately and allow the insurer an expense allowance and a reasonable profit while keeping the rates nondiscriminatory among insureds facing the same risks. In many states, insurers are permitted to cooperate in calculating property and liability insurance rate schedules, which are then subject to state approval. The aim of nondiscriminatory rates is to charge premiums that accurately reflect the expected (average in the long-term) losses faced by a given insured and thus ensure that two insureds facing identical risks are charged equal premiums.

1.3.2 Prevention of unfair practices

The regulation of unfair business practices seeks to prohibit false advertising, misrepresentation, the presentation of misleading factors, and comparisons with the product of an insurer's competitor. State statutes often require that an insured be given notice of cancellation and the reasons for the cancellation within a specified time before the effective date of the cancellation, particularly for family and small business insurance. State statutes also provide the method and jurisdiction whereby

insureds within their state may bring suit against out-of-state and mail order insurers.

1.3.3 Protection of the stability and solvency of the insurer

Insurance statutes uniformly require all insurance companies admitted to do business in a state to submit annual financial reports. This reporting requirement is the primary means whereby state insurance officials are alerted to the potential insolvency of an insurer.

2. TYPES OF INSURERS

Premium costs and, ultimately, insurance company strength are determined by three general criteria: claim experience, investment performance, and expense control. Actuarially determined claim experience varies little among types of insurers. However, the type of insurance company can have a direct impact on investment performance and expense control. Although insurers are not easily categorized, the following classifications are commonly referred to within the insurance industry.

2.1 Primary or Direct Insurers

2.1.1 Stock companies

Stock companies are owned by stockholders, who provide capital for the insurer and share in any profits and losses. Stockholders elect the board of directors who, in turn, elect officers to manage the company. Stock-company insurers differ little from other corporations that issue stock; capital is raised in the equity marketplace to improve financial position without relying solely on policyholders.

Most stock companies are profit-making insurers, although some nonprofit stock companies exist. Those that sell property insurance usually sell through the independent agency system. Under this system, described in section 3.1, which follows, agents are independent business people who represent more than one insurer. Some stock companies pay dividends to policyholders on certain types of insurance. Stock companies never issue “assessable policies,” whereby an insured can be charged an additional premium if the company’s losses are high; such losses are borne by stockholders.

2.1.2 Mutual companies

Mutual companies are owned by policyholders. They are, theoretically, nonprofit and exist solely for the benefit of their policyholders. Policyholders are similar to stockholders in that they also elect a board of directors and share in policy dividends. By not having to answer to separate policyholder and shareholder groups, mutual companies may have some overhead cost savings not enjoyed by stock companies. Smaller mutuals tend to issue assessable policies.

Class mutuals sell only a particular kind of insurance. Examples include farm mutuals and factory mutuals. General writing mutuals sell many different types of insurance. Mutuals can be participating, deviating, or both. Participating mutuals, particularly life insurance companies, often charge higher premiums than a stock company, at least initially, so that a dividend is more likely. Deviating mutuals charge a lower premium than stock companies but do not plan to pay dividends. Some mutuals combine both aspects, cutting the initial rate, and paying a dividend later if warranted.

2.1.2.1 Assessment insurers

Assessment companies retain the right to charge policyholders additional premiums if premiums paid are insufficient to meet claims. Some assessment insurers charge policyholders nothing until a loss occurs, then charge each member a pro-rated share—a policy known as an open-end contract. Mutual and reciprocal (see section 2.1.4, below) insurers that issue assessable policies constitute most of the existing assessment insurers.

2.1.2.2 Fraternal

A fraternal insurer is a nonprofit corporation, society, order, or volunteer association without capital stock, organized solely for the benefit of its members and beneficiaries. They often have a representative form of government, and are charitable and tax-exempt. Many fraternal originally started as assessment companies, but this method proved to be unsound. Most now operate on a reserve basis similar to that of other insurers, although some continue to issue assessable policies as a safety valve. Fraternal are authorized to do business under a special section of the insurance code, provided certain requirements are met.

Membership in fraternal associations is often centered around religious or patriotic orientation. Although similar to mutual companies in policyholder ownership, fraternal distinguish themselves by providing other fraternal benefits, often including grant and scholarship programs or benevolent programs for members in need. Fraternal are generally less diverse in the types of insurance provided.

2.1.3 Stock/mutual companies

Stock/mutual companies allow both stockholders and policyholders to vote for the board of directors. Only a few such companies exist.

2.1.4 Reciprocals

A reciprocal or interinsurance exchange company, like a mutual, is owned by policyholders. Unlike a mutual, however, policyholders in reciprocals appoint an individual or corporation known as an attorney-in-fact to operate the company. A key feature of reciprocals is the exchange of individual promises through a group arrangement. A reciprocal is unincorporated, with no capital other than advance premiums deposited by the owners. Early reciprocals kept separate accounts for each member. State regulations may require reciprocals to keep a reserve fund to protect subscribers from financial difficulties of the insurer. Reciprocals sell mainly automobile insurance and, like mutuals, may or may not be assessment insurers.

2.1.5 Lloyd's associations

Lloyd's is an organization joined together to provide certain services or insurance which is sold individually by the members. Each member assumes risks personally and does not bind the organization to the risk obligations.

Lloyd's of London operates worldwide, and in much of the United States sells what is known as a surplus-line market, consisting of risks that domestic insurers have rejected. In some states, Lloyd's is licensed to sell other lines. Standards for membership in Lloyd's are strict.

American Lloyd's are authorized by statute in some states. Generally, only certain types of insurance may be underwritten by Lloyd's groups. Most state statutes have minimum standards and requirements for American Lloyd's. The American Lloyd's are much smaller than Lloyd's of London and may write only a few lines.

2.1.6 Service insurers

Service insurers are technically not insurers in most states. They are unique to health insurance and provide prepaid plans for hospital, medical, and surgical expenses to the insured. They pay the provider of the service rather than provide cash benefits. The best known is probably Blue Cross/Blue Shield. Most service insurers are incorporated under special state laws and are given favorable tax treatment.

2.1.7 Government insurers

The federal government provides life and health insurance to military personnel and certain other federal employees. Some examples are the U.S. Government Life Insurance Plan, the National Life Insurance Plan, and the plans available to employees under the Railroad Retirement Act, the Civil Service Retirement Act, and the Federal Employees' Compensation Act. The Federal Crime Insurance program provides crime insurance to those who cannot otherwise obtain it. A similar program for flood-prone areas is available through the National Flood Insurance program.

States administer Fair Access to Insurance (FAIR) plans to ensure that properties that would be insurable except for their environment can be insured. FAIR plans operate in about half the states.

Social Security is probably the best-known government insurance program and is discussed further in section 9, which follows, and in the separate chapter on Social Security in this manual.

2.2 Reinsurance Companies

Reinsurance shares the risks written by one insurance (ceding) company with one or more (reinsurance) companies. This is sometimes done through agreements or treaties that specify the ways a group of risks will be shared between the ceding company and the reinsurer. In addition, a ceding company can cede individual risks to a reinsurer on a per-item basis.

Reinsurance is ceded in two general ways:

1. On an excess basis, whereby the ceding company keeps a certain dollar amount (retention) on each loss and pays a price to have a reinsurer pay all losses in excess of the retention
2. On a pro rata basis, whereby the ceding company and reinsurer share all specified losses and premiums in a given proportion

Reinsurance thus passes a given risk from a primary insurer to a secondary insurer.

Generally, insurance companies purchase reinsurance for these reasons:

1. To reduce the effect of unanticipated losses and protect projects
2. To allow the capacity to write longer risks
3. To assist in financing product lines by providing capital

3. AGENTS AND BROKERS

3.1 Agents

An agent represents the insurance company and operates under authority granted by an agency contract. Agents generally must be licensed by the state and may be required to complete certain courses or take an examination.

3.1.1 Authority

An agent's authority varies with the type of insurance being sold. A life insurance and health insurance agent usually does not have the authority to issue or modify insurance contracts. The agent primarily solicits, receives, and forwards applications from clients to the company. The agent can accept the first premium and may issue a binding receipt, which will cover the insured immediately (assuming the insured is later determined to be insurable).

Property and casualty agents have much broader authority than life and health insurance agents. They may bind the company by written or oral agreement. These agents may inspect risks for the company and collect premiums, and may be authorized to issue insurance contracts from their own offices.

3.1.2 General and local agents

Agents can be general or local. A general agent supervises all the company's business within a region, usually from a central headquarters with satellite offices staffed by local agents in surrounding areas. A local agent may also staff an independent retail office and represent several insurance companies. Agents are paid commissions on the insurance policies they sell or that pass through their hands although sold by another agent.

3.1.3 Exclusive and independent agents

Agents can work independently or with a company branch or district. Those who represent only one company are called captive or exclusive agents. Independent agents sell and service policies from many companies, and own renewal privileges. Thus, if the relationship between an independent agent and a company dissolves, the right to renew belongs to the agent. Independent agents have the advantage of drawing from several different companies and are frequently able to "shop around" for the best premium for clients.

3.1.4 Statutory employees

Agents are either independent contractors or common law employees under the Internal Revenue Code (IRC) for income and Social Security (FICA) tax purposes. However, for FICA tax purposes, certain full-time life insurance agents are considered statutory employees under IRC Section 3121(d)(3)(B). That is, they are independent contractors (self-employed) for income tax purposes but receive a Form W-2 with only Social Security withholding. Also, such statutory employees may be covered under company-sponsored retirement plans, since IRC Section 7701 permits self-employed agents to be covered.

3.2 Brokers

A broker is not a direct representative of any particular company. A broker is an independent salesperson who selects insurance coverage from whichever insurance company will best fill the client's needs, not unlike an independent agent. A broker orders the policies to be prepared by the insurer. When they are written, the broker delivers the policy to the client and is responsible for collecting premiums as they become due. Whereas the agent legally represents the insurer, a broker represents the insured. Hence the broker may not bind the insurance company before contacting it. Not all states license brokers. Some brokers are extremely large organizations providing many services in addition to ordering insurance.

3.3 Other Marketing Methods

Direct writing companies do not deal through agents or brokers but often market their insurance by having their employees deal directly with insureds. Some of these companies do business only by mail, particularly for life insurance.

4. HEALTH INSURANCE

The Social Security chapter herein discusses Medicare benefits. Essentially, Medicare is a federal health insurance program for people sixty-five or older. It is divided into two parts: hospital insurance and medical insurance. To be eligible for Medicare, people age sixty-five or older must meet at least one of the following criteria:

- They are entitled to monthly Social Security or railroad retirement benefits.

- They have worked long enough to be insured under the Social Security or railroad retirement system.
- They have worked long enough as federal employees to be insured for Medicare purposes.

See the Social Security chapter herein for more details regarding Medicare.

4.1 Individual Medical-Expense Insurance

Medical-expense insurance provides benefits for expenses arising from injury or sickness; many different kinds of policies are presently available. Health insurance differs as to the underwriting methods; the types of injuries, illnesses, and losses covered; the types of insurers providing coverage; and the benefits available.

4.2 Underwriting Factors

Five basic factors are considered in underwriting health insurance policies: age, physical condition, occupation, sex, and moral hazard.

Age. Age is a major factor in health insurance. Older people are more likely to become ill, suffer more serious injury in an accident, and not recover as quickly as younger people. The extent to which risk increases with age varies with the type of coverage being provided.

Physical condition. A history of certain health problems, a disability, or poor physical health in general may result in an insurer's declining to cover the potential insured or refusing to provide coverage for specific problems. A specialty company may be found to cover a particular existing health problem for a higher premium.

Occupation. Occupations are classified by the frequency and severity of injuries, exposure to hazards, nature of the work, and the length of the most likely disabilities faced by its members. Most insurance companies rank occupations numerically according to occupational hazards.

Sex. Statistics appear to indicate that women have more health problems than men, but studies also show that women are more likely to take better care of themselves and are less reluctant to visit doctors when problems are suspected.

Moral hazard. Moral hazards are most important in policies that have high disability-income benefits. Such a hazard exists when the insured is inclined to malingering, collect benefits, and not return to work.

4.3 Typical Policy Coverages and Provisions

Medical-expense insurance can generally be categorized as basic-expense insurance, major medical, and comprehensive and special policies.

4.3.1 Basic expense

Basic medical expense policies usually cover hospital stays, at a prestated per day limit or for a fixed maximum duration, and surgical costs in full or on a prestated scale based on the procedure and the services of the physician in addition to the hospital ancillary charges.

4.3.2 Major medical

Major medical coverage is designed to cover the catastrophic aspects of a prolonged and serious illness or injury, covering the days of hospitalization that exceed the coverage limits of the "Base Plan," physical therapy, equipment rental, etc. Major medical policies usually have a deductible of at least \$100, however, much larger deductibles are not uncommon. After the deductible has been met, payment is usually made on a co-insurance basis of 80 percent/20 percent. This means that the policy will pay 80 percent of covered charges above the deductible, while the individual is responsible for 20 percent. Many major medical policies have a lifetime maximum benefit limit of up to one million dollars.

4.3.3 Comprehensive

Comprehensive major medical coverage combines the basic and major medical coverage into a single policy or contract. This type of coverage has become the most common and widely used type of policy. A claim is first paid under basic medical with a possible deductible. Then some percentage of the remainder of the claim is paid through major medical until the benefit limits are reached.

4.3.4 Special health

A variety of special health insurance policies provide limited coverage in specific circumstances. Specified disease policies provide limited coverage for certain diseases, such as cancer or heart disease. Hospital indemnity policies pay a certain amount on a periodic basis to an insured while hospitalized. The benefit paid is not related to actual expenses incurred or wages lost during the insured's hospital stay.

Accident insurance provides coverage exclusively for accidental injury. Benefits may be paid for death, disability, dismemberment, or hospital and medical expenses.

4.4 Group Health Plans

Group health insurance is the most common form of employer-provided health insurance. The majority of health insurance is written on a group basis and covers many people under a single policy. Usually, group coverage is not written for fewer than ten people. Benefits included in many group health plans include medical expense, disability, accidental death and dismemberment, and dental insurance.

Medicare and the Medicare + Choice medical savings account (MSA) plans, available starting in 1999, are covered in the Social Security chapter.

Effective for taxable years beginning after December 31, 1996, the 1996 Health Insurance Portability and Accountability Act (H.R. 3103) makes MSAs available to employees covered under an employer-sponsored, high-deductible health plan of a small employer and to self-employed individuals. Individuals with Medicare supplemental insurance are not eligible to have an MSA. An MSA is a trust or custodial account, similar to an IRA, to cover out-of-pocket medical expenses. Contributions to an MSA are tax deductible; if made by an employer, they are tax-free to the employee. Earnings on an MSA are not currently taxable, and distributions from an MSA for medical expenses are also not taxable.

MSAs are only available to small employers, defined as an employer who employed, on average, no more than fifty employees during either the preceding or second preceding year. MSA contributions may be made either by an employee or the employer, but an individual is not eligible to make MSA contributions for any year in which employer contributions are made on behalf of the individual.

Individual contributions to an MSA are deductible in determining AGI, but are limited to 65 percent of the deductible under the high-deductible plan for individuals and 75 percent for family coverage. A high-deductible plan is a health plan with an annual deductible of: (1) at least \$1,500 but no more than \$2,250 for individual coverage; and (2) at least \$3,000 but no more than \$4,500 for family coverage.

Distributions for qualified medical expenses are nontaxable, but other distributions are taxable and subject to an additional 15 percent penalty unless made after age 65, or because of death or disability. Any balance remaining in the MSA of a decedent is includible in the decedent's estate (with special rules for surviving spouse and other

named beneficiaries). The legislation limits the number of taxpayers using MSAs and requires an annual evaluation of MSAs by the Treasury. After December 31, 2000, no new contributions may be made to MSAs except by, or on behalf of, individuals who previously had MSA contributions made on their behalf and employees who are employed by a participating employer. As with IRAs, MSA accounts may be rolled over, and no part of MSA trust assets may be invested in life insurance contracts.

4.4.1 Underwriting group policies

Underwriting of group policies is so structured that every member of the group is insured regardless of age, physical condition, gender, or occupation. Underwriting factors such as age, gender, occupation, and physical condition applying to a group are likely to be factors in determining the overall cost of the package.

4.4.2 Special provisions

Certain special provisions are unique to group insurance. A conversion privilege allows insured members to change to individual coverage in certain circumstances when they are no longer eligible for group coverage. All employers with twenty or more employees, with health insurance plans, are required by the Federal Consolidated Omnibus Budget Reconciliation Act of 1986 (COBRA) to offer continuation of insurance coverage upon termination of employment or death. (See also the Employment Regulations chapter of this manual.) Certificate provisions require an explanation of the coverage provided under the group policy.

Under a coordination-of-benefits provision, an insured under two plans will be paid under each plan only to the extent of medical expenses incurred rather than the full benefits under each plan. When there are two plans covering one insured, one plan is usually the primary plan—that is, it pays benefits first and without regard to other plans. An individually written plan, however, would not be included as a plan for coordination-of-benefits purposes.

4.4.3 Benefits and services

Benefits and services under group health plans are provided in several ways. Probably the best known are the “Blues”: Blue Cross/Blue Shield. Blue Cross/Blue Shield is not an insurer per se, but rather a service organization. It contracts with certain physicians and hospitals on a nonprofit basis and pays for services directly to the service provider, as opposed to the insured. In certain circumstances, cash benefits are paid to subscribers.

4.4.4 Health maintenance organizations (HMOs)

Health maintenance organizations (HMOs) are a relatively new approach to providing health care. Employers with twenty-five or more employees are required by federal law to offer coverage under an HMO if a federally certified plan is available nearby.

HMOs focus on preventive health care by providing medical exams and early treatment. Members usually pay a set fee on a regular basis. Medical care is provided through contracts with hospitals, clinics, group practices, and individual physicians. HMOs are usually sponsored by nonprofit organizations such as hospitals, unions, consumer groups, and governments. To be eligible to enroll in an HMO, an individual must generally be part of a designated group. Individuals are occasionally allowed to enroll, but coverage is meant to be provided on a special group basis. This field of medical coverage is very complex and is changing rapidly.

4.4.5 Preferred provider organizations (PPOs)

A preferred provider organization is a hybrid of a health maintenance organization and a traditional fee for service care. A preferred provider organization is a group of private practitioners who collectively sell their services at discounted rates to insurance companies, HMOs, and employers. Many of these currently exist under contract to Blue Cross and Blue Shield plans.

Similar to HMO subscribers, preferred provider subscribers have all their medical needs taken care of for a fixed monthly amount. Participants are not restricted to the doctors or hospitals of a preferred provider organization, but if a different doctor or hospital is used, participants must pay an additional charge over and above the annual premium of the preferred provider organization.

4.4.6 Franchise health insurance

Franchise health insurance is individual insurance administered on a group basis. It is provided to persons who cannot be written on a regular group basis. It is usually offered to employees of a common employer or to members of an association or professional society. Premiums are generally lower than with individual plans because they are collected by the employer and then paid to the insurer. Individual policies are issued and insureds may select optional and additional benefits. Franchise policies are underwritten individually if the number being insured is small.

4.5 Disability Insurance

Disability insurance provides periodic payments when the insured is unable to work because of injury or sickness. Benefits replace a portion of the wages or salary the insured is losing because of an inability to work. Policies are available on an individual or group basis. Most policies cover only the wage earner, not family members or dependents. Disability insurance policies vary by definition of disability, amount of payments, waiting period, and maximum benefit period. Coverage may or may not be provided in addition to workers' compensation.

4.5.1 Total disability

Disability policies can cover both total and partial disability. Total disability may be defined as an inability to work at any gainful occupation or at a specific occupation for which the insured is qualified. Some older policies also required that the insured be confined to the home and under the treatment of a physician. A more current and practical definition defines disability as an inability to perform the duties of an occupation for which the insured is suited by training, education, or experience. Typically, a policy will provide that, for a specified time after the beginning of the disability, the insured is deemed totally disabled if completely unable to work in his or her previous occupation.

4.5.2 Partial disability

Partial disability is the inability to perform one or more important duties of the occupation. Partial disability often pays a substantial percentage of the indemnity payable for the total disability, for a period of three to six months. A residual benefit pays for lost earnings after the insured returns to work if the insured cannot earn as much as prior to the disability.

4.5.3 Benefits and waiting period

The amount the insured receives on a weekly or monthly basis is generally based upon the insured's gross earnings and is limited to a percentage of earned income. The insured will have a waiting period, usually a number of days, immediately after the onset of the disability, during which benefits are not payable. The waiting period, also called the elimination period, serves the same purpose as a deductible.

The length of the waiting period is a factor in determining the cost of the insurance. Typical waiting periods range from weekly intervals, seven or fourteen days, to monthly intervals of thirty, sixty, ninety, 180, even 360 days. Some policies provide that if the insured is disabled

a specified number of days beyond the waiting period, benefits will be paid retroactively to the onset of the disability.

All policies have a maximum benefit period during which benefits will be paid. The benefit period can range from six months to a lifetime. The most common periods are up to three years, five years or ten years, up to age sixty-five, or through the insured's lifetime. The length of the benefit period is determined by whether the policy covers a long- or short-term disability; some policies cover both.

If a worker meets Social Security's definition of a disabling condition and has accumulated enough work credits based on age, he or she may be eligible to receive Social Security disability payments. (See also the Social Security chapter herein.) Most group benefits are likely to be limited by the insurer to the extent that they duplicate Social Security benefits received by the insured for the same disability. Insurers often adjust their payment downward if both Social Security and disability benefits become payable simultaneously.

4.5.4 Renewable and noncancelable

Individual policies can be noncancelable or renewable. A noncancelable policy is most favorable to an insured because the insured has the option to renew until age sixty-five or seventy at a premium that will never be increased. With guaranteed renewable policies, the insurer retains the right to increase premiums on all policies in the same category. Policies renewable at the option of the company preserve the right of the insurer to refuse to renew.

4.5.5 Obtaining coverage

Disability insurance can be obtained in a number of special forms. As a rider to life insurance, disability provides for monthly payments should the insured become totally disabled before age fifty-five or sixty. The waiting period is usually six months with a maximum benefit period to age sixty-five, providing that if the insured is still disabled the life insurance benefits will be paid as an endowment.

Disability coverage can also be purchased to cover business overhead and operation expenses. This is most useful to self-employed professionals and sole proprietors. Coverage for key employees pays for outside help to come into a business when a key employee is disabled. Buy-out insurance provides funds for members of a partnership or corporation to purchase the business interests of a totally disabled partner or stockholder. Certain policy terms will be based on the term of the buy-and-sell agreement.

4.6 Long-Term Care Insurance

Long-term care insurance has become increasingly popular due to skyrocketing nursing home costs and an increase in average life expectancy. Long-term care insurance can provide peace of mind to the insured in addition to the preservation of quality of life into retirement years.

Although Medicaid pays for long-term care, it is a need-based program. To qualify for coverage, an individual must meet stringent income and asset limitations.

Individuals with a low net worth may not be good candidates for long-term care insurance because the premiums may be cost-prohibitive. Also, such individuals will likely qualify for Medicaid after assets have been spent down. Individuals with a high net worth may be tempted to self-insure, hoping coverage will never be needed.

Under the 1996 Health Insurance Portability and Accountability Act, a long-term care insurance contract is treated as a medical plan for tax purposes, with employers permitted to provide long-term care insurance to employees [other than through a cafeteria plan or flexible spending arrangement (FSA)], and individuals permitted to deduct premiums for long-term care insurance similar to health insurance contracts.

Benefits received under a long-term care policy are nontaxable to the recipient, limited to \$175 per day, unless the recipient can show that the excess over the \$175 amount was used to pay unreimbursed costs for long-term care services.

Premiums paid for long-term care insurance are treated as medical expenses for purposes of Schedule A itemized deductions, and are also eligible for the self-employed health insurance deduction, limited to the following amounts:

| <i>In the Case of an Individual With an Attained Age Before the Close of the Taxable Year of:</i> | <i>The Limitation on Premiums Paid for Such Taxable Years Is:</i> |
|---|---|
| Not more than 40 | \$ 200 |
| More than 40 but not more than 50 | 375 |
| More than 50 but not more than 60 | 750 |
| More than 60 but not more than 70 | 2,000 |
| More than 70 | 2,500 |

These provisions are effective for taxable years beginning after December 31, 1996, for contracts issued after 1996; an existing policy may be exchanged solely for a qualified contract without gain or loss before January 1, 1998.

4.6.1 Types of policies

The majority of long-term care insurance policies are sold directly from insurance companies to individuals. A number of employers offer group policies to employees. Under these group policies, the employee usually pays the premium on the policy, which covers the employee, spouse, and often their parents. Various organizations, such as the American Association of Retired Persons (AARP), also offer long-term care policies on a group basis.

Long-term care insurance may also be purchased as a rider to some life insurance policies. The rider allows a portion of the death benefit or cash value to be used to fund long-term care expenses.

4.6.2 Choosing the right policy

Analysis of long-term care policies requires time and patience because the policies are not standardized. For analysis purposes, sample policies and coverage terms should be obtained from various carriers. Premium quotes from each carrier should be compared and used as a benchmark.

Insurance companies should also be reviewed using a rating service such as A. M. Best and Moody's. These services provide details of the company's financial strength and track record. Nursing homes should be contacted to determine the long-term care cost in the area in which the insured plans to retire.

4.7 Insurance Continuation

4.7.1 Consolidated Omnibus Budget Reconciliation Act

The federal Consolidated Omnibus Budget Reconciliation Act of 1986 (COBRA) supersedes most state law relating to insurance coverage continuation following employment termination. State law, however, will override federal law to the extent that the state law provides greater benefits to the employee.

All employers of twenty or more employees with health insurance plans (self-insured or through an insurance carrier) must offer continuation of insurance coverage on termination of employment or death.

Persons other than employees have the right to continue insurance coverage. Continued coverage must be offered to the following:

- Voluntarily and involuntarily terminated employees, except employees discharged for gross misconduct
- Employees who lose coverage because of change in employment status from full-time to part-time

- Employees' spouses and spouses who are divorced, widowed, or separated, and their dependents
- Dependent children who become ineligible because of divorce, marriage, or age

Insurance coverage may continue for a maximum of eighteen months. Spouses and dependents are eligible for thirty-six months of continuation. Coverage may be terminated if a qualified person fails to pay a premium or if he or she becomes covered by another group plan.

4.7.2 Family and Medical Leave Act

The Family and Medical Leave Act (FMLA) requires employers to continue group health benefits for employees on FMLA leave. The employer is responsible for the same proportion of insurance premiums as when the employee is at work. The employer may attempt to recover such premiums should the employee fail to return to work after the FMLA leave.

5. LIFE INSURANCE

Three main types of life insurance make up most of the life insurance sales: term, whole, and universal life. They differ primarily in length, investment characteristics, and cost.

5.1 Term Insurance

Term insurance provides coverage for a specific time period. The time period is frequently one year but can be as long as to age sixty-five. If the insured dies during the time period covered, the insurer pays the beneficiaries the face amount of the policy.

Term insurance is initially less expensive than whole or universal life insurance. Premiums increase as the insured gets older, but as a rule, annual premiums will stay constant during each policy term, at least with the shorter-term policies. The insurance company may guarantee that it will renew the policy for another term without requiring that the insured show insurability. Many term policies are convertible to permanent types of policies without evidence of insurability.

5.1.1 Select and ultimate pricing

Some companies have adopted "select and ultimate" pricing, whereby a new policyholder gets a price break and pays less than existing policyholders of the same age who are renewing their policies. Purchasers

should use caution with this type of arrangement because the insured ultimately pays for the coverage one way or another. Over a long term, the cost tends to stabilize to much the same level that a renewing insured pays. Companies also offer revertible policies that require the insured to take a medical exam at each renewal. The insured who passes the exam gets a lower rate than is normally charged. The insured who does not pass, however, will have to pay the often steeply increasing regular premium.

5.1.2 Death benefits

Most term policies offer death benefits only, without any savings element. During the term, the face amount of the coverage usually remains constant, although it can increase or decrease. Usually, a policy with a changing face amount is purchased to cover a specific contingency the insured wants to protect against should death occur. For example, credit life insurance, bought to cover a mortgage, would decrease death benefit as the outstanding balance of the loan decreases.

5.1.3 Term policy features

A policyholder can purchase many features in a term policy although not all are necessarily unique to term policies. The following may be considered.

- A convertible policy allows the insured to convert the term policy to a cash-value policy such as whole or universal.
- Participating policies, which are issued mostly by mutual companies, pay dividends.

(Text continued on page 21)

- A nonparticipating policy, usually issued by a stock company, does not pay dividends.
- A waiver-of-premium rider pays for the premiums if the insured becomes unable to pay because of disability; however, this will increase the cost of the policy.
- Accidental death benefits pay double or triple the face amount of the policy within a specific time period after the accident if the insured dies of accidental causes. This also increases the cost of the policy.

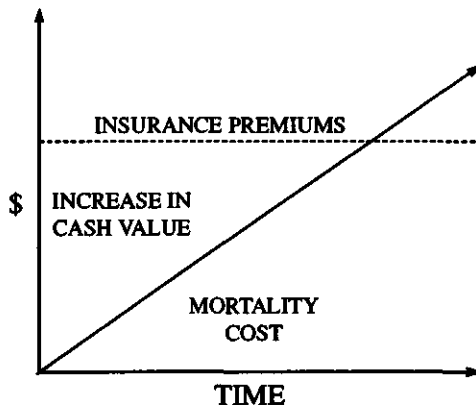
Term policies can be considered the most basic life insurance coverage available. Term coverage is low-cost and does not have any fringe benefits. Term insurance may not provide all the investment features an insured may want. Whole life and universal life are popular among purchasers who want more than simple death benefit protection, and are seeking an investment vehicle.

5.2 Whole Life Insurance

A whole life policy, or a “cash-value policy,” allows the insured to cash in the value of the policy. The policy is designed to cover the insured’s entire life. It has two basic elements, death benefit and cash value.

5.2.1 Whole life premiums

A whole life premium usually remains constant through the entire life of the policy, since a portion represents the mortality cost and the excess premium builds the cash value. The premium during the early years of the policy exceeds the actual cost of the protection. The insured, in essence, overpays in the early years and underpays in the later years. This inequity, however, is gradually reduced and eventually reversed in the later years of the policy by using a part of the cash value to fund the mortality cost.



Whole life policies are initially more expensive than term policies. For example, a thirty-five-year-old man purchasing a whole life policy might pay two thousand dollars a year for a \$200,000 whole life policy, whereas his initial annual premium for a top-rated term policy of equal face value would start at several hundred dollars. Whole life policies, however, offer other elements that are attractive to consumers.

5.2.2 Cash value

Whole life policies contain an investment element in addition to mortality protection. Upon termination of the contract, policyholders can cash in the value of their policies. When the insured does so, he or she receives the cash value that has accumulated to that point from payments on the insurance. The rate of return on a cash-value policy is known as the "Linton yield." There will be a negative Linton yield during the early years of the policy because expenses charged against the policy use up most, if not all, of the accumulated cash value. The yield can rise considerably, however, during the later years of the policy. The rate of return on a whole life policy is, therefore, indefinite. To set a respectable return on the insurance investment, an insured usually must keep the policy for a substantial period of time.

Policyholders can borrow against the cash value of the policy without terminating the contract, usually at a specified interest rate. If the insured dies or cashes in the policy, the amount received by the beneficiary or the insured will be reduced by the amount due on the loan.

5.2.3 Dividends

Whole life policies, like term policies, can be participating or nonparticipating. If the policy is participating (that is, if it pays dividends), the amount of dividend each policyholder receives is determined by the age of the policyholder, how long the policy has been in effect, and the kind of policy each insured holds. Dividends are usually paid annually and in certain amounts per thousand dollars of coverage. For example, if an insured had a \$100,000 policy and the insurer declared a dividend of \$2, the insured would receive \$200. The dividends may be paid in cash, used to purchase insurance, or added to the cash value of the policy. Interest earned on accumulated dividends, which are not used to purchase additional paid-up insurance, is generally taxable to the policyholder.

5.2.4 Tax benefits

Whole life policyholders can realize special tax benefits from a whole life policy. Currently, the cash-value buildup in a whole life policy is

tax-deferred and partially tax-sheltered. The insured need not pay tax on the cash-value increase of the policy until it is withdrawn. When the money is withdrawn, only the portion that exceeds what the insured paid in premiums minus dividends received is taxable. In addition, life insurance dividends are not taxable. For tax purposes, dividends are considered a refund of a prior overcharge.

5.3 Universal Life Insurance

In many ways, universal life insurance offers the best of term and whole life policies. Younger individuals with greater insurable risks can obtain low-cost coverage, whereas older individuals can look more toward the retirement planning aspect of the cash value. The insured receives an annual statement detailing the amount of death-benefit protection, the cash value, and the premiums paid. The annual premium is credited to the insured's account, then deductions are made for the insurance protection and company expenses. What then remains is the cash value of the policy.

Policyholders may borrow against the account, and can withdraw all or part of the cash value. As with whole life insurance, policyholders are not taxed on the cash-value increase until the amount is withdrawn. The insured is then taxed only to the extent that the value paid exceeds the premiums paid throughout the life of the policy.

Universal life can be purchased in two forms. Option A pays only the face amount of the policy to beneficiaries at the insured's death. Option B, the more expensive policy, pays the face amount and the accumulated cash value.

5.3.1 Basic features

Most universal policies have three basic elements. First is the interest rate, which determines the amount earned on the insured's premium and investment to be credited to the insured's cash value. Usually a baseline rate will be guaranteed by the company, typically 4 or 4.5 percent. The rate may vary by action of the board of directors or by a market index ratio. Second, the mortality charge is the amount charged against the cash value to cover the insurance protection. Third, company expense is charged against the cash value, but this is usually stable throughout the life of the policy. Some companies may pay for expenses by charging a one-time policy fee of, say, \$250.

5.3.2 Options

An insured has the option of changing the premium amount paid, depending on circumstances. Most often the insured can pick the premium he or she wants to pay. The insured can pay the target premium,

which is an amount established by the company. The insured can also pay less than the target amount, but if that amount falls low enough, no cash value will accumulate and the policy will be much like a term policy. Insureds can also pay more than the target premium, up to a point, in which case the insured may not be required to pay premiums for a certain time period.

Unlike whole life contracts that require a separate policy for additional purchased coverage, a universal policyholder can also increase coverage, within limits. If the policyholder does so, the same premium can be paid, but the cash value of the policy will rise more slowly. The important thing to remember with the last two options is that, somewhere, the policyholder will pay for the coverage. The accumulated cash value functions as a reserve that gives the insured and the company the ability to decrease premiums, increase coverage, and charge for mortality protection and expenses.

5.3.3 Unique features

Some universal life policies have unique features. As mentioned above, some policies have minimum-interest guarantees of 4 to 4.5 percent. Policyholders can borrow against the policy at a fixed or a variable rate. Some companies guarantee that the policy will not lapse during the early years of the policy, provided the minimum premiums are paid.

Some companies do not credit premium payments to the policy until the end of each month, which is comparable to a bank holding a deposit for several days before crediting it to the account.

Policies that have a guaranteed interest rate sometimes also have an excess-interest penalty. Any interest paid by the company on the cash value that is above the guaranteed rate is forfeited by the insured upon surrendering the policy for cash. Finally, some companies limit the percentage of cash value policyholders can withdraw within a certain time period.

5.3.4 Variable universal life

One of the newest offshoots of universal life is variable universal, sometimes called variable adjustable. Under a variable policy, the insured may choose the type of investment that earns a return on the cash value. The insured's policy is then paid whatever yield that particular underlying investment earns. The insured is essentially taking the risk of a good or bad investment, with the cash value and the insurance protection at risk from a bad investment. To mitigate the impact that such a situation might have, some companies guarantee to keep the policy in force for the first few years and pay a death benefit even if the cash value is insufficient to pay the cost of the insurance.

Investment options for variable policies normally include equity and bond mutual funds, as well as money market funds. Policyholders generally have the opportunity to periodically change investment vehicles as they perceive changes occurring in the financial markets. Accordingly, variable policies are often viewed as important retirement planning tools in addition to the death benefit protection they afford.

5.4 Key Person Insurance

A key person life insurance policy is written to insure the life of important business employees. The policy indemnifies the company for economic loss suffered from the death of a key employee. Key person insurance can be written on any employee who has special skill or knowledge, such as sole proprietors, directors, officers, managers, salespeople, and department heads.

The insurance pays for costs to keep the business going, recruiting and training a replacement, and for other problems that arise from the loss of a key employee. The amount of insurance usually purchased is three to five times the key person's annual salary. It is not uncommon, however, for a corporation to insure its executives for millions of dollars.

5.5 Group Term Plans

The other major type of business life insurance is the employee group plan. Group life insurance is usually provided through group term insurance. It can usually be written to include spouses and dependents of the group members.

5.5.1 Basic characteristics

Group term insurance normally requires a minimum of ten people under one contract, and coverage is usually provided without regard to individual insurability. Premiums are based on the characteristics of the group so that a policy covering older people would be more expensive than one covering younger people. Individuals within the group may not choose their benefit level.

Most group term insurance is one-year renewable term insurance. Premiums are most often paid by the employer, although employees may be required to pay a small part. Individuals in the group generally lose the coverage when they leave their employment, but most states have statutes that require that the resigning employee have the option to convert the plan to an individual policy upon resignation. The coverage is automatically continued in force for a thirty-day period. Employees may not be required to show evidence of insurability.

5.5.2 Group permanent life

Some group life insurance policies provide “permanent” rather than term coverage. In essence, this policy is a group form of a cash-value policy such as whole or universal life. The cash and nonforfeiture values in permanent life are available to employees to supplement a retirement plan. Group permanent life insurance makes up only a very small percentage of the total employer plans written. Employer contributions to a permanent life insurance policy may be taxable in part, as imputed income to the employee.

5.5.3 Noncontributory plans

Group life insurance is underwritten on the basis of the whole group and may be either contributory or noncontributory. A noncontributory plan requires no contribution from the employee to the cost of the policy. These individuals are therefore not allowed a choice as to whether they will be covered; coverage is automatic.

5.5.4 Contributory plans

A contributory plan requires employees to pay a portion of the insurance premium. Under a contributory plan, 75 percent of all eligible employees must choose to participate in the plan. This requirement protects the insurer from adverse selection, the tendency of the employees in poorer health to participate in the plan.

5.5.5 Amount of coverage

The amount of insurance an employee is provided usually depends upon the employee’s salary and job class. Only a few states still limit the amount of coverage that can be written under a group plan. Employees who are provided with more than \$50,000 in group term insurance coverage must annually include in income an amount determined, by reference to the IRS table defined at Regulation Section 1.79-3(d)(2), to be the value of the coverage that exceeds \$50,000.

5.6 Single-Premium Policies

Single-premium policies provide life insurance plus a pool of savings dollars to invest. Single-premium policies pay variable market interest rates, or may wrap insurance around other investment vehicles such as stocks, bonds, and mutual funds.

Single-premium policies are available for whole life insurance, under which an interest rate for the savings dollars is declared by the

company. These rates are changed at various intervals, normally once a year. Variable life insurance policies also offer the single-premium option. Under these policies, the individual is allowed to pick from a variety of investment alternatives.

Earnings on single-premium policies, as on other life insurance policies, are currently tax-deferred. If certain limitations regarding funding are met, the earnings may be withdrawn tax free by borrowing against the policy. Any borrowings are deducted from the value of the policy upon death.

For insurance contracts entered into after June 20, 1988, the Technical and Miscellaneous Revenue Act of 1988 restricts the ability to take tax-free withdrawals and tax-free loans against certain single-premium policies. Special rules apply to life insurance contracts funded at a more rapid rate than that allowed by the payment of seven level annual premiums. Pre-death distributions are treated as income first and then as recovered basis. Loans are treated as distributions, and an additional 10 percent early withdrawal penalty would be imposed unless the distribution occurs on account of disability or when the taxpayer is age fifty-nine-and-a-half or older.

Most companies do have a surrender charge if a single-premium policy is canceled in the first few years. Upon cancellation, the earnings of the policy will be taxed.

Single-premium policies, which were available in a variety of alternatives, have lost some of their popularity. Investment fees are often included in single-premium policies, and the net rate of return, rather than the gross rate of return, should always be analyzed.

5.7 Split Dollar/Reverse Split Dollar Policies

Normally, split dollar insurance is an arrangement between an employer and an employee under which the benefits of a life insurance policy are split between the employer and the employee. The employer typically pays the entire premium on a whole life insurance policy and retains the right to receive the cash surrender value of the policy. Upon the employee's death, the premiums paid by the employer are repaid by deducting the total premiums paid from the insurance death benefit. The remaining benefit is paid to the employee's personal beneficiary. Employers can use this vehicle to provide a valuable fringe benefit while being able to discriminate in favor of targeted employees.

If the employer retains the right to the cash surrender value of the policy, but pays the entire premium, the employee is annually taxed on the mortality cost of the pure insurance portion of the policy. The

amount reported as income by the employee is equal to the economic benefit of the personal insurance. This amount is based on one-year term insurance premium rates, referred to as P.S. 58 costs. If the employee pays a portion of the premium, the reportable income amount is proportionately reduced. It is common in this type of arrangement for the employee to pay an amount equal to the P.S. 58 cost, thereby avoiding any taxable income.

Reverse split dollar insurance reverses the rules discussed in the prior paragraph. In the typical reverse split dollar plan, the employer pays a portion of the premium equal to the economic benefit of the personal insurance (P.S. 58 cost) each year while the difference between this cost and the full premium is contributed by the employee. Generally, the employee owns the cash value portion of the policy and the employer controls the death benefit proceeds.

Both split dollar and reverse split dollar insurance are not unique types of life insurance but rather variations on the method of purchasing life insurance.

5.8 Second-to-Die Life Insurance

This type of life insurance policy names a married couple as joint insureds and pays the death benefit only upon the death of the second spouse. The premiums are significantly lower because of the two-death requirement. This policy variation is becoming popular because current federal estate tax law provides an unlimited marital deduction, which effectively delays payment of any estate tax until the second spouse dies. Estate planners often recommend life insurance to provide cash to pay estate taxes and prevent the sale of nonliquid assets. If the policy is owned by the decedents it is considered part of their estate, so an irrevocable life insurance trust may be established to hold the policy in its name and receive the proceeds. (See the chapter on Trusts, herein).

5.9 Living Benefits Insurance

Most insurance companies now offer *living benefits* or *accelerated benefits* coverage as an attachment to their whole life and universal life insurance policies. This alternative allows a terminally ill insured to withdraw part of the future death benefit to pay for large medical expenses. Insureds with extended stays in nursing homes also may withdraw funds to pay for these expenses. The sum eventually received by the beneficiaries is reduced by the amount withdrawn. Favorable tax treatment is awarded to pre-death withdrawals by some terminally ill insureds.

5.10 Annuities

Although not an insurance contract directly, annuities are products marketed through insurance companies that enjoy some of the tax privileges of cash value life insurance products. Annuities allow investors to establish a retirement plan while providing a tax-sheltered investment. They can be purchased in a lump sum or through a series of premium payments. Tax-deferred annuities present a valuable long-term investment option. They allow the investor to earn interest on the principal tax-deferred until the investor withdraws certain amounts or begins to receive payments under the annuity. Reference the chapter on Investment Vehicles for a more thorough discussion of annuity investments.

6. PROPERTY INSURANCE

Property insurance indemnifies against loss resulting from destruction of or damage to the insured's property or from its disappearance through theft. Property insurance can be purchased to cover real and personal property, the cost of reconstructing valuable papers, computer files, and accounts receivable, and expenses to keep a business operating after damage to buildings and equipment. Loss of income because of property damage or destruction can also be covered under property insurance.

There are two distinct areas of property insurance. One addresses direct losses, such as buildings, contents, and other tangible items. The second area addresses indirect losses, such as loss of income, loss of rents, and extra expenses. In many cases, the indirect loss may exceed the direct loss. For example, a retail commercial or manufacturing establishment may have a building fire that does substantial damage to the building (say \$100,000), but by the time the owner can rebuild, substantial income has been lost (perhaps \$200,000).

6.1 Perils/Property Commonly Insured

The perils and property of an insured will depend in part on the type of business the insured operates, the property owned, and the perils likely to be encountered by the insured. Property insurance is available on a named-peril basis, broad-form basis, or comprehensive basis.

6.1.1 Named-peril policies

Named-peril coverage insures against damage caused by listed perils such as fire, lightning, wind, hail, explosion, riot, smoke, aircraft, non-owned vehicles, and vandalism. On a named-peril policy, only the perils specifically listed are covered.

6.1.2 Broad-form policies

Broad-form or optional-perils policies provide coverage for the base perils listed above, in addition to damage by water; glass breakage; weight of ice, snow, or sleet; falling objects; and damage by owned vehicles.

6.1.3 Comprehensive perils

Comprehensive perils policies insure the insured against risk of physical loss from all perils, except those specifically excluded in the policy. The additional perils usually covered in addition to those covered by the named-peril and broad-form policies are theft, collapse, sewer back-up, earthquake, electrical damage, spillage of chemicals, and scorching.

Nonowned and hired auto coverage can be endorsed to a policy covering owned vehicles, rather than requiring a separate nonowned and hired automobile policy. It is normally much less expensive to simply add this as an endorsement to a policy covering owned vehicles. If the employer does not own any vehicles, this coverage may be added to the general liability policy.

6.1.4 Automobile liability coverage

Most businesses and individuals carry policies to protect against liability arising from automobile accidents. Such policies normally cover both liability and property damage and offer optional coverage for medical expenses.

Businesses should closely review the liability coverage amounts on policies to assure that single and aggregate liability coverages are adequate.

6.1.5 Nonowned and hired cars automobile liability

If an employee uses his or her personal car on company business and causes bodily injury or property damage to another party, the employer will most likely be named as a party in any ensuing lawsuit. Nonowned and hired cars automobile liability insurance gives the employer protection in such a situation. Additionally, excess liability coverage (see section 7.4) will not protect an employee in this situation unless there is primary nonowned and hired cars coverage.

Nonowned and hired auto coverage can be endorsed to a policy covering owned vehicles, rather than requiring a separate nonowned and hired automobile policy. It is normally much less expensive to simply add this as an endorsement to a policy covering owned vehicles. If the employer does not own any vehicles, this coverage may be added to the general liability policy.

6.1.6 Drive other car endorsement (DOC)

This endorsement to a commercial auto policy is necessary when and if an owner, partner, or officer of the business does not have a personal auto policy and the only auto available to the owner, partner, or officer is a company car. Auto insurance follows the vehicle, so if the owner, partner, or officer borrows a friend's auto and has an at-fault accident, the friend's auto policy will not cover the owner, partner, or officer. In addition, a commercial auto policy will not respond to liability, unless the DOC endorsement is made a part of the policy.

(Text continued on page 31)

6.1.7 Commercial inland marine

Commercial inland marine coverages can be extremely important to certain businesses in order to cover personal property off premises, or in transit, such as equipment, motor truck cargo, and electronic data processing equipment. Normal property coverage covers property only on, in, or within 100 feet of the insured premises.

6.2 Amount of Insurance

An important question to purchasers of property insurance is the amount to buy. The answer depends on the needs of the insured and the type of property to be insured. The first decision is whether to insure for actual cash value or for replacement cost.

6.2.1 Actual cash value

Actual cash value is the replacement cost of the lost or damaged property minus the decline in value because of age and normal wear and tear. For example, if it costs \$50,000 to rebuild a damaged or destroyed building that is seventy-five years old and only in fair condition, the insurer will pay a cash amount that is much lower than the \$50,000 replacement cost because of the decline in value because of age and condition of the building. Actual cash value puts the insured in the same financial condition with respect to the property after the loss as before the loss.

6.2.2 Replacement cost

Replacement cost covers the cost of replacing the property or goods without deduction for decline in value. Replacement cost cannot be added to a policy unless there is first 80 percent or higher co-insurance or agreed-value endorsement (see section 6.2.4 of this chapter). Replacement-cost policies usually require that the insured actually replace the property. The insured will be covered to replace, repair, or rebuild with like materials and labor. If the insured does not replace the property, the insured will be paid the actual cash value.

The insured must also decide what amount of coverage to purchase. Buildings should be appraised to determine both actual-cash-value and replacement-cost amounts. An inventory of personal property and equipment should include not only furniture and fixtures but also consumable supplies.

6.2.3 Co-insurance

Most insurance policies include a provision that penalizes the insured who fails to purchase coverage at a minimum percentage of the value

of the insured item, a provision known as the co-insurance clause. The minimum percentage is 80 percent on direct damage, but can be as low as 50 percent for indirect damage. For example, in purchasing insurance to cover property valued at \$100,000, if the co-insurance percentage is 80 percent, the insured should purchase at least \$80,000 of insurance so that the insurer will pay 100 percent of any loss up to the \$80,000 maximum. Co-insurance is a prerequisite to replacement cost (see section 6.2.2 of this chapter), agreed-value endorsement (section 6.2.4), and inflation guard coverage (section 6.2.5).

If the insured fails to insure at least to the minimum co-insurance percentage, the company will pay an amount that is a percentage of the actual amount purchased. The insured, in effect, becomes co-insurer for the uncovered amount. For example, if the insured chooses to insure 50 percent of the value, and the co-insurance percentage is 80 percent, the insurer will pay, as determined by a formula, 50 percent over 80 percent or five-eighths of the claim. One effective strategy to deal with co-insurance provisions is to purchase insurance for more than the co-insurance percentage multiplied by the property value. The reason is that the property value is the value at the time of the loss, unless an agreed-value endorsement, as described next, applies.

6.2.4 Agreed-value endorsement

Some insurance companies may allow the insured to insure the property on an agreed-value basis. This is done through an appraisal and an attached agreed-value endorsement. This agreement provides that the amount of insurance purchased is equal to the value of the property. Agreed-value provisions help avoid disputes as to the value of the property at the time of loss.

6.2.5 Inflation guard coverage

Another option is the automatic-increase endorsement that can be added to a policy. It provides for automatic increases in the amount of insurance to keep pace with inflation. Inflation guard coverage can be added to apply to buildings, contents, or both. The current minimum annual percentage is 4 percent, although higher percentages are available in 2-percent increments, such as 6 percent, 8 percent, and so forth. The annual percentage increases the policy amount and applies pro-rata on a daily basis. As an example, a \$100,000 policy on a building with a 10-percent inflation guard would pay \$101,640 if a total loss occurs sixty days into the policy. This is computed by taking $60/365$ of 10 percent, which computes to 1.64 percent. This inflation guard amount is then multiplied by the insurance amount, computing an inflation guard

amount of \$1,640. When added to the initial insurance of \$100,000, this produces the loss payment amount of \$101,640.

6.3 Deductibles

Most property insurance policies have deductibles. Deductible amounts may vary widely; however, a common deductible is \$250 per occurrence. Generally, the amount of the premium decreases as the amount of the deductible increases.

6.4 Insurable Interest

Insurable interest is important in property insurance. To have an enforceable contract, insurable interest requires that the insured have some kind of interest in the insured property. Requiring that the insured have a stake in the insured property avoids both wagering and the risk of failure to protect the property from harm. Insurable interest will usually be found to exist if the insured stands to suffer a financial loss from damage to the property. There is no middle ground; either an insurable interest exists or it does not. However, the amount depends upon the value of the insurable interest to the insured.

Insurable interest must exist at the time of loss. An insured may have an insurable interest when the policy is purchased but not have one when a loss occurs. Under the insurable-interest theory, one who has sold, lost, or transferred property no longer will suffer loss upon damage to the property, and the insurable interest is extinguished.

6.5 Increase in Risk

Insurance companies provide insurance by shifting the risk from the insured to the insurer. Premiums and policy provisions are based on assuming certain kinds and levels of risk. Any factor that increases that level of risk represents a potentially unacceptable risk to the insurer for the premium being paid.

Homeowners insurance assumes that the insured home is owner-occupied, at least for a certain percentage of the time. Premiums for owner-occupied versus vacant homes are quite different. If a homeowner insured by a homeowners policy later left the property vacant, the inherent increase in risk may be unacceptable to the insurer and the insurer may not be legally bound to cover the insured for the increased risk.

7. LIABILITY INSURANCE

Liability insurance is unlike other types of insurance in that it provides a direct benefit not to the insured but to a third party. Liability insurance pays on behalf of the insured for claims for damages, which the insured is legally obligated to pay to a third party, for bodily injury, property damage, personal injury, and other legal liabilities that may arise from the operations of the insured's business.

Many types of liability insurance are available, including

- General liability.
- Product liability.
- Professional liability.
- Malpractice liability.
- Errors and omissions liability.
- Excess liability.
- Director's/officer's liability.

7.1 Occurrence Policies

Traditionally, coverage to third parties under a liability policy has been made on an occurrence basis. This means that the claim is paid by the insurance company that insured the business when the accident or injury occurred. Thus, if a person is injured on the insured's premises but does not file a claim until four years later, the parties would look to the coverage provided at the time of the injury.

The occurrence policy has caused problems because situations such as that just described brought questions as to who was the insurer at the time of the injury, what were the policy limits, and whether the insurer is still in business. This is one reason that "claims-made" policies have become somewhat popular in recent years, especially for professional malpractice policies.

7.2 Claims-Made Policies

A claims-made policy responds when the claim is made or reported, unless, as explained below, the policy includes a retroactive date. The insurer that covers the company when the claim is made is liable (regardless of when the injury actually occurred). An insurance company could thus potentially have to provide coverage for an insured for claims that arose many years before that insurer first covered the insured.

Claims-made policies are controversial. A change in insurers by a business could result in a gap during which it is unclear whether coverage exists. If a claims-made policy is retroactive for five years, it will not pay for claims made for injuries occurring more than five years before the effective date of the policy. This approach may result in a coverage gap, and the insured may have to bear the consequences.

A policy provision known as “extended report date” or “tail” coverage can reduce or eliminate the gap created by switching claims-made liability insurance policies. A tail provision allows the insured to ask for extended coverage for claims that arise after the cancellation (except for nonpayment of premium) of the policy, extending coverage under the policy for one extra reporting period. The tail period may range from sixty days to an unlimited period of time, depending on the policy provision. A predetermined premium will be charged for the tail.

Gaps in coverage occur when

- The expiring policy is a claims-made policy and the replacement policy is a claims-made policy with a retroactive date later than the retroactive date of the expiring policy.

Example: Under expiring claims-made policy A, retroactive to January 1, 1997, Jane is covered for claims made during calendar year 1997. Replacement claims-made policy B covers Jane for claims during calendar year 1998 provided the occurrence was after September 1, 1997. If, in 1998, a claim is made against Jane for an occurrence in August of 1997, she is not covered. Thus, Jane must buy tail coverage for her expiring policy to cover occurrences between January 1, 1997, and August 31, 1997.

- The expiring policy is a claims-made policy and the replacement policy is an occurrence policy.

Example: Under expiring claims-made policy A, Jane is covered for claims made during calendar year 1997. Replacement occurrence policy B covers Jane for claims based on occurrences in calendar year 1998. Once policy A expires, Jane is without coverage for 1998 claims based on 1997 occurrences. Thus, Jane must buy tail coverage for her expiring policy to protect herself against such claims.

If the expiring policy is an occurrence policy or if the replacement policy is a claims-made policy with the same retroactive date as the expiring policy, no gap in coverage occurs.

7.3 General Liability Policies

Most general liability policies are known as commercial general liability. Formerly, these policies were known as comprehensive general liability.

The coverage contents of the two policies are roughly the same. The general liability policy covers

- Bodily injury to persons or damage to property from the business premises and operations.
- Injury or property damage arising from the use of a product or service provided by the business.
- Coverage for risks of businesses engaged in high-risk operations, such as risk of explosion, collapse, or underground hazards.
- Injuries or claims arising from personal injury, where personal injury means injury, other than “bodily injury” arising out of one or more of the following offenses:
 - False arrest, detention, or imprisonment
 - Malicious prosecution
 - Wrongful entry into, or eviction from, a room, dwelling, or premises that the person occupies
 - Oral or written publication of material that slanders or libels a person or an organization or disparages a person’s or organization’s goods, products, or services
 - Oral or written publication of material that violates a person’s right to privacy
- Medical payments for injuries incurred on the business premises.
- Coverage for fire damage to the occupied portion of a landlord’s building.

Automobile liability and workers’ compensation must be separately insured because they are not included in a general liability policy. There are a few other coverages for special situations, such as injuries arising from a company-hosted event with liquor served or from a company-sponsored entertainment on a boat. Newly acquired organizations also are generally automatically covered by the general liability policy.

As with all other insurance, liability has coverage limits: the occurrence limit and the aggregate limit. The aggregate limit, which is the aggregate amount the insurer will pay for the coverage provided during the policy period, is often double the occurrence limit. The occurrence limit is usually set by the insured and the insurer, and is based on the level of risk and other needs of the insured.

The aggregate limit is reduced by each occurrence that requires a coverage payment. Thus, if an insured has an occurrence limit of \$500,000, its aggregate limit could be \$1 million. If the insured then had three claims of \$300,000 each, the aggregate would be reduced to \$100,000. If a liability claim from a later occurrence exceeds the

remaining \$100,000, the insured would be covered only up to \$100,000 and would have to turn to an excess or umbrella liability policy to cover the balance of the claim. Some insurance companies, however, offer an aggregate greater than twice the occurrence amount.

Although professional liability policies are often considered and included in general liability policies, they are actually separate types of policies and are almost exclusively written on a claims-made basis. Examples of professional liability coverage include medical malpractice, malpractice insurance for architects and engineers, errors and omissions insurance for insurance agents, professional liability insurance for accountants, and professional liability insurance for attorneys.

7.4 Excess-Liability Policies

Excess-liability policies cover an insured for exposures that exceed the primary liability limits. Excess liability is sometimes sold in a specialty insurance market. For this reason businesses should investigate potential excess insurers before purchasing from them.

Excess policies tend to track the primary policy in coverage conditions, definitions, and exclusions. Excess insurers like to insure policyholders with high primary-insurance limits. Therefore, the cost of excess insurance tends to be lower when the insured has high primary-policy limits.

Excess liability “layers” insurance coverages. There is no coverage until the prior layer has been exhausted. Many companies purchase more than one level of excess coverage. This approach should be strongly considered, given the increasingly high verdicts that juries are awarding.

Excess-liability policies cover high limits of liability protection with very broad coverage provisions. The excess-liability policy provides excess coverage for general liability, automobile liability, and employer’s liability and usually will cover many exclusions and gaps in the primary liability policy.

Excess-liability insurers generally require assurance that the insured maintains a certain level of primary general liability, auto liability, and employer’s liability coverage. Here again, certain limits on primary coverage are required. Finally, most excess-liability policies have a self-insurance provision that operates like a deductible. This amount is frequently \$10,000 or more. This amount usually applies to losses not covered under the primary coverage.

Although the typical excess-liability policy provides very broad coverage, there are a number of standard exclusions. These exclusions should be examined by the insured who is purchasing a given policy

to determine whether or not they are acceptable. It is not unusual for companies to purchase multimillion-dollar excess-liability policies.

8. EMPLOYEE BONDING

Employee bonding covers losses due to dishonesty and fraud committed by employees. Fidelity bonds cover losses up to the policy limits.

8.1. Fidelity Bonds

There are two types of fidelity bonds: individual and blanket.

8.1.1 Individual bonds

Individual or name-position bonds cover only the individuals specified in the bond. Collection under this type of bond is dependent on proving that the named individual committed the dishonest act. The insured must also inform the company if the persons named in the bond leave employment. The insured must also be able to determine, in advance, which individuals are in situations in which dishonesty is possible.

8.1.2 Blanket bonds

A blanket bond covers all employees, with the premium based upon the number of employees who have access to money or property. A commercial blanket bond pays a flat amount specified in the policy. For example, if a bond has a face amount of \$50,000 and three employees acting together steal \$100,000, the maximum the insured can recover is \$50,000.

8.1.3 Bonding coverage

Bonds cover only employees, or those who work regularly for the employer and are paid a wage or salary. Nonemployees who handle money or sign checks can be covered under special riders. The amount of insurance to purchase depends on the total budget, built-in accounting controls, and security procedures of the insured. There is no standard or set amount.

8.1.4 Exclusions

Fidelity bonds commonly have two exclusions or limitations. First, there must be proof of a real loss and a reasonable certainty that the money

or property was stolen by an employee, not a member of the general public or other nonemployee.

A second restriction often imposes limits on the ability of the employer to retain an employee once a theft has been discovered. If such an employee is allowed to continue employment with the business, coverage ceases immediately. If an employer keeps an employee on duty because of a promise to pay back or for some other reason, coverage will end for that individual only.

8.2 Combination Crime Policies

The combination crime policy combines fidelity bond coverage with other coverage. Fidelity bond coverage is the basic coverage in such a policy. In addition, however, these policies cover loss through burglary, robbery, and the disappearance or destruction of money and securities. Coverage is provided for these losses both inside and outside the premises.

This policy, in essence, covers all losses described in the policy, whereas the fidelity bond covers acts of employees. The amount of coverage is purchased on the basis of potential loss inside and outside, the amounts of cash and property at risk, and the number of employees to be covered by the fidelity bond. As with fidelity bonds, deductibles are not usually required, although the insured may arrange one if desired.

9. SOCIAL SECURITY

Social Security, or Old Age, Survivors, Disability, and Health Insurance (OASDHI), is the only federally funded social insurance plan. OASDHI was established as one of the basic parts of the Social Security Act, first passed in 1935. Companion programs under the act include Medicaid, Aid to Families with Dependent Children (AFDC), Unemployment Insurance, and Supplemental Security Income (SSI).

Social Security provides benefits upon retirement, for disability and survivors of insured individuals, medical care and catastrophic health care coverage for the aged through Medicare and Medicaid, and public assistance through Supplemental Security Income for the needy and disabled. (Social Security is covered in detail in another chapter of this manual as is unemployment insurance.)

REFERENCES

- AICPA. *What a CPA Should Know About Business Insurance*. CPE Course Manual. New York: American Institute of Certified Public Accountants, 1989. Updated annually.
- Baldwin, Ben G. *Complete Book of Insurance: The Consumer's Guide to Insuring Your Life, Health, Property and Income*. Burr Ridge, Ill.: Probus, 1996.
- . *New Life Insurance Investment Advisor: Achieving Financial Security for You and Your Family*. Chicago: Probus, 1994.
- Black, Kenneth, and Harold Skipper, Jr. *Life Insurance*, 12th ed. New York: Prentice Hall, 1993.
- Brownlie, William D., and Jeffrey L. Seglin. *The Life Insurance Buyer's Guide*. New York: McGraw-Hill, 1989.
- Crockford, Neil. *Risk Management*. New York: State Mutual Book & Periodical Service, Ltd., 1992.
- Dorfman, Mark. *Introduction to Risk Management and Insurance*. 5th ed. New York: Prentice Hall, 1990.
- and Saul Adelman. *Life Insurance: A Financial Planning Approach*, 2d ed. Chicago: Dearborn Financial Publishing, Inc., 1991.
- Gibbons, Robert J., et al. *Insurance Perspectives*. Malvern, Penn.: American Institute for Chartered Property Casualty Underwriters, Inc., 1992.
- Goldwasser, Dan L. *Directors' and Officers' Liability Insurance (A Course Handbook)*. New York: Practising Law Institute, 1992.
- Greene, Mark, and James Trieschman. *Risk and Insurance*, 8th ed. Cincinnati: Southwestern Publishing Company, 1988.
- Gustavson, Sandra C. and James S. Treischmann. *Risk Management and Insurance*, 9th ed. Cincinnati: Southwestern Publishing Co., 1995.
- Humber, Wilson J. *Buying Insurance: Maximum Protection at Minimum Cost*. Chicago: Moody Press, 1994.
- Joint Committee on Taxation, Description and Analysis of Title VII of H.R. 3600, S. 1757, and S. 1775 ("Health Security Act") (JCS-20-93), December 20, 1993.
- Kensicki, Peter R. *Principles of Insurance Production*, 3d ed. Malvern, Penn.: Insurance Institute of America, 1991.
- Monippallil, Matthew. "Life Insurance as an Estate Planning Tool." *The Tax Adviser* 21, no. 5 (May 1990): 308.

- Mooney, Sean, and Larry Cohen. *Basic Concepts of Accounting and Taxation of Property/Casualty Insurance Companies*. 4th ed. New York: Insurance Information Institute, 1995.
- Mooney, Sean. *Insuring Your Business: What You Need to Know to Get the Best Insurance Coverage for Your Business*. New York: Insurance Information Institute, 1992.
- Pritchett, S. Travis. *Risk Management and Insurance*, 7th ed. St. Paul, Minn.: West Publishing Co., 1996.
- Rejda, George. *Principles of Risk Management and Insurance*, 5th ed. New York: HarperCollins College, 1991.
- Reynolds, John D., et al. *Health Insurance Answer Book*, New York: Panel Publishers, 1991.
- Scott, David L. *The Guide to Buying Insurance*. (Money Smarts Series). Saybrook, Conn.: Globe Pequot Press, 1994.
- Sneyd, Michael R. *Insurance*. Englewood Cliffs, N.J.: Prentice Hall, 1996.
- Vaughan, Emmett J. *Fundamentals of Risk and Insurance*, 7th ed. New York: John Wiley & Sons, Inc., 1996.
- Williams, C. Arthur, and Richard M. Heins. *Risk Management and Insurance*, 7th ed. New York: McGraw-Hill, 1995.

TRUSTS

1. TRUST FORMATION

- 1.1 General Concept
- 1.2 Reasons for Trust Creation

2. TYPES OF PERSONAL TRUST

- 2.1 Testamentary Trust
- 2.2 Inter Vivos Trust
 - 2.2.1 Revocable trust
 - 2.2.2 Irrevocable trust
 - 2.2.3 Reversionary trust

3. SPECIFIC USES OF TRUSTS

- 3.1 Minors
- 3.2 Children and Grandchildren
- 3.3 Spouse
- 3.4 Life Insurance
 - 3.4.1 Revocable unfunded life insurance trust
 - 3.4.2 Irrevocable unfunded life insurance trust
 - 3.4.3 Irrevocable funded life insurance trust
- 3.5 Business Use
- 3.6 Charitable Trusts
- 3.7 Trust for the Benefit of the Grantor (Living Trust)
- 3.8 Medicaid Trusts
- 3.9 Land Trusts

4. TRUST ADMINISTRATION

- 4.1 Trustee
 - 4.1.1 Duties
 - 4.1.2 Powers
 - 4.1.3 Liability
 - 4.1.4 Compensation
- 4.2 Beneficiary
- 4.3 Duration

5. INCOME TAXATION

- 5.1 Grantor
 - 5.1.1 Reversionary interest
 - 5.1.2 Adverse and related parties
 - 5.1.3 Beneficial enjoyment
 - 5.1.4 Reservation of administrative powers

TRUSTS

5.1.5 Powers that can be retained

5.1.6 Creating a defective grantor trust

5.2 Beneficiary

5.2.1 Distributable net income (DNI)

5.2.2 The throwback rules

5.3 Trust

6. GIFT TAXATION

6.1 Annual Exclusion

6.2 Gifts for the Benefit of a Minor (IRC Section 2503(c))

6.3 Demand (Crummey) Trusts

7. ESTATE TAXATION

7.1 Grantor (Decedent)

7.2 Beneficiary

7.3 Grantor Retained Income Trust

REFERENCES

1. TRUST FORMATION

A trust is a legal arrangement whereby one person (the trustee) owns property but holds and manages it for the benefit of someone else (the beneficiary).

1.1 General Concept

A trust can be a valuable tool for arranging for the disposition of an individual's wealth. A trust is legally defined as "a fiduciary relationship with respect to property, subjecting a person by whom the property is held to equitable duties to deal with the property for the benefit of another person, which arises as a result of a manifestation of an intention to create it."

The Internal Revenue Code contains no specific definition of trust, but Treasury Regulations Section 301.7701-4(a) provides: "in general, the term *trust* as used in the Internal Revenue Code refers to an arrangement created by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts."

Typically, the creation of a trust involves three parties:

- The *grantor*, sometimes referred to as the settlor or donor, creates and funds the trust and establishes the fiduciary relationship.
- The *trustee*, a fiduciary, holds legal title to the property for the benefit of another. The trustee may be an individual or corporation.
- The *beneficiary* or beneficiaries are entitled to all the income and principal of the trust.

Usually the trust comes into being by an agreement between the grantor and the trustee. The agreement is usually referred to as the trust instrument or trust indenture. The trust property is usually called the *corpus* or *principal* of the trust. Even though there are at least three parties to a trust, they are not necessarily different legal entities. For example, the grantor of a trust also may be a trustee; a beneficiary may be one of the trustees; and the grantor may also be a beneficiary. In many states at least two different legal parties are necessary for a valid trust.

1.2 Reasons for Trust Creation

Trusts are set up to satisfy the needs and wishes of the grantor to provide for others, conserve property, and so forth. Beneficiaries' needs may

or may not be involved. Grantors of trusts may also be primary beneficiaries and establish trusts in order to (1) obtain professional investment management and relieve themselves of the burden of managing their property or (2) avoid probate by putting their assets into a trust and managing their own property during their lifetime through the trust (see section 3.7).

A trust can be created for the benefit of family members or others, and may provide any of the following:

- Assurance that income will continue after the death of the grantor by providing professional management of assets.
- Tax advantages by transferring income-producing property to someone in a lower income tax bracket (restricted for children under the age of fourteen by the Tax Reform Act of 1986).
- Independent income to a beneficiary to permit pursuit of a career that may not be particularly remunerative.
- Elimination of guardianship for minors.
- Protection for minors, spendthrifts, and disabled persons.
- A spouse's lifetime beneficial use of income-producing property without subjecting the property to estate tax at the spouse's death.

2. TYPES OF PERSONAL TRUST

2.1 Testamentary Trust

A testamentary trust is created in the grantor's last will and testament. Since it is the will that creates the testamentary trust, the trust does not come into existence until the death of the testator and is not effective until the estate has been probated. The probate assets of the decedent's estate are normally used to fund the trust. However, other assets such as life insurance proceeds or death benefits from a qualified retirement plan can be made payable to the testamentary trust. A testamentary trust can be changed by revoking or amending the will that establishes it as long as the testator is alive and competent.

2.2 Inter Vivos Trust

An inter vivos trust, sometimes referred to as a *living trust*, is created during the lifetime of the grantor. It can provide that the grantor be the income beneficiary or it can pass property to other beneficiaries

either at the time the trust is set up or upon the death of the primary beneficiary. An inter vivos trust can be either revocable or irrevocable. An inter vivos trust usually becomes irrevocable upon the grantor's death.

2.2.1 Revocable trust

A revocable trust grants an individual or a group of people the right to change or terminate the trust. Most frequently this right is given solely to the grantor of the trust, which gives the grantor the flexibility of change during his or her lifetime. Since the grantor has retained the right to change the trust, a gift is not considered to have been made for gift tax purposes. The assets of the revocable trust will be included in the grantor's taxable estate, because it is treated as if the grantor never parted with the trust assets. Most states presume a trust to be revocable if the trust instrument is silent as to revocability. Other states presume the trust to be irrevocable unless declared expressly to be revocable. It is therefore important to declare in the trust instrument itself whether or not it is revocable.

2.2.2 Irrevocable trust

An inter vivos trust that cannot be changed is called an irrevocable trust. Such trusts can only be altered by court action or in certain circumstances whereby all the persons beneficially interested in the trust agree in writing to the change. Obtaining written consent from infant and charitable beneficiaries is problematic. When the grantor funds an irrevocable trust, a gift often results because the grantor is giving up all control over the trust property and cannot alter the terms of the trust once he or she signs the trust instrument.

An irrevocable trust can be used to save estate taxes. Because the grantor gives up control over the trust assets, such assets are not included in the grantor's taxable estate. If the trust contains a provision allowing the trustee to lend money to the estate or to buy assets from the estate, the trust may be used to help pay estate taxes without being included in the taxable estate. An irrevocable trust can also be used to save on income taxes by transferring income to a beneficiary who is in a lower tax bracket.

It is important to remember that the tax basis of the assets transferred to the trust is normally the same as the grantor's tax basis, so that when the grantor dies there is no step-up in basis. See section 2.5.1 of the chapter on Estate Planning.

2.2.3 Reversionary trust

A reversionary trust is basically a trust, for a term of years or a period measured by one's life, in which the property is used for a specific

beneficiary and then—upon the expiration of the time period or at the beneficiary's death—reverts to the grantor or spouse. The Clifford trust, based on the famous case *Helvering v. Clifford* 309 U.S. 331 (1940), established a minimum duration of ten years to shift the trust income to a beneficiary before the assets are returned to the grantor. (The Clifford rule is a federal tax concept and is not to be confused with state law, which allows such reversionary trusts without time limits.) An alternative to the popular Clifford trust is the spousal remainder trust, which can exist for fewer than ten years in which the income is shifted to a beneficiary, with the remainder irrevocably transferred to the grantor's spouse after the trust expires. Under the Tax Reform Act of 1986 certain reversionary trusts will be considered grantor trusts and therefore will not accomplish any of the tax savings that were available before passage of that law (see section 5.1.1 for a discussion of the income tax rules on reversionary trusts).

3. SPECIFIC USES OF TRUSTS

3.1 Minors

Since minors cannot legally manage their own property, a trust is a valuable instrument providing for such management. Extending the trust for a period of time after the minor reaches majority allows the child to develop mature judgment before having to manage his or her own assets. In most states, when a minor reaches majority (which can be as young as eighteen), under state law any property held for the minor in a custodian account under the Uniform Gift to Minors Act is automatically available to that person upon reaching the age of majority. Certain states extend the age to twenty-one, if language extending the age is in the account title at the time of the gift.

By transferring the property to a trustee for the benefit of the minor, the trust instrument could specify ages such as twenty-five and thirty for payout of a portion of the property to the beneficiary's control. Prior to the Tax Reform Act of 1986, trusts were often established for minors in order to obtain the benefits of the minors' lower income tax brackets. Under current law, if the beneficiary is under age fourteen, income tax due will be based on the parent's tax bracket, a result of the rule taxing unearned income of a child younger than fourteen in excess of \$1,300 (effective in 1996) at the top tax rate of the parent.

3.2 Children and Grandchildren

Even if a child is not a minor, a trust can help a child by protecting his or her financial security for a period of years. The child has the

freedom to pursue a career knowing that he or she has been made financially secure by the creation of the trust. A trust may also, depending upon state law, protect the child in case of an unsuccessful marriage in which the child's spouse makes claim for alimony, support, and division of property. A trust can be used to support a mentally retarded or otherwise incapacitated child for life.

Often, if the grantor is concerned that the beneficiary will borrow against his or her interest in the principal or income of the trust, a special spendthrift provision that denies the beneficiary a right to sell or pledge his or her interest can be inserted in the trust instrument.

The validity of spendthrift trusts is premised on the grantor's right to determine how the property is used and on the grantor's right to protect the beneficiary from his or her own inability to manage money. Spendthrift provisions are not recognized in some states. Specific state law should be reviewed.

3.3 Spouse

In the event of the death of a spouse, the surviving spouse may need a steady, dependable income to meet the living expenses of a family. The trust can be used not only to provide such income but also to protect the assets from being invaded. The responsibilities of investment and property management can be given to a professional, relieving the spouse of management responsibilities. Property put into trust from which a surviving spouse derives income only cannot be invaded by the spouse except as provided. In addition, this property will be free from marital rights of another should the spouse remarry. The property in the trust can pass directly to the deceased spouse's children or continue in trust for children without going through probate.

3.4 Life Insurance

Insurance is used to fill a variety of specific needs, such as the need

- To accumulate capital for retirement.
- To provide a fund for support of a relative.
- To provide a fund for the education of children.
- To provide liquidity in an estate.
- To prevent estate shrinkage by providing ready cash to pay debts, taxes, and expenses of estate settlement.

Life insurance proceeds are subject to estate tax if the insured owns the policy. (See the Estate Planning chapter for discussion of the tax treatment of life insurance.)

3.4.1 Revocable unfunded life insurance trust

The simplest type of insurance trust is called a *revocable unfunded insurance trust*. The life insurance policy stays in the name of the insured, but the insured designates that the proceeds of the policy are to be paid to a trust that the grantor/insured created. The insured will continue paying the premiums on the insurance policy and at death the insurance will be includable in his or her taxable estate. This type of trust is set up primarily for the management of the insurance proceeds. It is flexible in that the insured can always change the beneficiaries of the trust during his or her lifetime. Insurance trusts can be used to accomplish the foregoing and, under certain circumstances, the life insurance proceeds in an irrevocable trust can be excluded from estate taxes (see sections 3.4.2 and 3.4.3).

Example. If a wife already owns the insurance on her husband's life, she can transfer the policy to a trust and become the beneficiary of the trust. Upon the death of her husband, the trust can become irrevocable. If the wife remarries, the insurance proceeds are protected from passing to a second husband upon the death of the wife.

3.4.2 Irrevocable unfunded life insurance trust

This trust is one in which the insurance policies are assigned to an irrevocable trust for the beneficiaries. The trust instrument must state how the proceeds will be used on behalf of the trust beneficiaries. The premiums will have to be paid by the grantor of the trust, who may or may not be the insured. If the insured has transferred the insurance to an irrevocable trust more than three years before death, the insurance proceeds will not be included in grantor's gross estate and may not be included in the spouse's estate upon subsequent death. The disadvantage of this type of arrangement is that the trust is irrevocable, and, therefore, the trust cannot be changed, although the grantor/insured can always stop payment of premiums and the policy will lapse.

The dollars given to the trust to pay the annual premiums are considered gifts. If the gift does not qualify for annual exclusion (see section 6.1) because the gift is one of a future interest, the grantor will be using up part of his or her unified tax credit (see Estate Planning chapter). Crummey powers (see section 6.3 herein) are usually provided to the beneficiaries in the trust instrument to enable the annual gift to qualify as a gift of present interest, therefore qualifying for annual exclusion.

3.4.3 Irrevocable funded life insurance trust

In a funded insurance trust not only is the policy transferred into a trust but the grantor also transfers other assets such as securities or cash to the trustee. The trustee holds, manages, and invests the other assets and uses the income to pay the premium payments. If the income is used to pay premiums on the grantor's life or a spouse's life (except with respect to policies irrevocably payable for charitable purposes) it is taxable to the grantor.

3.5 Business Use

A trust can be used for business purposes as an employees' trust created for the employees of a corporation (see the chapter on Employee Retirement and Deferred Compensation Plans, section 3.1). Normally the creator of the trust is the employer and the beneficiaries are certain employees of the corporation. The trustee may be an individual, bank, trust company, or committee of employees. The trust property usually consists of employer contributions, which are used to fund the trust. Basically trusts are set up for business purposes to provide employees with funds when they become incapacitated before reaching normal retirement age or to provide funds for them after they have reached retirement age. The use of such a trust may both help reduce employee turnover and attract new employees. In addition, a voting trust may be adopted to require shareholders of a business corporation to vote as a bloc rather than as individual shareholders.

3.6 Charitable Trusts

Instead of leaving property outright to a charitable organization, the grantor may wish to retain some interest in the property and still receive income or estate tax benefits. This may be possible by creation of a charitable trust that meets stringent IRS guidelines.

Three approved trust forms may be used for qualifying charitable gifts of a *remainder interest*:

- Charitable remainder annuity trust
- Charitable remainder unitrust
- Pooled income fund

Definitions of these trusts can be found in "Types of Charitable Transfers" in the chapter on Estate Planning. A contribution of a remainder

interest in the trust to a charity is allowed as a current charitable deduction for income, gift, and estate tax purposes only if the trust vehicle by which it is made meets stringent standards.

A donor may transfer property to a trust creating an income interest in the property in favor of a charitable organization for a period of years or for the life or lives of an individual or individuals, with the remainder interest either retained by the donor or given to a noncharitable beneficiary. This is called a charitable lead trust.

The charitable contribution with respect to a charitable lead trust is equal to the actuarial value of the charitable annuity. However, in order to claim a deduction for the contribution to the trust, the trust's income during the annuity period must be taxable to the donor, which is generally accomplished by providing for reversion of the trust corpus to the donor at the conclusion of the annuity period. (If the trust were funded with tax-exempt bonds, the donor's tax with respect to this income would be zero.)

3.7 Trust for the Benefit of the Grantor (Living Trust)

Grantors can place all or part of their assets in a revocable living (inter vivos) trust and can name themselves or anyone else as trustee. A revocable living trust for the benefit of the grantor may be used for the following purposes:

- To assure that the grantor's plans and affairs will be kept private and avoid the expense of probate (which can run as much as 5 to 6 percent of the gross estate).
- To be able to change one's plan by merely amending the trust during one's lifetime.
- To guarantee a continuation of cash flow on investments in the estate owner's portfolio that will not be interrupted by death.
- To allow designation of persons to manage the assets after death.
- To allow designation of persons and entities who may not be allowed to serve as executors.
- To give a designated person an easy way to handle the grantor's affairs if the grantor becomes incapacitated.
- To provide for a smooth transition in continuing a family business.
- To avoid guardianships.
- To avoid creditors and evade in certain states (Connecticut, Indiana, Illinois, Ohio, and Massachusetts) a spouse's elective share or the percentage of the estate on which the spouse has a claim.

- To reduce the possibility of court challenges to the estate distribution by disgruntled heirs.
- To select a more favorable legal status for the administration of the trust (see below).
- To segregate community property from separate property to maintain the separate status of each.

For income tax purposes, the trust is ignored. The grantor continues to treat all income, losses, and deductions as his or her own, with the same character as if the trust did not exist. If the grantor is the sole trustee or a co-trustee, no separate tax identification or tax return is required. The grantor continues to use his or her existing Social Security number.

Estate owners concerned about the preservation of assets and the management of financial affairs in the event of physical or mental incapacity can establish a *standby trust* (also known as a successor or contingency trust). This is a lifetime trust; the grantor has complete control of the trust assets. Upon the grantor's physical or mental incapacitation, the successor trustee takes over the management of the trust. If the grantor becomes mentally incompetent, the power to revoke the trust becomes ineffective.

A revocable living trust can be administered in a state other than the state in which the estate owner lived at the time of death. The trust can avoid such state laws such as those in Florida, which require that the personal representative (executor) must be related to the decedent or domiciled in the state of Florida. An estate owner resident in Florida who wants a fiduciary who is not a member of the family or domiciled in Florida to administer his or her property after death can avoid this problem by using a living trust.

The estate owner who lives and works in one state but owns vacation or other property elsewhere can incur additional probate costs. Probate of the will takes place in the state of the estate owner's residence; however, separate legal procedures are necessary in other states where real estate is owned in the estate owner's name. Placing such property in a living trust can avoid these legal costs. The major purpose of a living trust, in fact, is to avoid the probate process. Since the title to the property is already in the trust, no passing of title is required following the estate owner's death. Avoidance of probate is an enormous benefit and can save significant costs and time.

A pour-over will should always be executed at the time the living trust is executed. The will is needed in case there are assets that are not in the trust's name. The will gives all the probate assets to the trust.

If the revocable living trust is unfunded, whatever probate property will pass to the trust after the grantor's death will incur probate costs

before the property can ultimately end up in the trust. By funding the trust during one's lifetime, problems of probating a person's estate can be avoided.

In most states, the grantor can be the sole trustee of his or her own trust. The grantor will therefore handle the writing of checks and purchase and sales orders as usual except that property will be in the name of the trustee. In those states that do not recognize a trust where the trustee and beneficiary are the same, a co-trustee, such as the grantor's spouse or a friend, attorney, accountant, or bank should be selected.

Gifts from revocable trusts, which normally qualify for a \$10,000 annual exclusion (see the Estate Planning chapter), may be included in the grantor's estate if the distribution to the donee was made directly by the trust within three years of the grantor's death under the contemplation-of-death rules (IRC Sec. 2035). To avoid this problem, the withdrawal is made by the grantor, followed by a gift to the donee (Private Letter Rulings Nos. 9010004, 9010005, 9015001, and 9016002).

For estates of decedents dying after August 5, 1997, the Taxpayer Relief Act of 1997 provides that a transfer from a revocable trust is treated as a transfer made directly by the decedent. This means that the transfers from a revocable trust within three years of the grantor's death can qualify for the annual exclusion and there is no longer a need to filter such gifts through the grantor's personal checking account.

The Taxpayer Relief Act of 1997 permits an election by a revocable trust established by the decedent dying after August 5, 1997, to be treated as part of the estate for income and generation-skipping transfer tax purposes. If no estate tax return is required, the election is effective for two years. If an estate tax return is filed, the election is effective until six months after the estate tax return is finally determined. The election will allow the following special income tax provisions afforded only to estates to be available to revocable trusts.

- Estates are allowed the charitable set-aside deduction.
- Active participation requirement under passive loss waived for the estate in first two years.
- Only estates can qualify for amortization of reforestation expenditures.

3.8 Medicaid Trusts

Individuals who feared that long-term care in a nursing home would drastically deplete their assets could artificially impoverish themselves

and shelter assets for their spouses and heirs by using irrevocable trusts carefully structured to comply with the federal law then in effect. The effect of the trust was to reduce income and assets of the grantor of the trust below the caps set by federal and state laws, so that Medicaid would pay the grantor's nursing home expenses.

Public Law 104-191, signed by the President on August 21, 1996, effective January 1, 1997, states that it is a crime if someone "knowingly and willfully disposes of assets (including by any transfer in trust) in order for an individual to become eligible for Medicaid assistance, if disposing of assets results in the imposition of a period of ineligibility for such assistance." A separate part of the law says that any professional who assists a person in committing such a crime is also guilty.

Advance planning in this area is required. The purchase of long-term care insurance should be considered, so that the nursing home resident's assets can be protected, but this must be done when the individual can obtain such insurance.

3.9 Land Trusts

Land trusts originated in Illinois and are now used in many states. This kind of trust is unique in that the trustee holds full legal and equitable

(Text continued on page 13)

title to the real estate, but the beneficiaries manage the property plus have full power to direct the trustee. The trustee executes deeds, mortgages, or otherwise deals with the property at the written direction of the beneficiaries. The beneficiaries collect rent, make improvements, and operate the property but do not hold or deal with legal title. A land trust provides faster and less expensive methods for conveying, financing, and holding interest in real estate. The arrangement is created by two instruments. The deed-in-trust conveys the property to the trustee. Contemporaneously with the deed-in-trust, a trust agreement is executed. Land trusts can provide the following benefits:

- Probate can be avoided by providing for disposition of beneficial interests upon the death of a beneficiary.
- Nonresidents of the state where the real estate is located can avoid ancillary probate at the time of death.
- The identity of the beneficiary (the purchaser) is not disclosed, since only the deed-in-trust is recorded.
- Since the interest of a beneficiary is personal property, marital rights of dower and courtesy do not apply.
- Where mortgage financing is used in connection with a land trust, personal liability of the beneficiary can be avoided.
- Judgments against the beneficiaries do not affect legal title.

4. TRUST ADMINISTRATION

4.1 Trustee

A trustee can be either an individual or a properly licensed state or federal institution. Usually individual trustees are family members, friends, or advisers; institutional trustees are trust companies or trust departments of commercial banks. The trustees act in a fiduciary capacity in that they have the ultimate duty imposed by law to hold property for the benefit of the beneficiaries. Naming a trustee is a very serious decision because the trustee is responsible not only to the income beneficiaries (those who are entitled to the income from the trust property), but also to the remaindermen who are entitled to the principal (corpus) of the trust. No one should choose a trustee lightly, and a named trustee should never lightly agree to serve. The trustees are responsible to the beneficiaries and must have integrity, responsibility, experience, availability, and willingness to serve. The trustees are also

responsible to the grantors in following the instructions of the trust instrument.

Will the trustee have any conflict of interest that would cloud administration of the trust? Will conflicts arise because the trustee is related or partial to any beneficiary? The best procedure is probably to select an individual trustee and a corporate trustee to act together. A corporate trustee, usually impartial, specializes in handling trusts and has the necessary experience. The corporate trustee never dies as an individual does, so the corporate trustee will always be there. However, there should be some mechanism for removing and replacing any institutional or other unrelated discretion-holding fiduciary. The trust may be well served by selecting an individual co-trustee who has a relationship to the beneficiaries, whether as a family member or as an adviser who knows the needs of the family. The individual should be a family friend or relative who understands what was intended by the setting up of the trust instrument. For business or personal reasons the grantor may choose to cover the matter in a discretionary provision rather than by expressed direction. It is important that the trust instrument also provides for adequate successor trustees so that it will not be necessary to go to court to find a successor trustee. Selecting successor trustee should be undertaken with the same care exercised in choosing the original trustees. A competent attorney must draft all trust instruments to ensure their proper legal effect.

4.1.1 Duties

The primary responsibility of a trustee is both to manage and to preserve trust property. These responsibilities are different from those of an executor or administrator, who is required to preserve and distribute the property he or she holds. Even though trustees can delegate certain duties to accountants, attorneys, real estate agents, and tax consultants, they cannot delegate their overall duty to administer the trust. When they accept the trust, trustees undertake to carry out the terms of the trust and thus assume all responsibility for the acts or omissions of the persons they employ. Although state law may impose certain duties and restrictions on a trustee, most duties are derived from the trust instrument, whether it is an inter vivos trust indenture or is created under a will setting up a testamentary trust.

The trustee has a conflict of duties: conservation of trust property versus impartiality when it comes to tax planning that shifts the burden between income and principal beneficiaries. A trustee must refrain from dealing with the trust property personally and from commingling such trust property with his or her own; in addition, the trustee must exercise any discretionary duties with impartiality. The trustee has a

duty to make the trust property productive and should not let the trust fund remain unavailable for investment for an unreasonable length of time. If there are two or more trustees, each is liable for his or her own breaches of trust and not for those of co-trustees unless he or she allowed the co-trustees to commit a breach of trust by failure to exercise reasonable care. Further, unless the trust instrument states otherwise, the trustee has a duty to render an accounting.

Some of the other duties of a trustee in the administration of a trust are to

- Exercise reasonable care and skill (“prudent-man” standard) in acting as a trustee.
- Comply with the terms of the trust.
- Be fair and impartial in dealings with the beneficiaries.
- Make the trust corpus productive within the terms of the trust.
- If the state whose law controls the trust has adopted the Prudent Investors Act, comply with “prudent investor” standards, unless the trust instrument provides otherwise.

Under the prudent investor standards, the trustee looks for a total return and is investing both for current (income) and long-term benefit (capital appreciation). The trustee sees the portfolio as a whole and diversifies investments to limit specific risks.

4.1.2 Powers

The powers of the trustee are derived from statutes, common law, and the trust instrument itself. In many instances the statutory powers granted a trustee by the state where the trust is initiated are sufficient to manage the trust. Nevertheless, since trustees may be required to deal with third parties who are unfamiliar with the laws of the state, it is desirable to itemize their powers in the trust instrument. If a trust will be required to deal with real estate in a state other than the state in which the trust is located, the trustee should be given all statutory powers granted trustees in the foreign state with respect to the real estate in that state.

To enable trustees to carry out their duties, the trust instrument or the law must give trustees certain powers to administer the trust. If the grantor retains some of these powers, the trust income, even if the trust is irrevocable, may be includable in the grantor’s taxable income and the corpus may be part of the grantor’s estate (see sections 5.1.5 and 7.1).

4.1.3 Liability

Trustees are liable to the beneficiaries for any actual losses resulting from breach of fiduciary duty and may be surcharged by forcing them to personally make good any such losses. In addition, a beneficiary may force removal of a trustee. The standards imposed on a trustee are strict—some feel too strict. The grantor may wish to rectify this by inserting in the trust instrument an exoneration clause (sometimes called an exculpatory clause), stating that the trustee will not be liable except for losses caused by willful neglect or bad faith. Even though these clauses afford some protection, they are normally construed against the trustee.

4.1.4 Compensation

Trustees' compensation is usually established either in the trust instrument or by operation of applicable state law. Many states provide statutory guidelines for the compensation of trustees, which are usually based on a percentage-of-value approach but have sliding scales. In the absence of a state statute or an agreement between the trustee and the grantor or beneficiaries, the value of the services (and hence the fee to which the trustee is entitled) is a question of fact, measured by the value of such services as established in the community. Most institutional trustees regularly promulgate and disseminate fee schedules. Normally, trustees' fees are not a major concern to most estate owners; a trustee's performance is likely to be the major concern.

4.2 Beneficiary

In most circumstances the beneficiary should have no control of the trust other than possibly changing the trustee if the trustee does not perform satisfactorily. Note that if all beneficiaries consent and are in existence courts will generally agree to a trust termination if there is no ultimate purpose of any kind requiring the continuation of the trust. If the grantor's purpose in establishing the trust has not been fully accomplished, the trust cannot be terminated even though all beneficiaries desire that it should be terminated.

4.3 Duration

Many grantors wish to control the trust in perpetuity, which frequently conflicts with the so-called rule against perpetuities. The common-law rule against perpetuities is measured by lives in being plus twenty-one years. Currently, all states except Wisconsin and Idaho have some rule

against perpetuities that limits the duration of a trust. Since state rules are not completely uniform, the trust drafter must be alert to individual state problems. If the drafter fears a perpetuities problem, he or she should consider the inclusion of a “savings” clause in the trust instrument, thereby allowing a court to reform the trust to the grantor’s wishes within the confines of the rule.

There is no limit on the duration of a trust that has a charitable purpose. Trusts for the benefit of a recognized charity can be created in perpetuity, but caution should be exercised because, in time, a specific charity may cease to exist.

5. INCOME TAXATION

5.1 Grantor

A grantor who transfers property to a trust and retains certain powers over or interests in the trust is treated as the owner of the trust for federal income tax purposes under the grantor trust provisions of Internal Revenue Code Sections 671 to 678. As a result, the income and deductions attributable to that trust are included directly in the grantor’s taxable income.

5.1.1 Reversionary interest

Under the Tax Reform Act of 1986, the income of a trust is generally taxed to its grantor if the grantor retains (or gives a spouse living with the grantor at the time of the gift) a power or a reversionary interest of more than 5 percent of the value of the transferred property. An exception occurs when the trust may revert only after the death of an income beneficiary before age twenty-one who is a lineal descendant of the grantor. Clifford trusts and spousal remainder trusts will therefore be taxed as grantor trusts. For a trust created pursuant to certain binding property settlement agreements entered into before March 1, 1986, a grantor is treated as an owner of that portion of a trust in which he or she has a reversionary interest in corpus or income if the interest will or may reasonably be expected to result in possession or enjoyment within ten years of the transfer to the trust.

5.1.2 Adverse and related parties

An *adverse party* is one who has a substantial beneficial interest in a trust that would be adversely affected by the exercise or lack of exercise of a power possessed with regard to the trust. A *nonadverse party* is one

who does not come within the definition of an adverse party. A related or subordinate party is a nonadverse party who is either a close relative (spouse living with the grantor; father, mother, issue, brother, or sister), an employee of the grantor, a corporation or employee of a corporation in which the holdings of the grantor or the trust are significant, or a subordinate employee of a corporation of which the grantor is an executive. A party who is close to the grantor is considered subservient to the wishes of the grantor.

5.1.3 Beneficial enjoyment

A grantor is treated as the owner of any portion of a trust with respect to which the grantor or a nonadverse party, without the consent of an adverse party, has the power to control the beneficial enjoyment of the related corpus or income. Thus the trust income will be taxed to the grantor in any of the following circumstances:

- If the income may be distributed currently to the grantor or the grantor's spouse, whether or not it is so distributed.
- If the income may be held or accumulated for future distributions to the grantor or the grantor's spouse, whether or not it is so held or accumulated.
- If the income may be applied to the payment of premiums on insurance covering the life of the grantor or the grantor's spouse, whether or not it is so applied.
- If the income is actually applied or distributed for the support or maintenance of a beneficiary whom the grantor is legally obligated to support or maintain.

5.1.4 Reservation of administrative powers

Under IRC Section 675 a grantor is treated as the owner of a portion of a trust with respect to which

- The grantor or a nonadverse party has the power to deal for less than adequate and full consideration.
- The grantor or a nonadverse party has the power that enables the grantor to borrow trust income or corpus without adequate interest or without adequate security.
- The grantor has borrowed income or corpus of the trust and has not repaid the amount before the beginning of the taxable year, unless the loan provides for adequate interest and security and is made by an independent trustee.

- The grantor has retained the power exercisable in a nonfiduciary capacity (a) to vote stock of a corporation in which the holdings of the trust and the grantor are significant from a viewpoint of voting control, (b) to control the investments of the trust in such corporations, or (c) to reacquire trust corpus by substituting other property of equivalent value.

5.1.5 Powers that can be retained

Grantors who do not retain a beneficial interest in a trust can retain the following powers under IRC Section 674 without being subject to income tax:

- The power to apply the income for support of a dependent to the extent that the power is not actually so used.
- The power to allocate income or corpus among charitable beneficiaries.
- The power to distribute corpus (a) to beneficiaries within a fixed class of beneficiaries subject to a reasonably definite standard or (b) to income beneficiaries when the corpus distribution is an advancement of that beneficiary's proportionate share of the trust.
- The power to withhold income temporarily from a beneficiary within a fixed class of beneficiaries where the withheld income must be distributed to that beneficiary or his or her estate or the beneficiary has the general power of appointment over the property.
- The power to withhold income during the disability of a beneficiary within a fixed class of beneficiaries.
- The power to allocate items between income and corpus.
- The power held by an independent trustee of distributing income and corpus among a fixed class of beneficiaries.
- The power to allocate income or corpus to beneficiaries within a fixed class of beneficiaries subject to a reasonably definite external standard.

Income will not be taxable to grantors merely because an independent person neither related to nor subservient to them can distribute, apportion, or accumulate income to or for a beneficiary or class of beneficiaries and pay out corpus to or for a beneficiary or class of beneficiaries. A group of trustees is independent so long as not more than half the trustees are related or subordinate parties who are subservient to the wishes of the grantor.

5.1.6 Creating a defective grantor trust

The fact that the grantor is taxed as the owner for income tax purposes does not necessarily mean the trust would be included in the grantor's estate as long as the trust is properly drafted. The estate tax rules (see section 7.1 of this chapter) are not as broad as the grantor trust income tax rules.

There are reasons to create a "defective" trust, according to which the grantor of the trust would be taxed as the owner of the trust for income tax purposes under Internal Revenue Code Sections 671 to 678, yet the assets of the trust would not be included in the grantor's estate.

Defective grantor trusts can be effective funding vehicles after the trust is established, where the ulterior motive is to "make additional gifts" of the income tax payments on the income earned by the trust without actually making the gifts. The grantor's estate is reduced by the tax payments at no gift tax cost because the grantor is obligated to pay this tax and therefore not making a gift to the trust beneficiaries.

Example. Mrs. Jones owns \$600,000 of corporate bonds paying \$36,000 a year in interest. By transferring the bonds to a defective trust assuming there was no gift tax because of the unified credit, Mrs. Jones continues to pay income tax of \$11,000 on the income earned by the trust. Thus, after ten years, Mrs. Jones effectively increased her estate by \$110,000, estate tax free.

If she left the property by will, the \$25,000 a year after-tax interest would accumulate in her estate and would be subject to estate tax.

Note, however, that the Internal Revenue Service has raised some doubts about the continuing viability of defective grantor trusts. (See IRS Letter Ruling 9444033.)

5.2 Beneficiary

5.2.1 Distributable net income (DNI)

Normally beneficiaries are taxed on the amounts that are required to be distributed or the amounts actually distributed currently to them, except that distributions are included in the gross income of the beneficiary only to the extent of the distributable net income (DNI) of the trust. DNI, an ingenious concept introduced in the 1954 Internal Revenue Code, is the most important aspect of fiduciary income taxation. It serves as the overall limitation on the amount of the distribution deduction available to the trust as well as a limitation on the amount taxable to beneficiaries. The underlying theory of fiduciary income

taxation is that total taxable income must be taxed. Thus, whatever a trust gets as a distribution deduction must be reported by the beneficiary. In general, the character of the income in the hands of the beneficiary is the same as it was in the hands of the trust. Thus, an amount received or receivable by a beneficiary, which amount is deemed to consist of tax-exempt income, will not be taxed to the beneficiary.

For example, a trust that is required to distribute all of its income (a simple trust) to one beneficiary, earned \$9,000 in taxable interest and \$1,000 in tax-exempt interest, and incurred no expenses. The following is the computation of DNI and taxable income to the beneficiary from the trust:

| | |
|---|-----------------|
| <u>Taxable income—fiduciary income tax return (Form 1041)</u> | |
| Tax-exempt interest (Section 641(b)) | -0- |
| Taxable interest (Section 641(b)) | \$ 9,000 |
| Exemption (Section 642(b)) | (300) |
| Taxable income before distribution deduction | <u>\$ 8,700</u> |
| <u>DNI (Section 643)</u> | |
| Taxable income before distribution deduction | \$ 8,700 |
| Add: Exemption (Section 643(a)(2)) | 300 |
| Exempt income (Section 643(a)(5)) | <u>1,000</u> |
| DNI | <u>\$10,000</u> |

Although DNI is \$10,000, the *deductible DNI* is \$9,000 (\$10,000-\$1,000). The last sentence of Section 651(b) prevents a deduction for any portion of the DNI that consists of tax-exempt income. (This computation is made on Schedule C of Form 1041.)

| | |
|--|-----------------|
| Taxable income before distribution deduction (per above) | \$ 8,700 |
| Distribution deduction: | |
| Income required to be distributed currently (Section 651(a)) | \$10,000 |
| Limited to deductible DNI (Section 651(b) (see above)) | <u>(9,000)</u> |
| Taxable income | <u>(300)</u> |
| <u>Reportable by beneficiary</u> | |
| Income required to be distributed currently (Section 652(a)) | <u>\$10,000</u> |
| Limited to DNI | <u>\$10,000</u> |

(continued)

| | | |
|---|-----------------|-----------------|
| Character of amounts reportable under Section 652(a) (same as character of DNI) (Section 652(b)) | <u>Taxable</u> | <u>Exempt</u> |
| Tax treatment to beneficiary | <u>\$ 9,000</u> | <u>\$ 1,000</u> |

This computation is reprinted from *Income Taxation of Estates and Trusts*, CPE Course Handbook (New York: American Institute of Certified Public Accountants, Inc., 1987), p. H4-5.

If the trust agreement authorizes the trustee to make discretionary distribution of income, the trust is classified as a “complex trust.” IRC Sec. 663(b) allows trustees of complex trusts to elect to treat distributions during the first 65 days of the trust year as if they have been made on the last day of the immediately preceding tax year. If the trustee does not make the election, the distributed income is deducted by the trust and taxed to the beneficiary in the year the actual distribution is made. Since most trusts are now in a higher tax bracket than the beneficiaries, this election allows the trustee an opportunity after year end to equalize the marginal tax rates of the trust and the beneficiary.

5.2.2 The throwback rules

When the trust distributed previously accumulated income to a beneficiary, the tax on that distribution was determined by special averaging rules. Under those rules (called the accumulation distribution or throwback rules), the income was taxed at the average of the top tax rates for the beneficiary during three of the preceding five years, excluding the highest and lowest years. With the tax rates for trusts introduced by the 1986 Tax Reform Act (see section 5.3), the trust’s tax bracket will probably be higher than that of the beneficiary who is charged with the throwback income, resulting in a higher tax paid by the trust than that required of the beneficiary. Although the tax paid by the trust is credited to the beneficiary, it cannot result in a net credit or refund to him or her. The throwback rule does not apply to accumulation of income during the minority of a beneficiary. Income accumulated by a domestic trust prior to the beneficiary’s attaining the age of twenty-one, or years a beneficiary was not in existence, is not subject to the throwback rules. This exception, however, does not apply in the case of distributions from multiple (more than two) trusts.

The Taxpayer Relief Act eliminated the “throwback rules” for most domestic trusts for distributions in tax years beginning after August 5, 1997. The throwback rule continues for foreign trusts, domestic trusts that once were foreign, and certain domestic trusts created before March 1, 1984, that would have been treated as “multiple trusts.”

5.3 Trust

Two or more trusts are treated as one trust for federal income tax purposes if these trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries and the principal purpose of the trusts is the avoidance of federal income tax.

A trust is taxed on income if it does not distribute it to a beneficiary. Under earlier law trusts paid tax on their accumulated income at the same rates as a married individual filing a separate return.

Income tax rates for trusts and estates for taxable years beginning in 1997 are as follows:

| <u>If taxable income is</u> | <u>The tax is</u> |
|-----------------------------------|---|
| Not over \$1,650 | 15 percent of taxable income |
| Over \$1,650 but not over \$3,900 | \$247.50 plus 28 percent of the amount over \$1,650 |
| Over \$3,900 but not over \$5,950 | \$877.50 plus 31 percent of the amount over \$3,900 |
| Over \$5,950 but not over \$8,100 | \$1,513.00 plus 36 percent of the amount over \$5,950 |
| Over \$8,100 | \$2,287.00 plus 39.6 percent of the amount over \$8,100 |

Income tax rates for trusts and estates for taxable years beginning in 1998 are as follows:

| <u>If taxable income is</u> | <u>The tax is</u> |
|-----------------------------------|---|
| Not over \$1,700 | 15 percent of taxable income |
| Over \$1,700 but not over \$4,000 | \$255.00 plus 28 percent of the amount over \$1,700 |
| Over \$4,000 but not over \$6,100 | \$899.00 plus 31 percent of the amount over \$4,000 |
| Over \$6,100 but not over \$8,350 | \$1,550.00 plus 36 percent of the amount over \$6,100 |
| Over \$8,350 | \$2,360.00 plus 39.6 percent of the amount over \$8,350 |

Before passage of the Tax Reform Act of 1986, the accumulation distribution rules permitted the deferral of taxation without any interest accruing on deferred taxes. Trust income tax was very fertile ground for aggressive tax planning. Now, however, the tax bracket of the trust will be higher than that of any of the beneficiaries, so there will be no tax advantage to accumulating income and paying it out at a later date.

Trusts must now pay quarterly estimated federal taxes in the same manner as individuals. If the estimated payments made by a trust exceed the trust's tax liability, the trustee may elect to treat the excess as an estimated payment made by a beneficiary. The election is made on a fiduciary return that must be filed within sixty-five days after the close of the taxable year. The excess payment is considered as paid on the last day of the calendar year, so the beneficiary can take credit for this payment on the January 15 estimated payment following the calendar year.

For income tax returns filed after August 5, 1997, the Taxpayer Relief Act of 1997 requires that income tax returns of beneficiaries of a trust or an estate be filed in a manner consistent with the information furnished by the fiduciary, or that a statement identifying the inconsistency be filed.

6. GIFT TAXATION

6.1 Annual Exclusion

A gift of a current income interest in a trust (that is, where the trust income is to be paid out to a beneficiary at least annually) is a gift of a "present interest" for gift tax purposes and is thus eligible for the gift tax annual exclusion of \$10,000 (indexed annually for inflation after 1998 in one-thousand-dollar multiples) or \$20,000 with spousal consent, per beneficiary. If a trust contains a direction or authorization to accumulate the trust income, the interest of the beneficiary is a "future interest" that is not eligible for the \$10,000 annual exclusion.

In most cases it will be desirable to limit the size of a present interest gifted to the amount of the annual exclusion because the excess will at least erode the available unified credit of the grantor, or even result in a fairly heavy tax if the credit has already been exhausted. However, a series of excludable annual gifts can result in substantial gift tax savings.

The value of the remainder interest in a trust is a future interest and therefore the annual exclusion does not apply. However, the gift of a remainder interest in the trust to a donee who is the income

beneficiary of the trust is a gift of present interest that qualifies for the exclusion in those states whose laws provide for merger of interest and termination of the trust. A gift to a minor will not be considered a future interest if the property and its income may be expended for the benefit of the minor prior to his or her attaining age twenty-one and may be distributed to that individual at that time or to his or her estate in the event of his or her prior death (see section 6.2).

(Text continued on page 25)

6.2 Gifts for the Benefit of a Minor (IRC Section 2503(c))

Trusts for the benefit of a minor are really a statutory creation, Section 2503(c) having been added to the Internal Revenue Code in 1954. It was originally intended as an exception to the rule denying the annual gift tax exclusion to gifts of future interests. Since the trustee of such a trust is given discretionary power to withhold or distribute trust income and capital, there exists a true "future interest." The annual exclusion, though, is allowed for gifts to such a trust if the trust is irrevocable and meets the three primary requirements of IRC Section 2503(c):

- The trust instrument must authorize the unlimited use of the trust property and income "for the benefit of the donee before his attaining the age of twenty-one (21) years." This requirement is satisfied by giving the trustee absolute discretion to make distributions to or for the benefit of the minor. Implicit in this requirement also is the necessity that only one child may be the beneficiary (the donee); there must be a separate trust or valid separate share for each child intended to be benefited. Further, the child must be born; a transfer in trust for an unborn child does not qualify.
- The trust property must pass into the child's ownership at age twenty-one. Revenue Ruling 74-43, 1974-1 CB 285, holds that this requirement is satisfied so long as the beneficiary has the right to demand, within a "limited" time after attaining age twenty-one, that the trust assets be delivered to him or her, even if the trust further provides that if no demand is made the trust may then continue by its own terms beyond age twenty-one.
- If the minor dies before age twenty-one, the trust assets must pass to his or her estate or to the donee's appointee pursuant to a general power of appointment. The term *estate* in this section of the code is a specific term so that child's "heirs," "descendants," "next of kin," and so forth are not his or her "estate"; a mere remainder to such persons will not qualify the trust.

The trust instrument should designate successor beneficiaries, such as siblings, nieces, nephews, and the like in the event the beneficiary fails to do so by defaulting in exercise of a general power of appointment. This is permissible and should always be included in the trust instrument. The fact that the local law prevents a minor from exercising his power of appointment does not disqualify the trust.

6.3 Demand (Crummey) Trusts

Many parents are not content to pass substantial wealth to their children through a minority trust under IRC Section 2503(c) because such a

trust passes the wealth to children at age twenty-one. These parents prefer to pass the wealth to their children at a more advanced age such as thirty or thirty-five. A gift of money to a trust to be distributed to the children at age thirty or thirty-five creates a future interest in the children. Without the benefit of the minority exception, such a gift does not qualify for the annual gift tax exclusion. If the trust could be found to create a present interest, however, the annual exclusion would apply.

A trust creating a present interest in a beneficiary who is not to receive any distributions for several years is commonly referred to as a Crummey trust after the case of *Crummey v. Comm.*, 397 F.2d 82 (9th Cir. 1968), in which the use of such a trust was upheld. A Crummey trust creates a demand power, commonly referred to as a Crummey power, in the beneficiary to withdraw trust assets from the trust when those assets are gifted to the trust. This power, which is designed not to be exercised, creates a present interest in the power holder and qualifies gifts to the trust for the annual exclusion. Thus, the grantor can contribute up to \$10,000 (\$20,000 with spousal consent) to the trust annually without paying gift tax on the contribution.

When establishing a Crummey trust, the following factors should be kept in mind:

- The power should be limited to occasions when additional gifts are made to the trust. Only then is there need of a present interest deduction.
- The power should be limited to the lesser of the amount of the gift or the amount eligible for the exclusion. For example, if a husband and wife make a \$25,000 gift to the trust, the demand right should be limited to \$20,000. There is no benefit gained by making the entire \$25,000 subject to demand since the additional \$5,000 does not qualify for the annual exemption.
- The power holder must know of his right and must have time within which to exercise his right (Rev. Rul. 81-7, 1981-1 C.B. 474). Thus, the grantor should provide notice to the beneficiary any time a gift is made to the trust. If the beneficiary is a minor or other legally incompetent person, such notice should be given to his or her natural or legal guardian.

7. ESTATE TAXATION

7.1 Grantor (Decedent)

Trust property will be taxed in the grantor's estate if the grantor alone, or in conjunction with another, retains the power to alter, amend, or

revoke the trust or to designate who is to enjoy the trust income or corpus. Retention of the right to the trust income or the use of trust property is sufficient to include the assets of the trust in the grantor's estate.

In addition, the grantor's estate is taxed if the transfer to the trust is not intended to take effect until the grantor's death. This applies where

- Possession or enjoyment of the property could be obtained by surviving the grantor.
- The grantor has retained a possibility of regaining the property (reversionary interest), having it return to the estate, or having a power of appointment over it.
- The value of this reversionary interest immediately before the grantor's death exceeded 5 percent of the value of the entire property.

It is not necessary that the power to alter the terms of the trust be one that may be operative in favor of the grantor. Even if the grantor completely severs any personal economic benefit but keeps the right to designate who is to enjoy the interest or principal, the power has the same effect as if the principal itself were subject to recapture by the grantor for personal benefit. The rules for determining whether income of a trust is taxable to a grantor and whether the corpus is includable in the grantor's estate for estate tax purposes are thus not the same. The following are examples of techniques that can be used to cause a trust to be a grantor trust without causing the trust assets to be included in the grantor's taxable estate:

- Use trust income to pay premiums on the grantor's life insurance (Section 677(a)(3)). (See section 3.4.3, herein.)
- Designate the grantor's spouse a permissible distributee of trust income, thereby violating Sections 677(a)(1) and 677(a)(2). (See section 5.1.3, herein.) The distributions made to the grantor's spouse should not be used to discharge a grantor's legal obligation to support his or her spouse, or else the trust would be included under Section 2036.
- Grant a third person (even an independent trustee) the power to add beneficiaries designated as recipients of trust income or principal. This power will violate Sections 674(a) and 674(c). It is important that the grantor should not be the person actually retaining the power to add beneficiaries to the trust, because, under Section 2036 or 2038, it would cause the trust to be included in the grantor's estate.

If the grantor of an inter vivos trust reserves the right to replace a corporate trustee after removing the original corporate trustee without cause, an unlimited discretionary power to distribute trust income and principal to the grantor's adult children held by the corporate trustee would then be attributable to the grantor for estate tax purposes.

7.2 Beneficiary

Sometimes a trust instrument grants powers to a beneficiary. Whether these powers are considered a general power of appointment or a limited power of appointment will determine whether the possession of these powers would cause a beneficiary to be subject to estate tax.

Only powers defined as "general powers of appointment" result in taxability. Basically for tax purposes, a general power of appointment is one that can be exercised by a person in favor of himself or herself, his or her estate, or creditors.

A power to consume, invade, or appropriate income or corpus for the donee's benefit does not always necessarily constitute a general power of appointment. If the power is limited by ascertainable standards such as for health, education, support, or maintenance of the donee, it is not a general power. In short, the holder's duty regarding use of the power must be reasonably restricted in terms of his or her needs for health, education, or support or any combination thereof. However, a trustee's powers to invade for "general happiness" (Est. of John Russell Little, 87 TC No. 34 (1986)), or to invade for any special "need" (IRS Letter Ruling (TAM) 8601003 (9/20/85)) are not considered ascertainable standards. A power of appointment encompasses only a power granted to the donee by a third party. It does not include any right or power retained by the creator of the power to transfer property. The power of appointment confers upon someone other than the creator the right to make some disposition of the property interest.

Since October 21, 1942, general powers of appointment have had the following effects upon the holder of the power:

- If the power is held at death (even though not exercised) the property subject to the power will be included in the holder's gross estate.
- If the holder had exercised it in his or her own favor prior to death, the power would no longer exist and therefore would not be subject to tax; however, the property he or she acquired would be included in the gross estate and taxed. It is possible for the holder to make a qualified disclaimer of the power. A qualified disclaimer has the same effect as if the person to whom the power was granted had

never had the power. A disclaimer can be used only if the individual learned of the power conferred upon him or her and refused to accept it at the outset. If the individual actually assumes the power and later lets it go, the effect is a release, not a disclaimer, and will result in a taxable gift.

7.3 Grantor Retained Income Trust

A grantor retained income trust (GRIT) has become a popular method of saving on both estate and gift taxes. Under a GRIT, the grantor receives income from the trust (either a fixed-payment Grantor Retained Annuity Trust (GRAT) or a fixed percentage of the fair market value of the trust property) for a term of years, after which time the assets are distributed to the remainder beneficiaries.

If the grantor survives the term of years, the benefits gained by using a GRIT are twofold. First, the trust assets, including all appreciation in value subsequent to the date of transfer to the trust, pass to the beneficiaries free of estate and gift taxes. Second, since the beneficiaries obtain only a remainder interest (that is, they receive only what is left after the term of years expires, in this case the assets but not the income produced by them), the initial value of the assets placed in the trust is discounted below the market value of the assets for gift tax purposes. Thus, the value of the remainder interest to the beneficiary is far less than the value of the same assets directly transferred to the beneficiary. The longer the term created by the trust, the greater the discount on the value of the assets. The discount rate is equal to 120 percent of the mid-term applicable federal rate (AFR) rounded to the nearest two-tenths of a point. The AFR is based on the yields of Treasury securities and is published monthly by the Internal Revenue Service.

Example. Grantor places \$100,000 in trust and retains a fixed amount of income produced by the trust for ten years, after which time, the trust assets pass to his son. Assuming a discount rate of 8.4 percent, the remainder interest is valued under Treasury Gift and Estate Tax Valuation Table B at only \$32,900.00.

If the grantor does not survive the term of years, however, the trust assets are included in the grantor's taxable estate. To mitigate the consequences of the death of the grantor before the term has expired, many practitioners recommend that a series of grantor retained income trusts be created. For example, instead of setting up a single trust for a term of ten years, a grantor can set up a series of trusts, one for five years, another for eight years, and another for ten years. Thus, if the grantor survives only six years after the trusts are created, only the assets

of the eight- and ten-year trusts will be included in his or her taxable estate.

If the grantor is insurable, consideration should be given to taking out life insurance on the grantor's life to cover the loss of the estate tax savings if the grantor dies during the term of the GRIT. The insurance should not be owned by the grantor, so the proceeds would not be included in the grantor's estate. (See the chapter on Estate Planning for more details about keeping insurance proceeds out of the insured's taxable estate.)

Other items that should be considered when establishing a GRIT include the following:

- No step-up in basis is permitted for GRIT property if the grantor survives the period of the trust. Use of higher-basis assets could reduce the income tax consequences to the beneficiary if the GRIT property is sold after the trust is terminated.
- There is a disadvantage to gift-splitting with a spouse if the grantor dies before the expiration of the trust. If the value of the trust's assets at the time of death is included in the grantor's taxable estate, the grantor's unified credit used to offset the gift tax on the grantor's half of the gift is still available. However, if the grantor's spouse elected to treat half of the gift as if made by him or her, the unified credit used for that portion of the gift would be wasted.

See the Estate Planning chapter for a detailed discussion of changes in GRITs under the Revenue Reconciliation Act of 1990.

REFERENCES

- Bittker, Boris I., et al. *Federal Taxation of Income, Estates and Gifts*. 5 vols. Boston: Warren, Gorham & Lamont, 1991. Supplemented.
- Brecht, Stephen C. *Living Trust Simplified*. Mamaroneck, N.Y.: Hastings House Publishers, 1994.
- Brown, Gordon W. *Administration of Wills, Trusts, and Estates*. Albany, N.Y.: Delmar Publishers, Inc., 1993.
- Burkett, Larry. *Wills and Trusts*. Chicago: Moody Press, 1992.
- Clifford, Denis. *Make Your Own Living Trust*, 2d ed. Los Angeles: Nolo Press, 1996.
- Commerce Clearing House Editorial Staff. *What You Ought to Know About Living Trusts: How They Work, What They Accomplish, What Is Involved*. Riverwoods, Ill.: CCH Inc., 1992.

- Courtney, Brian. *Butterworths Trust Taxation Manual, 1993*, 3d ed. Charlottesville, Vir.: LEXIS Law Publishing, 1993.
- Crouch, Holmes F. *Trusts and Trustees: Tax Guide 305*. Saratoga, Calif.: Allyear Tax Guides, 1994.
- Crumbley, D. L., and Edward E. Milam. *Keys to Estate Planning and Trusts*, 2d ed. Hauppauge, N.Y.: Barron's Educational Series, Inc., 1993.
- Daly, Eugene J. *Thy Will Be Done: A Guide to Wills, Taxation, and Estate Planning for Older Persons*, 2d ed. Buffalo, N.Y.: Prometheus Books, 1994.
- DeGrandpre, Charles A. *Wills, Trusts, and Gifts*, 2d ed. Charlottesville, Vir.: LEXIS Law Publishing, 1994. Supplemented.
- Esperiti, Robert A., and Renno L. Peterson. *The Living Trust Workbook: How You & Your Legal Advisors Can Design, Fund & Maintain Your Living Trust Plan*. New York: Viking Penguin, 1995.
- Estate Planning: Wills, Trusts*. 2 vols. Upper Saddle River, N.J.: Prentice Hall. Loose-leaf service.
- Fiore, Ernest D., Jr., Mark L. Friedlich, Thomas McInerney, and Alan Chevat. *Modern Estate Planning*. 7 vols. New York: Matthew Bender & Company, Inc., 1981. Loose-leaf service.
- Greisman, Bernard, and J.K. Lasser Institute. *Estate Tax Techniques*. 3 vols. New York: Matthew Bender & Company, Inc., 1955. Loose-leaf service.
- Haskell, Paul G. *Preface to Wills, Trusts, and Administration*, 2d ed. Westbury, N.Y.: Foundation Press, Inc., 1994.
- Kess, Sidney, and Thomas Lauletta. *Financial and Estate Planning Guide*. Riverwoods, Ill.: CCH, Inc., 1998.
- Kramer, John L. *Prentice Hall's Federal Taxation: 1997 Corporations, Partnerships, Estates and Trusts*. Upper Saddle River, N.J.: Prentice Hall, 1996.
- Krikorian, Betty L. *Fiduciary Standards in Pension and Trust Fund Management*. Charlottesville, Vir.: LEXIS Law Publishing, 1993. Supplemented annually.
- Lane, Norman H., and Howard M. Zaritsky. *Federal Income Taxation of Estates and Trusts*. Boston: Warren, Gorham & Lamont, 1988. Updated semiannually.
- McGovern Jr., William M., et al. *Wills, Trusts and Estates, Including Taxation and Future Interests*. St. Paul, Minn.: West Publishing Co., 1995.

- Mennell, Robert L. *Wills and Trusts in a Nutshell*, 2d ed. St. Paul, Minn.: West Publishing Co., 1994.
- Nolfi, Edward A. *Basic Wills, Trusts, and Estates*. Legal Studies Series. Westerville, Oh.: Glencoe/McGraw-Hill, 1994.
- Nossman, Walter L., and Joseph L. Wyatt, Jr. *Trust Administration and Taxation*. New York: Matthew Bender & Company, Inc., 1966. Loose-leaf.
- Philadelphia Institute Staff. *Introduction to Estates and Trusts*, 2d ed. St. Paul, Minn.: West Publishing Company, 1992.
- Practising Law Institute Staff. *Income Taxation of Estates and Trusts*. New York: Practising Law Institute, 1993. Supplemented.
- Riddall, J. G. *The Law of Trusts*, 5th ed. Charlottesville, Vir.: LEXIS Law Publishing, 1996.
- Rounds, Stowell, and Joseph J. O'Connell. *How to Save Time and Taxes Preparing Fiduciary Income Tax Returns: Federal and State*, 2d ed. New York: Matthew Bender & Company, Inc., 1985. Loose-leaf updates.
- Rudy, Theresa M., Kay A. Ostberg, and Jean Dimeo. *Your Guide to Living Trusts and Other Trusts: How Trusts Can Help You Avoid Probate and Taxes*. Washington, D.C.: H A L T, 1994.
- Schumacher, Vickie, and Jim Schumacher. *Understanding Living Trusts*, 4th ed. Santa Monica: Schumacher & Co., 1996.
- Stephens, Richard B., Guy B. Maxfield, Stephen A. Lind, and Dennis A. Calfee. *Federal Estate and Gift Taxation*, 7th ed. Boston: Warren, Gorham & Lamont, 1996. Supplemented tri-annually.
- Williamson, John H. *The Wills, Trusts and Estate Planning Handbook, 1994*. Lakewood, Colo.: Argyle Publishing Company, 1994.

ESTATE PLANNING

1. FUNDAMENTAL ESTATE PLANNING CONCEPTS

- 1.1 Family
- 1.2 Estate Value
- 1.3 Planning Objectives
- 1.4 Maximizing the Estate
- 1.5 Other Facts
- 1.6 Cash Flow Analysis
- 1.7 Estate Planning Team
 - 1.7.1 CPA
 - 1.7.2 Attorney
 - 1.7.3 Life insurance underwriter
 - 1.7.4 Investment counselor
 - 1.7.5 Trust officer

2. THE CONVENTIONAL WILL

- 2.1 Definition and Purpose
- 2.2 Who Should Make a Will
- 2.3 Intestacy
- 2.4 Required Formalities
- 2.5 Changes
 - 2.5.1 Codicil
 - 2.5.2 Revocation
 - 2.5.3 Restatement after revocation

3. WILL COMPONENTS

- 3.1 Estate Owner's Domicile
- 3.2 Marital Deduction Provision
 - 3.2.1 Pecuniary formula
 - 3.2.2 Fractional formula
 - 3.2.3 Pecuniary credit shelter formula
 - 3.2.4 Equalization formula
- 3.3 Tax Apportionment
- 3.4 Common Disaster
- 3.5 Identification of Beneficiaries
- 3.6 Guardianship of Minor Children
- 3.7 Dispositive Provisions
- 3.8 Powers
 - 3.8.1 Real estate
 - 3.8.2 Investments
 - 3.8.3 Self-dealing

4. FEDERAL ESTATE

- 4.1 The Gross Estate
 - 4.1.1 Tangible personal property
 - 4.1.2 Real estate
 - 4.1.3 Stocks and bonds
 - 4.1.4 Mortgages, notes, and cash
 - 4.1.5 Insurance
 - 4.1.6 Jointly owned property
 - 4.1.7 Community property
 - 4.1.8 Other property
 - 4.1.9 Alternate valuation date
 - 4.1.10 Qualified family-owned business interest
- 4.2 Allowable Estate Deductions
 - 4.2.1 Funeral and administration expenses
 - 4.2.2 Debts, mortgages, and liens
 - 4.2.3 Marital deduction
 - 4.2.3.1 Maximum marital deduction
 - 4.2.3.2 Qualified terminal interest property (QTIP)
 - 4.2.4 Charitable deduction
- 4.3 Computation of Estate Tax
 - 4.3.1 Taxable estate
 - 4.3.2 Tentative estate tax
 - 4.3.3 Unified credit
 - 4.3.4 Credit for state death taxes
 - 4.3.5 Credit for federal estate tax previously paid
- 4.4 Special Deferred Payment Rules

5. GIFT TAX

- 5.1 Annual Exclusion
- 5.2 Transfers for Educational and Medical Expenses
- 5.3 Marital Deduction
- 5.4 Gift Splitting

6. TAX ON GENERATION-SKIPPING TRANSFERS (GST)

7. INCOME TAX

- 7.1 Income Tax Basis for Property Transferred by Gift
- 7.2 Income Tax Basis for Property Transferred at Death
- 7.3 Gifts to the Decedent Within One Year of Death
- 7.4 Survivors Community Property Tax Basis

8. SPECIAL ESTATE PLANNING SITUATIONS

- 8.1 Estate Freeze
 - 8.1.1 Recapitalizations

ESTATE PLANNING

8.1.2 Corporations and partnerships

8.1.3 Trusts

8.1.3.1 Qualified personal residence trust

8.1.3.2 Grantor retained annuity trust

8.1.3.3 Grantor retained unitrust

8.1.4 Buy-sell agreements

8.2 Family Limited Partnerships (FLPs)

8.3 Charitable Transfers

8.3.1 Planning considerations

8.3.2 Types of charitable transfers

9. POSTMORTEM ESTATE PLANNING

9.1 Qualified Disclaimers

9.2 Timing Distributions

9.3 Deductions of Administration Expenses

REFERENCES

APPENDIX: Estate Planning Practice Aids

1. FUNDAMENTAL ESTATE PLANNING CONCEPTS

Estate planning is a process of providing for the financial needs of an individual during his or her lifetime and of transferring the remaining property with a minimum amount of taxes and administration expenses at death. Estate planning is therefore concerned with maximizing the estate by minimizing income, gift, and estate taxes while taking into consideration the estate owner's goals and the family's need for future income and capital.

1.1 Family

The estate planner must know who the family members are and who the intended beneficiaries are, as well as their needs and ability to manage money. The domicile of the client must be established so that the estate can avoid multiple state tax and administration problems. Consideration should also be given to how the surviving spouse will manage with regard to personal support and the support of dependent children during the period of administration. It is important that the surviving spouse have sufficient cash and other liquid assets, which—along with insurance-policy proceeds—should cover living costs for the family until the other assets are liquidated.

Minor children or other children may require special attention. A determination must be made as to whether any of the children or grandchildren are adopted and to see whether they have the same rights as children born from the marriage. An incompetent child may require custodial care, and the estate owner may wish to provide that child with adequate financial provisions for life to ensure the child's security and remove a possible financial burden from the siblings.

Guardianships for minor children may have to be established if both parents are deceased. Elderly parents may have to be provided with special trusts upon the death of a child who was supporting them.

1.2 Estate Value

The estate planner must review all assets to determine proper ownership of these assets, with a determination of who is going to receive specific property. Unique features of the assets must be understood. The assets must be valued; this is normally a very simple task, but determining the value of a going business or an interest in a partnership, limited liability company, or a closely held corporation can be very complicated.

1.3 Planning Objectives

The estate planner must understand the financial requirements for the estate owner's beneficiaries, but should also be aware of the aspirations of the estate owner. The estate planner should know the answers to the following questions:

- What are the estate owner's hopes for his or her children and what opportunities should be available to them (college, trade school, or their own business)?
- What is the estate owner's judgment of the requirements of the surviving spouse and children and of their capacity to manage financial affairs?
- What are the estate owner's thoughts concerning how much income would be required for the surviving spouse and their children?
- What is the philosophy of the estate owner regarding how much ready cash should be made available to his or her children?
- What amount of liquid funds would be needed to pay off liabilities of the estate?
- How much is needed to educate the children?
- What are the estate owner's charitable intentions and commitments?
- What assets does the estate owner feel should be disposed of at his or her death and what assets should be passed on to children?

1.4 Maximizing the Estate

One of the objects of estate planning is to maximize the estate, which can be accomplished by minimizing the estate tax. Even so, the estate planner should not make recommendations to minimize the tax if the long-term effect would be detrimental to the future size of the estate. The estate planner must have a thorough understanding of how the estate tax works and of which assets of the estate owner would be includable in the taxable estate. In addition, estate planners should be aware of the following factors:

- In recent years, inflation and "bracket creep" have subjected more and more individuals to the onerous impact of estate taxation.
- Lifetime gifts may help reduce future estate tax.
- Business interests may have to be transferred during the lifetime of the estate owner in order to avoid future appreciation's being subject to estate tax.

- Insurance on the estate owner's life may have to be transferred to an irrevocable trust or to the children in order to keep the insurance out of the estate owner's and the spouse's taxable estate.

1.5 Other Facts

The first step in devising an estate plan is to gather the facts. The estate planner must collect accurate and detailed information for an accurate and complete picture of the estate owner's assets. (See the appendix to this chapter for questionnaires that can be useful in obtaining the information.) With these facts available it will be possible to project the probable growth of the estate, determine how tax liabilities against it may be minimized, and estimate how much income is to be expected either on retirement or to the family after death.

1.6 Cash Flow Analysis

A complete analysis must be made of the estate owner's current income, including tax-exempt income, and future income such as Social Security and other retirement benefits. The cash flow analysis should also include both living expenses and expenses for the surviving spouse and children after the estate owner's death.

1.7 Estate Planning Team

The skill of more than one individual is required to obtain and analyze the estate owner's information properly and to prepare all documents necessary to implement the estate plan. Formulation of the plan requires some discussion with other members of the estate planning team, which often includes the estate owner's CPA, lawyer, life underwriter, investment counselor, and bank trust officer. The team of planners should have a strong financial background and an existing professional relationship with the estate owner and his or her family.

1.7.1 CPA

Unlike other members of the estate planning team, the certified public accountant sees his or her client on a regular, recurring basis. Because of this frequent (sometimes annual) contact with the estate owner, the CPA should be familiar with the estate owner's affairs and can help in gathering information as well as determining the value of assets. In addition, the CPA can be particularly useful in valuing closely held businesses. The CPA can also prepare the estate tax and income tax

projections using sophisticated computer techniques that allow for multiple “as if” propositions.

1.7.2 Attorney

The attorney’s primary responsibility is to review the ownership of assets, add his or her views to the CPA’s regarding the tax laws, interpret probate laws, and prepare the necessary legal documents that can implement the plan such as the will, buy-sell agreements, and trust agreements. The attorney must make sure the client’s wishes are expressed by the documents and will be followed after death. The attorney will be aware of proposed testamentary dispositions that might violate state laws, such as the rule against perpetuities, and can assure that the documents are properly executed.

1.7.3 Life insurance underwriter

The life insurance underwriter will review the estate owner’s insurance and recommend changes that may be required to meet the needs of the estate owner. Insurance may be needed to fund buy-sell agreements as well as to pay estate taxes and administrative expenses. The life insurance underwriter can also advise the other members of the team and the estate owner as to available funding vehicles.

1.7.4 Investment counselor

The investment counselor will review the estate owner’s investments and make recommendations with regard to current and future holdings. This adviser may help establish the standards to be used in investing trust or other estate assets.

1.7.5 Trust officer

It is a good idea to have a trust officer involved in the original planning if the estate owner is going to use a bank as executor or trustee. The trust officer can recommend ways to minimize administration costs and preserve capital in investments. If the estate plan calls for the estate owner to set up a living trust, a bank will probably be called in to administer the trust after the estate owner becomes incapacitated or dies.

2. THE CONVENTIONAL WILL

2.1 Definition and Purpose

A will is an instrument that enables an individual to dispose of his or her property upon his or her death. In addition, the will appoints a

fiduciary and makes provisions for the administration of the estate. Wills can be revoked at any time during the estate owner's lifetime and there can be special instructions for funeral arrangements and upkeep of cemetery plots.

Certain property does not pass under a will. This property is often referred to as *will substitutes*. The following is a list of will-substitute property:

- Life insurance payable to a named beneficiary
- Joint property with right of survivorship
- Bank accounts in trust for another individual
- Qualified retirement plans payable to a named beneficiary

Since the property listed above does not pass under a will, determination must be made as to what is controlled by the will. This property is often called the *probate estate* and can be quite different from the taxable estate.

2.2 Who Should Make a Will

Every person of sound mind who is not a minor has a right to make a will disposing of real and personal property. There are certain restrictions that most state laws place on your right to dispose of your property by will. For example, some states require that a certain portion of a married person's property must be left to a surviving spouse; or that certain properties be set off for a surviving spouse and minor children apart from the estate; or that children born after a will has been executed be entitled to a share of the estate unless they have been mentioned or provided for in appropriate ways; or that gifts to charities be limited in estates where the decedent is survived by a parent or children.

2.3 Intestacy

Each of the fifty states has laws that prescribe in great detail what happens to a citizen's property if there is no will or will substitute. These laws are generally referred to as *statutes of descent and distributions* or as *statutes of intestate succession*; thus, if a person dies without a will, the state takes over and makes a will for the person. As a consequence, the estate may go to the wrong person, or to the right person but in the wrong form. Property not disposed of by a will goes to the heirs outright even though they may not be capable of handling it and would be better served if it were in trust. If such persons are minor

beneficiaries, court-appointed guardians will be required to manage their inheritance during minority. The administrator of the estate, designated by statute, may be a person the testator would not have chosen to handle the estate. If the spouse is deceased, a guardian of the minor children will also be designated by law; the person named by the court will not necessarily be the one best suited for the job or the one the deceased parent would have selected.

2.4 Required Formalities

Each state has its own specific set of formalities required to make a will valid. The number of required witnesses to the will differs from state to state. A witnessed will is accepted in all jurisdictions, the unwitnessed will only in some. It is therefore wise to avoid using the unwitnessed will, particularly if the individual is likely to leave assets in more than one jurisdiction, since the use of this type of will would increase the possibility of some of the dispositive provisions failing.

Although there are some variations in state statutes with respect to preparing a witnessed will, these requirements are essentially applicable to all common law jurisdictions:

- The will should be declared in an instrument in writing.
- The testator should sign the instrument; if that is not possible, another person should sign for the testator, in the testator's presence and at the testator's request.
- This signature of the testator or person requested to sign must be following the text of the will immediately and without leaving any intervening space.
- None of the witnesses should be beneficiaries, executors, or trustees under the will.
- The testator should expressly ask the attesting witnesses to attest "the execution of the will."
- All the witnesses to the testator's signature should see the testator sign.

It is very important that local law be checked to make sure that the will has been executed according to the law.

2.5 Changes

2.5.1 Codicil

A codicil is a change to the will; it is treated as part of the will and must be executed the same way. A codicil is generally an amendment to the

will rather than a replacement for it; hence the will's provisions remain effective except to the extent changed by the codicil. Today, with the use of word processing equipment, many attorneys are changing the wills and avoiding the use of codicils.

2.5.2 Revocation

A will can be revoked by an intentional positive act, such as cancellation, obliteration, or destruction or by operation of law. In some states, a divorce may automatically invalidate a provision in favor of a spouse. Revocation by operation of law is difficult to guard against.

2.5.3 Restatement after revocation

If the will has been revoked by law contrary to the testator's wishes, or if the testator has revoked the will and wishes to restore it, the will can sometimes be revived by republishing it or by reexecuting it just as it was originally executed.

Many states adhere to a rule that the destruction or revocation of a second will when the first will is still intact automatically revives the first will; they assume an intention to revive the first will from the fact that the testator did not destroy it when the second was made.

3. WILL COMPONENTS

The will is one of the most important documents a person can make and, therefore, it is important that it be drawn by an attorney with a thorough understanding of the estate owner's wishes and present and future obligations.

3.1 Estate Owner's Domicile

It is important to establish the estate owner's domicile. Typically, this is very easy; however, with many people spending their winters in Arizona or Florida and still owning or renting real estate in Northern states, the question of domicile cannot be taken too lightly. A determination has to be made as to which is the estate owner's principal home. This may require a review of where the estate owner files tax returns, registers cars and votes, and whether the person has filed a homestead tax exemption in the state believed to be his or her domicile. It is important to note that even though a person establishes a domicile in one state, any real property located in another state is subject to that state's inheritance or estate tax.

The determination of a person's domicile is important, because under state law a person's domicile determines the

- Execution requirements for a valid will (see section 2.4 of this chapter).
- Amount of the decedent's estate that passes to family members if there is no will (intestacy) (see section 2.3 of this chapter).
- Amount of state inheritance or estate taxes.
- Rights of a surviving spouse as to an elective share (percentage of the estate on which the spouse has a claim).

3.2 Marital Deduction Provision

Property left to the surviving spouse, either outright or in trust, can qualify for the unlimited marital deduction (see section 4.2.3). If the intention is to minimize taxes in the successor's estate, a formula clause may be used to limit the amount passing to the surviving spouse; the rest of the property can then be left in trust (credit shelter trust) for the surviving spouse's benefit or for the benefit of the entire family. This strategy allows the property passing to the trust to be "sheltered" by the deceased spouse's unified credit (up to \$600,000).

3.2.1 Pecuniary formula

One method of limiting the amount going to the surviving spouse, which is necessary to cancel out the federal estate tax, is by using a pecuniary formula. This formula gives the spouse an amount with a minimum marital deduction that would "zero out" the estate. This bequest can be given outright or in trust. The advantage of using this formula is that a fixed-dollar value is going to the surviving spouse. There are, however, two major disadvantages associated with this formula:

- The surviving spouse does not share in any appreciation or depreciation of the estate during the period of administration.
- The gain is realized by the estate when the bequest of a fixed amount is satisfied by assets that have appreciated in value at the time of distribution (Revenue Ruling 60-87, CB 1960-1, 286; Revenue Ruling 56-270, CB 1956-1, 325).

3.2.2 Fractional formula

The fractional-formula clause gives the surviving spouse a share or percentage of the residuary estate. Under this formula, the surviving

spouse shares in any appreciation or depreciation of the estate from date of death to date of distribution. The surviving spouse thus may suffer if there is a severe shrinkage. Additionally, no capital gains are generated when the estate distributes property in kind so long as the distribution does not have the effect of an exchange among the residuary beneficiaries.

The use of the pecuniary instead of the fractional formula or vice versa is sometimes determined by the drafter's personal preferences. The fact that either one, drawn properly, will generate the needed marital deduction does not mean that one method is not preferable to the other in certain circumstances.

3.2.3 Pecuniary credit shelter formula

In a very large estate, where the amount of the credit sheltered trust will be insignificant, it would simplify the administration if the credit sheltered trust first received the fixed-dollar amount and the surviving spouse or marital trust received the residue of the estate. In this formula, the credit sheltered trust is given an amount equal to the largest amount without incurring a federal estate tax.

The advantage of using this formula is the avoidance of capital gain taxes with the marital portion if the bulk of the estate appreciates in value. Only funding of the credit shelter trust with appreciated assets would be subject to capital gains tax.

3.2.4 Equalization formula

If both husband's and wife's estates are over \$600,000 and both the estate owner and his or her spouse are of an advanced age, the estate planner should consider a formula in which the amount left to the surviving spouse would be an amount that would equalize both estates. Equalizing the two estates, and subjecting the estate of the first spouse to die to estate tax upon death, may be more cost effective than subjecting the combined estates to estate tax (at higher rates) on the death of the surviving spouse.

3.3 Tax Apportionment

In most states, if there is no specific clause in the will as to who pays the estate taxes, each recipient of property from the estate must pay his or her applicable share regardless of whether or not they were designated to receive property in the will. It is very common in many wills to avoid state law and make the residuary beneficiaries pay all the taxes and waive any right of reimbursement from assets that pass outside

the will. Thus, everyone but the residuary beneficiaries would receive their inheritance free of estate tax.

Many estate planners are often surprised by the large amount of assets that pass outside of the will. These may include the following:

- Jointly owned property that passes directly to the surviving owner, such as a residence or bank accounts
- Life insurance that is included by the IRS as part of the estate for federal tax purposes
- Pension benefits, such as IRA and 401(K) plans
- Property that passes pursuant to a living trust
- Property subject to a general power of appointment

If the preceding property is received by the same beneficiaries in the same proportions as those of the residue of the estate, there is no problem. If there is a difference, however, it does not make sense to put the entire tax burden on the residue. In many cases, the assets go to someone other than the residuary beneficiary.

In addition, if some of the remainder beneficiaries are charities, the increase in the tax burden for the residue could reduce the charitable deduction and increase the tax to be paid if a spouse or charity is receiving a portion of the residue. If a spouse or charity is receiving a portion of the residue, the will should say that none of the tax to be paid out of the residue will come out of the spouse or charity's portion.

With regard to QTIP trusts included in the estate of the surviving spouse, if the will of the surviving spouse has a tax clause in which it is stated that the residuary estate pays for all taxes, whether or not the property passes under the will, this can cause a problem if the beneficiaries of the residuary estate and the beneficiaries of the QTIP are not the same. In those cases, the tax clause should not require the residuary estate to pay the estate tax on the value of the property included in the QTIP trust that is taxable in the surviving spouse's estate.

3.4 Common Disaster

The estate owner and the beneficiaries may die in a common disaster or in such circumstances that it is impossible to determine the order of death. In a case in which the estate owner's will leaves \$600,000 in a nonmarital trust for the benefit of the surviving spouse and he or she has the majority of the property and wants to utilize the \$600,000 exemption in his or her estate and the spouse's estate, it is normally recommended that a clause be included directing that the poorer

spouse shall be deemed to have survived so that the property passing to the beneficiaries would have the benefit of \$1,200,000 of exemption equivalency.

3.5 Identification of Beneficiaries

It is very important that the correct name and location of charitable organizations be obtained for the will; charitable organizations are often known by names other than their legal ones. Specific identification of all the beneficiaries should be made to avoid any problems with people with similar names.

3.6 Guardianship of Minor Children

A will should detail the guardianship arrangements for minor children by specifying who will care for the children in the event of the parents' death and who will manage the children's finances. These responsibilities need not be vested in the same person.

In some instances, a will may have a clause arranging to compensate guardians "above and beyond the cost of caring for the child." All wills should have a clause appointing a second-choice guardian if the first-choice guardian either dies or cannot act as guardian.

A will can authorize funds for an addition to the existing home of the guardian, so the minor can have his or her own bedroom.

Under most state laws, natural parents have a paramount right to the guardianship of their children, though that right is not absolute. The custodial parent may designate in the will someone other than the natural parent. The will can express a custodial parent's stance on an ex-spouse's suitability as a parent; however, the state court ultimately makes the final guardianship decision.

3.7 Dispositive Provisions

Determination should be made of who will receive the property if the beneficiary dies before the estate owner (should it go to the children of the beneficiary or should the bequest lapse and then pass on to the residuary beneficiaries?). In many states, adopted children are treated as natural children; therefore, if the estate owner wants to treat adopted children or grandchildren differently, the will should state that fact.

The will should give the executor the right to hold tangible personal assets that may pass to minors or to sell them for the benefit of the minor.

It usually makes sense to appoint a trustee of property left to minors rather than leaving it outright to a minor. In most states, property left to a minor is subject to the jurisdiction of the surrogate or probate court and annual accountings may have to be filed. By using a trust set up in the will, the expense of the administration of a minor's property through the courts can be avoided. In addition, instead of having the minor obtain the property at eighteen, the will can state a later age at which the minor will obtain the property.

3.8 Powers

Usually, broad fiduciary powers are necessary and advisable to permit flexible administration. Many states have given the fiduciary broad powers in dealing with the assets of the estate. However, since we are never sure what state the estate owner may be domiciled in at the time of death, it is a good idea to give broad powers in the will even though state law may give such powers.

3.8.1 Real estate

In many states, if the will specifies no powers to sell real estate, the executor must go to court and obtain permission in order to sell real property. This will be an added expense to the administration of the estate.

3.8.2 Investments

Determination must be made whether the executor should have the power to retain a closely held corporation's stock and partnerships or be required to sell them. Normally, if there is no specific contrary power in the will, the executor should have the power to retain closely held stock or businesses rather than be forced to sell them. In addition, giving the executor broad powers of investment is normally a good idea, since no one knows what assets will be the best investment in the future. However, a testator can suggest in the will the type of investment in which the executor should invest. Specific powers should also be given to allowing the executor to retain unproductive property for a reasonable time.

3.8.3 Self-dealing

Sometimes the executor and attorney or investment adviser are the same person, and often there can be a substantial saving in expenses if the executor performs other duties for the estate. This should be discussed in detail with the estate owner. In many states, an attorney

or CPA cannot function as such and be an executor. In addition, if the CPA is the executor and his or her accounting firm is performing independent audits, that person will no longer be considered an independent accountant and therefore may have to give up either the executorship or the accounting work.

4. FEDERAL ESTATE

The unified federal estate and gift tax is a tax on the privilege of transferring property during one's lifetime and at death. Thus the gift tax and the estate tax are really part of the unified transfer tax.

4.1 The Gross Estate

The gross estate, the starting point in estimating estate tax, includes the value of any property (probate and nonprobate) the estate owner had an interest in at death, as well as property in which the estate owner retained an interest, power, or control at the time of demise. Internal Revenue Code Sections 2031 and 2033 are the basic gross estate provisions. These sections are very broad and all-inclusive. The term *value* means fair market value at date of death, with the exceptions of the alternate valuation date (see section 4.1.9, below) and special-use valuation (see section 4.1.2, below).

4.1.1 Tangible personal property

The ownership of tangible personal property is one of the most troublesome areas in estate planning. Unlike securities, most personal property has no legal written title. In some cases, it is impossible to know who owns the furniture in a house. In some states there is presumption that the furniture in a house rented or owned by a husband belongs to him when in fact it may belong to his wife. Disposal of tangible personal property is normally not documented by a written conveyance signed by the donor. A personal property insurance floater can help in determination of which property is owned by the estate owner. Copies of bills or checks showing payment by one spouse may be necessary in order to identify ownership of the property, which in community property states is usually owned equally if acquired over time from community funds.

If articles of personal property have an artistic or intrinsic total value of \$3,000 (e.g., jewelry, furs, silverware, paintings, antiques, coin or stamp collections), an appraisal by an expert would be required.

4.1.2 Real estate

It is important that the attorney examine copies of deeds to real estate. The attorney also may be required to give his or her opinion in regard to a state's homestead rules affecting the ownership of the real estate. In jointly owned real estate, it is important to determine the effects that will result from the death of one spouse (see section 4.1.6, below).

One goal of estate planning is the avoidance of ancillary proceedings, required when estate owners own property in a state that is not their legal domicile. Such proceedings take place in the state in which the property is situated and entail the additional expense of having a person appointed to handle the proceedings there. To avoid ancillary proceedings, planning consideration should be given to holding the real estate in joint name, or in a living trust, partnership, S corporation or limited liability company. As a general rule, interest in a partnership, S corporation or limited liability company is considered intangible property and does not subject the estate owner to ancillary proceedings. It is important that the deed to the entity property is in the name of the entity and not in the name of the entity owner, or else an ancillary proceeding would be required.

Real estate can usually be valued by an expert appraiser. The general rule is to value the property on the basis of its highest and best use even if it is not being so utilized. For example, land presently used for farming that could be converted into either a residential subdivision or an industrial park has greater value than if it could only be used as farmland. The Internal Revenue Service would value the land at this higher and better use even though the property would continue to be used as farmland. This valuation method has caused hardship for those who wanted to continue the property in a family business; an executor may therefore elect, under Section 2032A, to value qualified property on its actual use as either farm or special business property. For the special-use valuation to apply, the estate owner must be a citizen or resident of the United States at the time of his or her death and the real property must be located in the United States and actively used as a farm or in a closely held business. The special-use valuation cannot reduce the estate owner's gross estate more than \$750,000 (a figure that will be indexed for inflation after 1998) below the value under the regular valuation method. In addition, the value of the farm or closely held business (both real and personal) must be at least 50 percent of the estate owner's gross estate, and at least 25 percent of the value of the gross estate must be qualified real property. Special-use valuation is particularly important to farmers and ranchers; advisers must have specific knowledge of all the rules and regulations of this method when advising such people.

See section 4.1.10 for a discussion of real estate used in a “qualified family-owned business.”

If the land is subject to a qualified conservation easement, the Taxpayer Relief Act of 1997 allows an election to exclude from a taxable estate up to 40 percent of the value of the land subject to the easement. The maximum exclusion is as follows:

| <i>Year of Death</i> | |
|----------------------|-----------|
| 1998 | \$100,000 |
| 1999 | 200,000 |
| 2000 | 300,000 |
| 2001 | 400,000 |
| 2002 and later | 500,000 |

There is no step-up in basis to the extent the value of the property subject to the exclusion is excluded from the gross estate.

(Text continued on page 19)

4.1.3 Stocks and bonds

Marketable securities are valued at the mean between the highest and lowest quoted selling price on the valuation date. If there is no market activity on the valuation date but there are sales within a reasonable period before and after that date, a weighted average of the mean between the highest and lowest quoted selling prices on the nearest dates before and after the valuation date is used (Treas. Reg. Sec. 20.2031-2(b)). The average is weighted inversely by the number of trading days separating the valuation date and the selling date. For example, assume that no sale arose on the valuation date. Five business days before the valuation date and three days after the valuation date the most recent sales occurred. Five days before the valuation date the mean was \$100 and three days after the valuation date the average was \$96; the value therefore would be computed as follows:

$$\frac{(3 \times \$100) + (5 \times \$96)}{8} = \$97.50 \text{ per share}$$

Ownership of a large block of stock may be governed by the blockage rule (Treas. Reg. Sec. 20.2031-2(e)) under which a discount is taken on market value. If it can be shown that the block of stock is so large in relation to the actual sales on the existing market, then the shares cannot be liquidated within a reasonable time without depressing the market. Therefore, the price at which the block could be sold outside the market (through an underwriter) is a more accurate indication of value rather than market quotations. Mutual funds are valued at their redemption price (bid) value.

Only one U.S. Treasury bond (3¹/₂%, due Nov. 15, 1998) may be redeemed at par to pay federal estate tax. These bonds can be obtained from the Federal Reserve Bank. Bonds used to pay federal estate tax are valued at face value rather than at market value and are known as "flower" bonds. (Treasury bonds issued after March 3, 1971, do not carry this redemption privilege.) This flower bond pays a very low interest, so an analysis should be made to determine whether it should be acquired. It usually makes sense to acquire these bonds if the estate owner is terminally ill: Flower bonds must be owned by the decedent at the time of death. The purchase of these bonds by an attorney-in-fact under a durable power of attorney (which survives incompetency or incapacity) or by the trustee of a revocable trust should be valid.

The valuation of a closely held business corporation creates special problems since there is no established fair market value for the stock shares. In Rev. Rul. 59-60, 1959-1 C.B. 237, the Internal Revenue Service has established guidelines for valuing closely held businesses. For stocks,

the guidelines spell out relevant factors such as net worth of the company, prospective earning power, dividend-paying capacity, goodwill, or other intangible value. These guidelines are nevertheless not all-inclusive since no one closely held corporation is exactly the same as another. To avoid problems with the Internal Revenue Service in valuing closely held corporations, consider the use of restrictive agreements or mandatory buy-sell agreements. In addition to the tax reasons for a buy-sell agreement, there are many nontax reasons for a buy-sell agreement, such as control passing to a particular person or persons. Any value based on an option to buy will not fix the value of the shares; there must be an obligation to sell. The fair market value of closely held corporation bonds depends on the soundness of the security, the interest yield, maturity date, and other relevant factors.

4.1.4 Mortgages, notes, and cash

Cash, United States currency, and bank deposits are valued at their face value. Notes, whether secured or unsecured, and mortgages are valued at the amount of the unpaid principal plus interest accrued to date of death unless the executor can establish a lower value or worthlessness. Note that a below-market interest rate can result in a lower value.

4.1.5 Insurance

Life insurance is purchased for many reasons, including the creation of a liquid estate, to protect from costs that will be sustained through death taxes and probate costs, to fund buy-sell agreements, and to utilize the tax shelter of inside build-up in a whole-life form of insurance. Normally, death proceeds of insurance are received income-tax-free. If someone other than the insured owns the policy for more than three years (see below) and the proceeds are payable to that person, they may be received free of estate tax even though the insured pays the premiums.

If the insured owns the policy on his or her life, the proceeds are subject to estate tax. If at death the estate owner owns a policy on someone else's life, that asset is included in the estate at the replacement cost (a figure that normally can be obtained only from the insurance company). Insurance that has been transferred by the insured within three years of the insured's death is includable in the insured's estate under the contemplation-of-death rules (IRC Sec. 2035).

Following the 1981 tax reform measure, which provided for an unlimited marital deduction, survivorship life insurance (also known as second-to-die insurance) has become a popular vehicle for estate tax savings. A survivorship policy pays benefits on the death of a surviving spouse. Because the date of payment is determined by the longer of

two lives, the premiums for survivorship insurance are significantly less than premiums for similar coverage payable on the death of one spouse.

If a survivorship policy is owned by the children or by an irrevocable trust (see the chapter on Trusts), the proceeds are exempt from estate and income taxes. A couple can acquire survivorship insurance with proceeds roughly equaling the amount of the estate tax on their estate. The children or the trust then have a source of funds with which to pay estate taxes when both parents are deceased. Such funds are especially useful when estate taxes are owed on a closely held business or other nonliquid assets the children wish to preserve.

4.1.6 Jointly owned property

Most property owned jointly by a husband and wife is held as a “tenancy by the entirety.” On the death of one spouse the property becomes legally owned by the surviving spouse, and only half the property is included in the estate tax return of the deceased spouse. Property can also be owned jointly by persons who are not husband and wife. In such cases, the property is held as “joint tenancy” and the property passes to the survivor on death. This type of ownership should be clearly indicated by the deed or other instrument by which the conveyance is made. The usual method is to make the conveyance to “John Smith and Roger Smith as joint tenants with full right of survivorship, and not as tenants in common.” These words are not necessary in many states if the property is conveyed to a husband and wife because such conveyance automatically creates a joint tenancy with survivorship or a tenancy by the entireties. If the property is owned by two individuals as a joint tenancy and those individuals are not spouses, the proportion to be included in a deceased tenant’s owner’s gross estate is based on the percentage of his or her contribution to the total cost. This percentage is applied against the fair market value of the entire property on the day of the decedent’s death. Note that the value of the entire property in cases involving persons other than spouses will be included in the gross estate unless the amount contributed by the survivor is proved. In determining the amount of the survivor’s contribution, any part of a contribution that was originally received from the decedent by gift cannot be included.

If property is held by tenants in common, each party owns an undivided interest in the property and there is no right of survivorship. Each party may sell his or her own portion without the consent of the other parties. A decedent’s interest in property as a tenant in common passes under his or her will just like any other property that the person owns and is thus includable in the gross estate. It is very important for the estate planner to look at copies of the deeds that set up joint

property. Most estate owners will not have the detailed information describing how the property is held. In addition, it is important for the attorney to make a determination under state law of whether the property is held as tenants in common or as joint tenants. Some states require the words *tenants in common* to create a tenancy in common, while other states require that if property is given to two people and the words *right of survivorship* do not appear on the deed, they are automatically considered tenants in common.

4.1.7 Community property

The concept of community property is a creature of statute and exists in Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin. Community property exists only between husband and wife and there are variations among the community property laws of the nine states. If the property is considered community property, normally half is included in the estate of the deceased spouse. Familiarity with the specific community property rules of each state is important in determining what is considered community property. Not all property acquired while residing in the state may be considered community property. In addition, if the estate owner moves from a community property state to a noncommunity property state, part of his or her property may still be subject to the community property rules. In community property states a married person may own separate property, usually property acquired before marriage. In addition, property acquired by gift, bequest, devise, or descent would also be considered separate property.

4.1.8 Other property

Other property may include a partnership interest, which would have to be valued much like an interest in a closely held corporation; debts due the decedent; income accrued to date of death; unpaid compensation for work performed prior to death; employee death benefits contracted for by the decedent; claims, rights, patents, and copyrights; royalties; leaseholds; and judgments. Property in which the estate owner had certain legal or beneficial interests, or property subject to a general power of appointment possessed by the estate owner that he or she chose not to transfer during life, is includable in the estate. The estate may also include joint and survivor annuities, refund annuities and other payments received under similar contracts or agreements to the extent that the estate owner contributed to the purchase price, as well as payments to be made pursuant to qualified retirement plans and individual retirement accounts.

4.1.9 Alternate valuation date

The executor can value the gross estate at alternate valuation date values. The alternate election is on an all-or-nothing basis: all assets are valued at either date of death or the alternate valuation date. In general, the alternate valuation date is six months after date of death except for property distributed, sold, exchanged, or otherwise disposed of before the six-month interval, which is valued as of the disposition date.

The alternate valuation date can be used only when the gross estate value is less on that date than the date of death *and* results in a reduction of estate tax.

4.1.10 Qualified family-owned business interest

For deaths occurring after 1997, the Taxpayer Relief Act of 1997 added a new exclusion from the gross estate for a “qualified family-owned business interest” to the extent such interest plus the applicable exclusion of the unified credit does not exceed \$1.3 million. For an individual dying in 1998, the maximum amount excludable would be \$675,000 (\$1,300,000 less the applicable exclusion amount for 1998 of \$625,000). The maximum exclusion in 2006 would only be \$300,000 (\$1,300,000 less \$1,000,000).

The Internal Revenue Service Reconstruction and Reform Act of 1998 converted the above exclusion to a deduction retroactively to January 1, 1998. The 1998 Act retains the \$1.3 million ceiling on family business interest that is exempt from estate tax, but unlike the former exclusion, the deduction may not exceed \$675,000, and it doesn’t drop; it stays at \$675,000. The applicable exclusion is a minimum of \$625,000, regardless of the year of the decedent’s death.

If the qualified family-owned business is worth less than \$675,000, all of the qualified family-owned business interest would be deductible in full and the applicable exclusion is allowed on the excess of \$1.3 million over the amount of qualified family-owned interest deducted. For example, in 2004, if the qualified family-owned business interest is valued at \$500,000, the applicable exclusion allowed is \$800,000.

In order to qualify for the exclusion, the value of the qualified family-owned business interest, plus certain gifts of the qualified family-owned business interest made by a decedent, must exceed 50 percent of the “adjusted gross estate” as that term is defined in Code Section 2033(A).

If the business is not carried on as a proprietorship, then either (a) 50 percent or more of the entity must be owned (directly or indirectly) by the decedent and members of the decedent’s family or (b) 30 percent of the entity must be owned by the decedent and members of the decedent’s family and either (x) 70 percent or more of the entity

must be owned by two families or (y) 90 percent or more of the entity must be owned by three families.

The following are other requirements to qualify for the exclusion.

- The principal place of business must be in U.S.
- The stock or securities of the entity must not have been publicly traded within three years of death.
- The value of the family-owned business interest is reduced to the extent the business holds passive investments, cash, or marketable securities in excess of reasonably expected daily working capital needs of business.
- The decedent or a member of the decedent's family must have owned and materially participated in the business operation for at least five of the eight years prior to the decedent's death.

The estate tax benefits of the exclusion are subject to recapture if any of the following events occur within the ten-year period after the decedent's death.

- A qualified heir does not materially participate for at least five years of any eight-year period.
- The heir disposes of any portion of the qualified family-owned interest other than to a family member.

4.2 Allowable Estate Deductions

Once the value of all property included in the estate owner's gross estate has been determined, the next step is to compute and itemize allowable deductions against the gross estate.

4.2.1 Funeral and administration expenses

Funeral expenses are limited to those amounts actually expended by the executor. They include the undertaker's charges, burial costs, cemetery plot costs, and cost of headstones. Also included as a funeral expense is the cost of transportation incurred by the person who takes the decedent's body to the place of burial. Administration expenses include attorney's, executor's, accountant's, and appraiser's fees; court costs; publication fees; and other expenses necessary for estate administration. The executor has an election to deduct administrative expenses from the gross estate (Form 706) or from the estate's income tax return (Form 1041); see section 9.3, below. A particular expense can be divided between the estate and income tax returns in any proportion the executor chooses. Following the Tax Reform Act of 1986, the estate tax rates

are generally higher than individual rates; thus it is generally beneficial to deduct these expenses on the estate tax return when there is no marital deduction available and the estate is taxable.

4.2.2 Debts, mortgages, and liens

Debts secured by mortgages and liens are deductible separately but only if the encumbered property is included in the gross estate. Expenses of the decedent's last illness would also be included in this category. The debt or claims against the estate must be enforceable against the estate, so if the statute of limitations has expired and these debts cannot be enforced against the estate, they cannot be taken as a deduction.

(Text continued on page 25)

(This could occur when creditors fail to file claims against the estate within the period prescribed by applicable state law for perfecting claims.)

4.2.3 Marital deduction

To the surviving spouse, the marital deduction is perhaps the most important of the deductions from the gross estate. The marital deduction is allowed to citizens or residents of the United States but only with respect to property the value of which is included in the gross estate.

Under the marital deduction provisions of the Economic Recovery Tax Act of 1981, the marital deduction is unlimited. Thus a decedent can leave a spouse the total estate without any estate tax at all. However, any property received by the surviving spouse that is owned by the surviving spouse at the time of his or her death may be subject to a substantial estate tax at that time.

For example, assume that a husband has an estate of \$700,000 and a wife has an estate of \$700,000. If the husband dies in 2002 and leaves his entire estate outright to his wife there would be no federal estate tax, but on her subsequent death in 2006 the wife would have a taxable estate of \$1,400,000 and gross federal estate tax of \$512,800 less unified credit of \$345,800 and the credit for state death taxes of \$58,000, or \$109,000 (see illustration A that follows). Note that the Taxpayer Relief Act of 1997 replaced the \$192,800 unified credit with an increasing credit that increases to \$345,800 by 2006 (see section 4.3.3, herein).

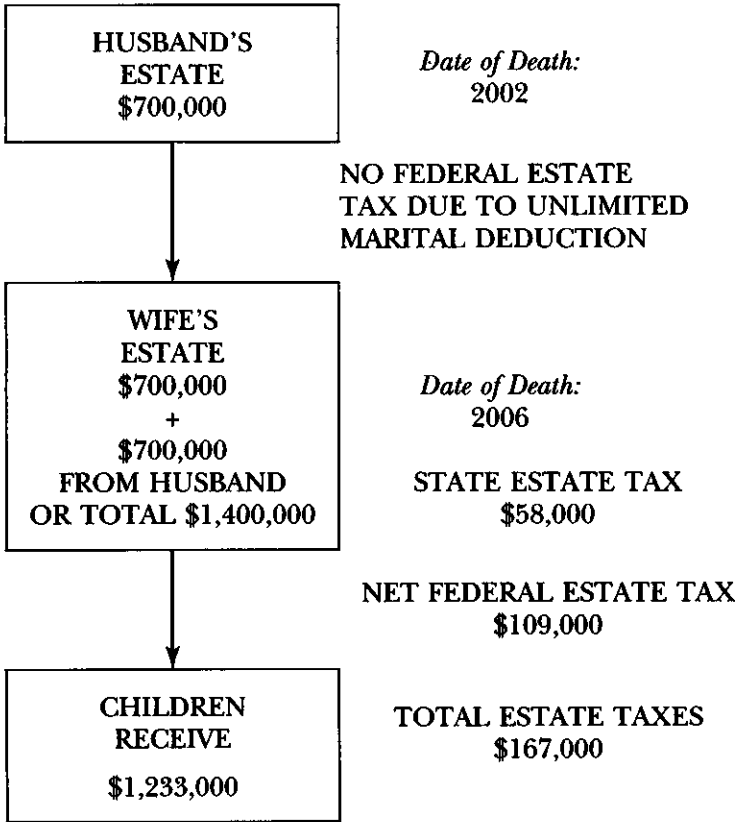
If the husband left the entire \$700,000 in trust (credit shelter trust) for his wife and that bequest did not qualify for marital deduction, at his death there would be no federal estate tax, but on the subsequent death of the wife there would also be no federal estate tax on the spouse's estate because her estate would be less than \$1,000,000 (see illustration B that follows). The value of the credit shelter trust set up by her husband would not be included in her estate since she was merely the income beneficiary, and the funds in the trust would pass to her children tax free.

If the husband's estate is larger than \$700,000, and his will or revocable trust has a formula creating a credit shelter trust (up to \$700,000), in 2002 it would increase each year to \$1,000,000 in 2006) and marital deduction share, there still would be no estate tax on his death.

Example: The husband has an estate of \$1 million and the wife has an estate of \$300,000. Assuming the husband dies first, in 2000, under the formula in his will or revocable trust, \$675,000 would be left to credit shelter trust and the remaining \$325,000 in the marital deduction share.

Illustration A.

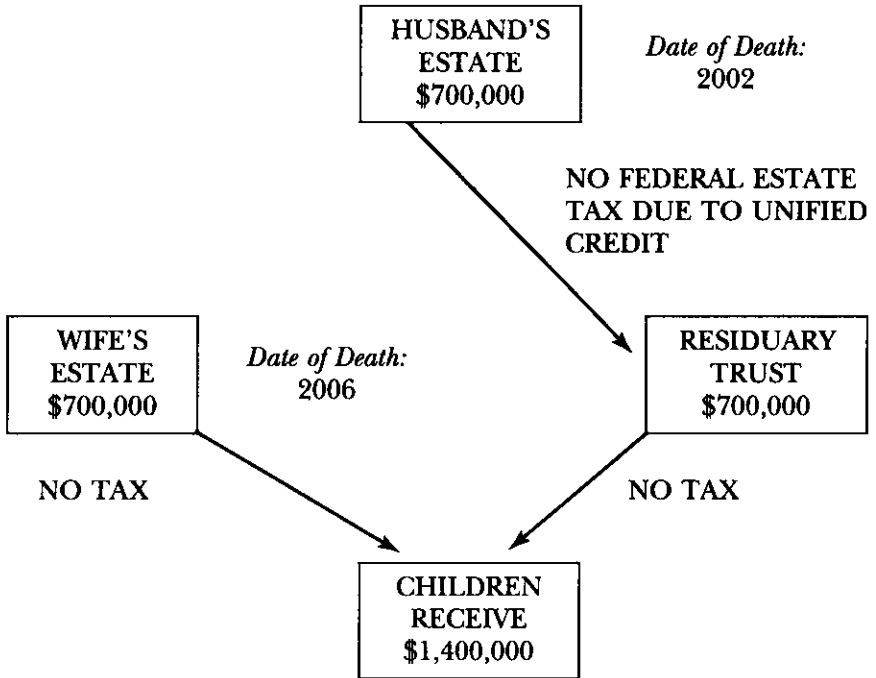
OUTRIGHT DISTRIBUTION (ENTIRE ESTATE LEFT TO WIFE)



There would be no federal estate tax on either death, assuming the appreciation after the husband's death is less than the increase in the effective exemption (see section 4.3.3 herein).

The preceding plan of setting up a credit shelter trust must generally be taken even in community property states to avoid inclusion of the entire \$1,400,000 (\$2,000,000 in 2006) in the estate of the surviving spouse. In other words, if the first to die leaves all to the surviving spouse, there will be only one \$675,000 (\$1,000,000 in 2006) exemption even if all the assets are owned fifty/fifty under the community property law. Thus, a credit shelter trust is still needed to provide for the surviving spouse's needs and to take advantage of both \$675,000 (\$1,000,000 in 2006) exemptions.

Illustration B.

USE OF NONMARITAL TRUST (CREDIT SHELTER TRUST)

The unlimited marital deduction may not apply to wills signed before September 12, 1981 (see section 3.2.4, herein). Note that to be allowed, the marital deduction must pass to a surviving spouse, creating problems concerning whether such person is actually a surviving spouse or not.

4.2.3.1 *Maximum marital deduction.*

Although the unlimited marital deduction generally applies to decedents dying after 1981, a transition rule keeps the marital-deduction limitation in effect on half the adjusted gross estate when a formula bequest is made by certain decedents dying after 1981. The transition rule provides that if the decedent's will or trust created on or before September 12, 1981, contains a formula expressly providing that the spouse receive a maximum amount of property qualifying for the marital deduction allowable for federal estate tax purposes, the amount that can be left to the spouse under this clause will be determined in accordance with the law in effect on December 31, 1981. The transition rule will not apply if the clause is amended after September 12, 1981, and

the amendment refers to “unlimited marital deduction” or if state laws have been amended to interpret such clauses as constituting a valid unlimited marital deduction.

Notwithstanding the transition rule, the IRS has held on several occasions that where the clause refers to the law or statute in effect at the date of death, the transition rule is not applicable and the unlimited marital deduction is applicable (IRS Letter Ruling 8510023).

4.2.3.2 Qualified terminal interest property (QTIP).

A *terminal interest* is one that ceases after a period of time or upon the occurrence of a contingency. Under prior law, a terminal interest passing to the surviving spouse generally would not qualify for the marital deduction. In 1982, Congress changed the rules so that property transferred through a “qualified terminal interest property trust” (or QTIP) qualifies for the marital deduction if an irrevocable election is made to include this property in the transferee spouse’s estate upon death. The executor can make a partial election as long as the surviving spouse receives an income interest in a specific portion (a fractional or percentage interest only) of the property so that the elective part will reflect its proportionate share of the increment or decline in the whole of the property. The election must be made on a timely filed Estate Tax Return (Form 706).

Under Reg. 20-2056(b)-7(b), if a partial election is made, the trust can be divided into separate trusts. The severance of the trust must occur no later than termination of the period of the estate administration and, although the severed trusts must be based on fair market value on the date of division, the trusts do not have to be funded with a pro rata portion of each asset.

Congress’s solution, the QTIP, enables property to qualify for the marital deduction while not allowing the transferee any control over the ultimate disposition of the property. Thus, the donor spouse retains control over the ultimate disposition of the property placed in the QTIP. However, the QTIP requires that all the property income must be paid to the surviving spouse and the principal must solely benefit the spouse during his or her lifetime. There is no ability to split the income between beneficiaries other than the spouse.

Undistributed income of the QTIP trust at the time of the surviving spouse’s death can pass with principal to the remainder beneficiaries, rather than to the estate of the surviving spouse (Treas. Reg. Sec. 20.2056(b)-7(d)(4)).

Note that since the property is included in the estate of the surviving spouse, in cases where the survivor is much younger than the estate owner, the value of this property with appreciation ultimately can far exceed the amount of property value at the time of the decedent’s

death. At the death of the surviving spouse, the QTIP property will receive a step-up in basis under IRC Section 1014 to its fair market value at the time of the spouse's death.

4.2.4 Charitable deduction

For estate tax purposes, there is no limit on the amount that may go to a qualified charitable organization. An individual could therefore leave his or her entire estate to a charity. State law, however, may limit an amount a person can leave to a charity if he or she is survived by a spouse and/or children. In addition to an outright bequest to a charity in order to obtain a charitable deduction, it is possible to split the charitable bequest to either an income interest or a remainder interest. The bequest can thus be enjoyed by a private beneficiary either before or after it is enjoyed by an institutional charitable beneficiary (see section 8.3.2, herein).

4.3 Computation of Estate Tax

4.3.1 Taxable estate

Having reduced the gross estate by allowable deductions, we arrive at the taxable estate. The taxable estate is increased by the amount of all adjusted taxable gifts made by the decedent after 1976 to determine the tentative tax base. The following is a schematic of the structure of the unified transfer tax:¹

| | | |
|--------|------------------------------|----------------------|
| | Gross Estate | (Secs. 2031–2044) |
| Minus: | Administration Expenses | (Sec. 2053) |
| Minus: | Funeral Expenses | (Sec. 2053) |
| Minus: | Debts | (Sec. 2053) |
| Minus: | Losses During Administration | (Sec. 2054) |
| | <hr/> | |
| Equals | Adjusted Gross Estate | (Sec. 2056(c)(2)(A)) |
| | <hr/> | |
| Minus: | Charitable Deduction | (Sec. 2055) |
| Minus: | Marital Deduction | (Sec. 2056) |
| | <hr/> | |
| Equals | Taxable Estate | (Sec. 2051) |
| | <hr/> | |
| Add: | Adjusted Taxable Gifts | (Sec. 2001(c)) |
| | <hr/> | |
| Equals | Taxable Base | |

¹Adapted from *Estate and Gift Taxation*, CPE Course Manual. (New York: American Institute of Certified Public Accountants, 1986), pp. 1–4.

| | | |
|----------|---|----------------|
| Compute: | Unified Transfer Tax on Taxable Base | (Sec. 2019(c)) |
| Minus: | Credits | |
| | Unified Credit | (Sec. 2010) |
| | Credit for State Taxes | (Sec. 2011) |
| | Gift Tax Credit | (Sec. 2012) |
| | for Pre-1977 Gifts | |
| | Credit for Tax on Prior Transfers | (Sec. 2013) |
| | Credit for Foreign Death Taxes | (Sec. 2014) |
| Equals | <u>Tax Payable</u> | |

4.3.2 Tentative estate tax

The next step is to compute the estate tax on a tentative tax basis. The following table shows the computation as it appears in IRC Section 2001 and in the instructions for table A of Form 706:

| Unified Transfer Tax Rate Schedule | | | | |
|------------------------------------|--------------|-------------------|----------------|-----------|
| If the amount is: | | Tentative tax is: | | |
| Over | But not over | Tax + Percent | On excess over | |
| \$ 0 | \$ 10,000 | \$ 0 | 18% | \$ 0 |
| 10,000 | 20,000 | 1,800 | 20 | 10,000 |
| 20,000 | 40,000 | 3,800 | 22 | 20,000 |
| 40,000 | 60,000 | 8,200 | 24 | 40,000 |
| 60,000 | 80,000 | 13,000 | 26 | 60,000 |
| 80,000 | 100,000 | 18,200 | 28 | 80,000 |
| 100,000 | 150,000 | 23,800 | 30 | 100,000 |
| 150,000 | 250,000 | 38,800 | 32 | 150,000 |
| 250,000 | 500,000 | 70,800 | 34 | 250,000 |
| 500,000 | 750,000 | 155,800 | 37 | 500,000 |
| 750,000 | 1,000,000 | 248,300 | 39 | 750,000 |
| 1,000,000 | 1,250,000 | 345,800 | 41 | 1,000,000 |
| 1,250,000 | 1,500,000 | 448,300 | 43 | 1,250,000 |
| 1,500,000 | 2,000,000 | 555,800 | 45 | 1,500,000 |
| 2,000,000 | 2,500,000 | 780,800 | 49 | 2,000,000 |
| 2,500,000 | 3,000,000 | 1,025,800 | 53 | 2,500,000 |
| 3,000,000 | — | 1,290,800 | 55 | 3,000,000 |

4.3.3 Unified credit

In 1997 a unified credit of \$192,800 was allowed against the unified transfer tax imposed on the taxable base. The unified credit was equivalent to an exemption of \$600,000 from the taxable base (*i.e.*, the unified

transfer tax on \$600,000 is \$192,800). The above credit is available for lifetime gifts made and for estates of decedents dying after 1976.

The Taxpayer Relief Act of 1997 increased the unified credit beginning in 1998 through the year 2006. The maximum amount that can be protected from tax by the unified credit, previously referred to as an “exemption equivalent” but now called the “applicable exclusion amount,” increases from \$600,000 to \$1,000,000 in the year 2006. The phase-in is as follows:

| <i>Year of Death or Gift</i> | <i>Unified Credit</i> | <i>Applicable Exclusion Amount</i> |
|----------------------------------|---------------------------|--|
| 1997 | 192,800 | 600,000 |
| 1998 | 202,050 | 625,000 |
| 1999 | 211,300 | 650,000 |
| 2000 and 2001 | 220,550 | 675,000 |
| 2002 and 2003 | 229,800 | 700,000 |
| 2004 | 287,300 | 850,000 |
| 2005 | 326,300 | 950,000 |
| 2006 and thereafter | 345,800 | 1,000,000 |

Beginning in 1988, the benefit of the unified credit and the graduated rates was phased out for taxable gifts and estates exceeding \$10 million. The gift and estate tax liability for taxable transfers in excess of \$10 million is increased by 5 percent of the excess until the benefit of the unified credit and graduated bracket is recaptured.

Taxable gifts before 1988 are counted toward cumulative transfers in determining the rate adjustment for transfers made after 1987, but the tax rate on gifts before 1988 remains unchanged. Thus, if a person made \$7 million in gifts before 1988 and \$5 million in transfers after 1987, \$2 million of transfers (that is, the excess of \$12 million total transfer over \$10 million) are subject to the adjustment. If a person made a total of \$22 million in gifts before 1988, no transfers after that date are subject to the rate adjustment.

4.3.4 Credit for state death taxes

The state death tax credit is given for taxes paid on property included in the decedent's gross estate. The credit equals the lesser of the total of the taxes actually paid to any state or the District of Columbia, or the amount determined by the use of table C in the instructions for Form 706 (reproduced here in Table 1, below), which also appears in Section 2011 of the Internal Revenue Code.

Many states require as a minimum estate or inheritance tax the greater of the tax computed under the state law or the credit allowed

Table 1. Credit for State Death Taxes

| <i>Adjusted taxable estate exceeding*</i> (1) | <i>Adjusted taxable estate* not exceeding column (1)</i> (2) | <i>Credit on amount in column (1)</i> (3) | <i>Rate of credit on excess over amount in column (1)</i> (4) |
|--|---|--|--|
| \$ 40,000 | \$ 90,000 | \$— | 0.8% |
| 90,000 | 140,000 | 400 | 1.6 |
| 140,000 | 240,000 | 1,200 | 2.4 |
| 240,000 | 440,000 | 3,600 | 3.2 |
| 440,000 | 640,000 | 10,000 | 4.0 |
| 640,000 | 840,000 | 18,000 | 4.8 |
| 840,000 | 1,040,000 | 27,600 | 5.6 |
| 1,040,000 | 1,540,000 | 38,800 | 6.4 |
| 1,540,000 | 2,040,000 | 70,800 | 7.2 |
| 2,040,000 | 2,540,000 | 106,800 | 8.0 |
| 2,540,000 | 3,040,000 | 146,800 | 8.8 |
| 3,040,000 | 3,540,000 | 190,800 | 9.6 |
| 3,540,000 | 4,040,000 | 238,800 | 10.4 |
| 4,040,000 | 5,040,000 | 290,800 | 11.2 |
| 5,040,000 | 6,040,000 | 402,800 | 12.0 |
| 6,040,000 | 7,040,000 | 522,800 | 12.8 |
| 7,040,000 | 8,040,000 | 650,800 | 13.6 |
| 8,040,000 | 9,040,000 | 786,800 | 14.4 |
| 9,040,000 | 10,040,000 | 930,800 | 15.2 |
| 10,040,000 | — | 1,082,800 | 16.0 |

*Tentative taxable estate less \$60,000

Table 2. Credit for Federal Estate Tax Previously Paid

| <i>Period of time exceeding</i> | <i>Not exceeding</i> | <i>Percent allowable</i> |
|---------------------------------|----------------------|--------------------------|
| — | 2 years | 100 |
| 2 years | 4 years | 80 |
| 4 years | 6 years | 60 |
| 6 years | 8 years | 40 |
| 8 years | 10 years | 20 |
| 10 years | — | none |

on the federal estate tax return for state death taxes. Some states, such as Florida, have no separate estate or inheritance tax but do require payment of the credit for the estate death taxes to be paid (sponge taxes).

4.3.5 Credit for federal estate tax previously paid

Sometimes a decedent's estate may contain property that was previously taxed in the estate of another decedent who was a transferor of the property. When this is the case and the property was included in the transferor's taxable estate within ten years before or two years after the current decedent's death, IRC Section 2013 allows a credit for a federal estate tax previously paid (see Table 2, above).

The credit is limited to the lesser of the federal estate tax attributed to the transferred property in the transferor's estate, or the federal estate tax attributable to the transferred property in the transferee's estate. There is no requirement that the transferred property be identified in the estate of the transferee, or that it be in existence on the date of the transferee's death.

4.4 Special Deferred Payment Rules

The estate planner should be familiar with the special rules that apply to an interest in a closely held business. IRC Section 6166 provides for an automatic 14-year deferred payment arrangement for the estate tax attributable to an interest in a closely held business. To qualify, the interest must exceed 35 percent of the adjusted gross estate. The adjusted gross estate is simply the gross estate minus deductions claimed under IRC Sections 2053 and 2054. Those deductions are for debts, administration and funeral expenses, mortgages, and casualty losses. The charitable and marital deductions do not enter into the computation of the adjusted gross estate. The deferred payout privilege applies to qualifying stock in a closely held corporation, partnership interest, or even a sole proprietorship.

Under Section 6166, payment of the estate tax attributable to the closely held business interest is entirely deferred for four years. The balance is then payable in ten equal annual installments. Simple interest of only 4 percent (2 percent for estates of decedents dying after 1997) per annum is payable on the tax attributable to the first million dollars of a closely held business included in the gross estate. For calendar years after 1998, the \$1 million amount will be adjusted for inflation in multiples of \$10,000 based on increases in the CPI. For estates of decedents dying after 1997, the interest rate on any excess value is reduced to 45 percent of the rate charged for underpayment of taxes.

For estates of decedents dying before 1998, the interest rate is at the usual Treasury rates. Interest only must be paid during the first four years of the deferral. There are provisions for acceleration of the payment when the business is disposed of during the deferral period.

There is no deduction for income or estate tax purposes for the interest paid on the installment payments for decedents who die after 1997. Estates of decedents dying before 1998 may elect to have the 2-percent interest rate apply to the portion that was previously eligible for the 4-percent rate. The election must be made before January 1, 1999 and is effective for installments due after the election but not before 1998. If the one-time election is made to use the lower interest rate, the estate will not be able to deduct the interest for installments due after the date of the election.

5. GIFT TAX

Lifetime gifts generate tax benefits. Specifically, if the gift qualifies for the annual exclusion, not only will there be no gift tax, but on the death of the estate owner, the property will be excluded from the estate. Estate owners who make taxable gifts remove from their estates the appreciation from the time of the gift to the date of death, significantly reducing the tax cost to the estate. Furthermore, if gifts of income-producing property are made to donees (most effective for those over the age of 13), there may be a saving of income taxes by deflecting the income from the higher marginal income tax rate of the donor to the lower rates of the donee. Lifetime gifts are reported annually to the Treasury on Form 709, the gift tax return. They are later included in the estate tax return, Form 706, as part of the taxable base. The actual payment of the gift tax effectively reduces the taxable base by the amount of gift tax paid, and even if the gift tax has not been paid before the decedent's demise it will be deductible as a debt of a decedent.

5.1 Annual Exclusion

There is an annual gift tax exclusion of \$10,000 (indexed annually for inflation after 1998 in multiples of \$1,000) for each donee. If the donor's spouse joins in the gift by consenting to the gift on the gift tax return (Form 709) each spouse is entitled to take an annual exclusion of \$10,000 for each donee (see section 5.4, below). The annual exclusion is, however, available only for a gift of a present interest (one whose enjoyment commences immediately after the gift is made). Thus, in making gifts with the use of a trust, the trust must qualify for the

annual exclusion if the estate owner wants to obtain the benefits of the annual exclusion. With regard to gifts in trust for the benefit of a minor, no part of the transfer will be considered a future interest if the terms of the transfer meet the following conditions:

- Both the property and its income may be expended by or for the benefit of the minor donee prior to his or her obtaining the age of twenty-one. To the extent not so expended, it will pass to him or her at that time.
- In the event of the donee's death prior to twenty-one, the property and income not expended will pass to his or her estate or to a person appointed by him or her under the exercise of a general power of appointment.

5.2 Transfers for Educational and Medical Expenses

The voluntary payment of medical expenses and education expenses for another is exempt from gift taxation. Note that the education payment exclusion only applies to tuition paid, not to dormitory or other housing costs, meals, or books.

The payment must be made directly to the medical care provider, or qualifying education organization as defined in Regs. Sec. 25.2503-6(b)(2). Contributions to a "qualified state tuition program" (as defined in Section 529 of the Code) are treated as incomplete gifts for federal gift tax purposes. The gift tax consequences of the distribution will be determined at the time that a distribution is made from the program.

5.3 Marital Deduction

As under the estate tax, there is an unlimited gift tax marital deduction for gifts to a spouse. The reasons are the same as for estate tax marital deduction (discussed in section 4.2.3, above).

5.4 Gift Splitting

Gifts made by a married person to one other than a spouse can be considered as if half has been made by the consenting spouse. Thus if the donor and spouse elect to split gifts by filing a gift tax return with the consenting spouse's signature, \$20,000 (indexed annually for inflation after 1998 in multiples of \$10,000) can be given to each third-party donee without gift tax. If the donor and spouse elect to split gifts

totalling not more than \$20,000 (indexed annually for inflation after 1998 in multiples of \$10,000), they may file a short-form gift tax return (Form 709-A).

6. TAX ON GENERATION-SKIPPING TRANSFERS (GST)

The generation-skipping transfer (GST) tax is imposed at 55 percent on transfers under a trust, or on direct transfers, to a “skip person,” that is, a beneficiary related by blood to the transferor or the transferor’s spouse, who is more than one generation younger than the transferor (for example, a grandchild). Any of the following transfers will be a taxable event subject to GST tax:

- Taxable distribution (any distribution of principal or income to a skip person from a generation-skipping trust)
- A taxable termination (expiration of an interest in a trust that defers property to a skip person, such as expiration of life estate)
- Direct transfer (direct skip), such as an outright transfer from a grandparent to a grandchild, where the grandparent sets up a trust for a grandchild

If an event gives rise both to a taxable termination and a direct skip, it is treated as a direct transfer. Characterization as direct skip, taxable termination, or taxable distribution is relevant to the question of who must pay GST tax. The liability for the GST tax is as follows:

- If a direct skip, the transferor (or transferor’s estate) is liable (IRC Sec. 2603(a)(3)).
- If a taxable termination, the trustee is liable (IRC Sec. 2603(a)(1)).
- If a taxable distribution, the distributee is liable (IRC Sec. 2603(a)(2)).

In all cases, the tax is charged to the property that is the subject of the taxable transfer, unless otherwise directed pursuant to the governing instrument by specific reference to the tax imposed (IRC Sec. 2603(b)). Transfers of up to \$1 million (indexed annually for inflation after 1998) per grantor are exempt.

Inter vivos transfers made after September 25, 1985, are subject to GST tax. The law does not apply to transfers from trusts that were irrevocable before September 26, 1985, or to transfers made pursuant to wills in existence before September 26, 1985, if the decedent died before 1987. If a decedent was incompetent on October 22, 1986, and

remained incompetent until death, trusts included in the incompetent decedent's estate, or direct transfers at the time of the incompetent decedent's death, are exempt. All direct transfers to a skip person will be exempt from GST tax, if at the time of the transfer the parent of the skip person, who is the child of the transferor, is dead. This exemption does not apply to distributions from a trust.

For a transfer made after 1997, the Taxpayer Relief Act of 1997 has expanded the deceased parent exception to include transfers to collateral heirs (for example, grandnieces and grandnephews), provided that the decedent had no living descendants at the time of the transfer. The exception is also extended to transfers in trust where the parent of the trust's beneficiary was dead at the time of transfer is subject to gift or estate tax.

There is only one GST tax on double skips. So, if the donor's will makes a direct bequest to his or her great-grandchild, the bequest is subject to one GST tax even though two generations are skipped. In the case of a trust that provides that income is paid to a child for life then to a grandchild for life, then remainder to great-grandchild, there is taxable termination on the child's death and again on the death of the grandchild.

The GST tax does not apply to any inter vivos transfer that is exempt from gift tax due to the \$10,000 annual exclusion or because it is made for certain tuition or medical payments.

Planning Tips. Consider the following GST planning tips:

- Establish a separate trust for grandchildren with up to \$1 million of property. This will exempt the entire trust from GST tax.
- If it is preferable on the son's or daughter's death to pay estate tax on trust funds going to grandchildren, give the son or daughter a general power of appointment.
- If an inter vivos trust for grandchildren has been established before September 26, 1985, do not add any property to this trust.
- The most important planning consideration is ensuring full use of the GST exemptions available to the testator and the testator's spouse.
- In lieu of deferring the funding of the long-term family trust, testators of substantial wealth should consider an immediate funding of such trust with an amount equal to their GST exemption.

7. INCOME TAX

As a result of the unlimited marital deduction for estate tax purposes and with the unified credit applicable exclusion amount of up to

\$1,000,000 by the year 2006, many estates will owe no federal estate taxes. However, careful consideration should be given to the income tax basis for the property transferred during lifetime and at death.

7.1 Income Tax Basis for Property Transferred by Gift

If the fair market value of the gifted property on the date of the gift exceeds the donor's adjusted basis in the property, the donee's (the recipient's) basis in the property will be the same as the donor's basis (Section 1015(a)). For pre-1977 gifts, the donee's basis may be increased by the amount of the gift tax paid by the donor with respect to the particular gift. The sum of the gift taxes plus the donee's basis cannot exceed the fair market value of the gifted property as of the date of the gift (Section 1015(d)(1)).

If the fair market value on the date of the gift is less than the donor's basis, the donee's basis will be determined when the gifted asset is sold, as described below:

- If the donee sells the property at a gain: the donee's basis will equal the donor's adjusted basis;
- If the donee sells the property at a loss: the donee's basis will equal the fair market value at the time of gift;
- If the donee sells the property for an amount between the donor's basis and the fair market value at the time of the gift: the donee's basis will equal the sales price; thus, no gain or loss will be recognized on the sale.

For gifts made after 1976, the donee may increase the donor's basis by only a portion of the gift taxes paid on the appreciation. Use the following formula to determine the amount of increase:

$$\frac{\text{FMV at time of gift} - \text{Donor's adjusted basis}}{\text{FMV of the gift}} \times \text{gift taxes paid}$$

For example, if a taxable gift was made in 1987 with a fair market value
(Text continued on page 37)

of \$20,000 on the date of the gift, the donor's basis was \$6,000 and the donor paid a \$10,000 gift tax with respect to that gift, the donee's *new* adjustment basis will be (including increase):

$$\$6,000 \text{ plus } \frac{14}{20} \times \$10,000 \text{ or } \$13,000$$

7.2 Income Tax Basis for Property Transferred at Death

Most property included in the gross estate of the decedent gets a stepped-up income tax basis based on the valuation date. This new basis becomes the basis in the hands of the estate or the beneficiaries of the estate when they sell the property (IRC Sec. 1014 (a)(1)). Under special holding period rules, the gain or loss on sale of that property would be considered long-term capital gain or loss even if the property is sold within one year after the decedent's death (IRC Sec. 1223 (11)).

7.3 Gifts to the Decedent Within One Year of Death

An exception to the stepped-up basis rule occurs with respect to appreciated property acquired by the decedent by gift within one year of the decedent's death if such property passes to the donor or the donor's spouse. In this case, the basis of the property will equal the adjusted basis that the decedent had therein just prior to death.

7.4 Survivor's Community Property Tax Basis

The survivor's half of the community property gets a basis step-up, even though it is not included in the estate of the first to die. This is particularly significant with regard to homes owned as community property (see section 4.1.7 for list of community property states).

8. SPECIAL ESTATE PLANNING SITUATIONS

8.1 Estate Freeze

The so-called "estate freeze" is a type of estate planning whereby the owner of a family business, generally a corporation or partnership,

attempts to lower his or her taxable estate by transferring appreciating assets to other (generally younger) family members, thereby capping or freezing the value of the owner's estate derived from the value of the business as it stands at the time of the transfer while passing on potential appreciation to the transferees. The estate freeze is intended to avoid estate taxes on the appreciated value of the assets when the owner dies. Naturally, the transferor usually claims at the time of the transfers that most of the value of the business is in the interest he or she retained thereby minimizing gift taxes. However, after the transferor's death, executors frequently take the position that most of the value of the business is in the interest transferred, thus reducing estate taxes. Through use of various types of stock transfers, owners try to retain actual control of the assets transferred while minimizing estate taxes as well as gift taxes.

8.1.1 Recapitalizations

In a common type of estate freeze, the owner retains an interest with a fixed value, such as a preferred stock with voting rights, and then transfers common stock by gift or sale to younger family members active in the business. The preferred stocks generally are created in a recapitalization and constitute most of the business's value when created. The value of the gifts of the common stock might be so slight at the time of transfer as to fall within the annual gift tax exclusion amount. After the transfer, all additional growth in the value of the business would adhere to the common stock, and transfer taxes might be completely avoided.

Congress enacted Internal Revenue Code (IRC) Section 2036(c) to curb what it perceived as subterfuges to avoid estate and gift taxes. IRC Section 2036(c) as enacted in 1987 did not work, primarily because it did not deal directly with the valuation problems at the time of the transfer. IRC Section 2036(c) was repealed retroactively in 1990 and replaced with several new sections dealing with the valuation of preferred stock, transfers to trusts, lapsing rights, and buy-sell agreements. The new rules are found in Chapter 14, IRC Sections 2701 to 2704. They are intended to assure more realistic gift tax valuation at the time of the transfer.

8.1.2 Corporations and partnerships

Under the new rules, when an estate freeze occurs and there is a significant change in the structure of the family business, a value is determined for the entire business under ordinary valuation principles. Then the value of any "applicable" retained interest held by the transferor is determined as set forth in Chapter 14. In general, under Chapter

14, the value of the retained interest will be lower and the value of the transferred interest higher than in the past. The value of the retained interest (including the value of distribution rights, liquidation, put, call or conversion rights pertaining thereto) is subtracted from the value of the entire business to determine the value of the transferred shares. It is expected that the result will be higher gift taxes payable upon the transfer of the common shares.

Where applicable, the new rules require that the value of the retained interest and the value of the entire corporation, partnership, or other property be determined at the time of the initial transfer. The difference between them is usually assumed to be the value of the gift and is subject to gift tax at that time. Unless certain well-defined criteria, which vary with the nature of the property transferred or retained, are met, the law requires the retained interest to be valued at zero. This in turn requires that gift or transfer taxes be paid based on the value of the entire assets of the business or the total worth of the property before the transfer.

It should be noted that the gift tax statute of limitations does not expire on an undisclosed or inadequately disclosed transfer even though a gift tax return was filed for other transfers in the same year.

In cases where there is a transfer of common stock in a corporation or any interest in a partnership to a member of the family, in which rights to income and capital are junior to other equity interests, the value of such a transfer cannot be less than the value determined by assigning to all such junior equity interests a value equal to 10 percent of the total of all equity interests plus the total amount of indebtedness to the transferor or to an applicable family member. Therefore it will be impossible for such a transfer not to incur some gift tax effect.

Basically, Chapter 14 comes into play when common shares or other interests are transferred to younger family members while preferred shares or other interests are retained by older family members. The language is technical. It speaks of an interest in a corporation or partnership being transferred to a "member of the family" (defined as the transferor's spouse, a linear descendant of the transferor or his or her spouse, or the spouse of a descendant), while an "applicable retained interest" is held by the transferor or "an applicable family member" (defined as the transferor's spouse, an ancestor of the transferor or spouse, or the spouse of such ancestor).

The new rules apply to transfers occurring after October 8, 1991. However, interests created before that date are not protected upon a subsequent transfer.

The valuation rules do not apply to a retained interest that is marketable or an interest that differs from a marketable interest only

with respect to voting rights for stock and management rights and liability limits for partnerships.

8.1.3 Trusts

When a transferor retains an interest in the income from assets transferred to a trust, thus creating a grantor retained interest trust (GRIT), the value for gift tax purposes of the remainder interest transferred to a member of the family as defined in IRC Section 2702 (e) is normally the value of all the assets less the amount equal to the value of the annual income interest. (See the chapter on Trusts for a discussion of the general rules of GRITs.) However, the retained income interest would not be considered a “qualified interest” and thus would not be deductible from the entire value of the original trust assets unless:

- The trust is a grantor retained annuity trust (GRAT), carrying the right to receive a fixed amount at least annually.
- The trust is a grantor retained unitrust (GRUT), carrying the right to an annual fixed percentage of the fair market value of the trust assets determined annually.

If the trust is not a GRAT or a GRUT in which the retained income interest is “qualified,” the entire trust value would be considered for gift tax purposes as transferred to the family member remaindermen, and the GRIT would be treated as an outright gift.

Example: A grantor transfers \$500,000 to a GRIT and retains the right to income from the trust for ten years. At the end of this time, the trust terminates and its assets are distributed to the grantor’s children. The gift tax value of the transfer will be \$500,000 at the date of the trust’s establishment.

A GRIT that is neither a GRAT nor a GRUT can remain viable in the following circumstances:

- Remaindermen are related to the grantor, but do not meet the definition of “member of family” in IRC Section 2702(e), such as nieces, nephews, and their spouses.
- The trust is funded solely with tangible property.
- The trust is funded solely with the personal residence of the grantor.

8.1.3.1 *Qualified personal residence trust.*

Grantor retained interest trusts or GRUTs funded with personal residences are excellent estate planning vehicles that allow the homeowner to continue using the family home for the duration of the trust. At the

end of the trust term, the legal title to the home passes to the trust beneficiaries—usually the grantor’s children—at a discounted value for gift tax purposes, even though the home is likely to have appreciated. The grantor can rent the home after the trust terminates.

Example: The present value of the gift of a \$600,000 home to a trust, retaining the right to its use for 15 years, is approximately \$174,000. If the grantor dies during the term of the trust, the value of the property at the time of the grantor’s death will be included in his or her estate.

8.1.3.2 Grantor retained annuity trust.

A grantor retained annuity trust or GRAT is an irrevocable trust agreement whereby the grantor can receive a fixed amount each year during the term of the trust (Reg. Sec. 25.2702-3(b) (1)). The gift to trust remainder beneficiaries would be valued at a discount, and the appreciation of the assets would be removed from the grantor’s estate. Even if the grantor dies during the term of the GRAT, less than the full value of trust property is included in the grantor’s estate, provided the grantor does not retain a contingent interest in the trust.

Example: F establishes a GRAT. She transfers property worth \$500,000 to the trust and retains a yearly annuity of \$50,000 (10 percent) for a period of ten years. The beneficiaries of the trust are her children. The value of the gift to her children is computed as follows:

| | | |
|---------------------------------|-----------------|------------------|
| Total value transferred to GRAT | | \$500,000 |
| Less present value of annuity: | | |
| Annual payments | \$50,000 | |
| Present value factor | <u>× 6.9591</u> | <u>347,955</u> |
| Net gift amount to children | | <u>\$152,045</u> |

If F survives for ten years, the remainder of the trust property passes to her children free of additional gift or estate tax. If F survives only a portion of the ten years, the remaining value of the annuity interest is included in F’s taxable estate.

Assume that F dies five years after the creation of the GRAT. At that time, interest rates have increased by 2 percent. The value of the property in the GRAT at that time is \$700,000. The value of the annuity interest at the time of F’s death is \$193,480 ($\$50,000 \times 3.8696$).

The ability to gain tax savings depends on the ability to maintain the principal of the GRAT. Thus, if the income level from the property is substantially less than the annuity amount, the principal of the trust may be diminished.

A disadvantage of a GRAT is that the grantor's beneficiaries will likely have less tax basis in the property, since the trust assumes the grantor's tax basis.

8.1.3.3 Grantor retained unitrust.

The grantor retained unitrust or GRUT is similar to the GRAT, except the grantor has the irrevocable right to receive payment, at least annually, of a fixed percentage of the net fair market value (determined annually) of the trust assets. Trust distributions can vary each year depending upon the value of the trust.

8.1.4 Buy-sell agreements

The Internal Revenue Service determined that IRC Section 2036(c) applied to buy-sell agreements. Such agreements between family members had been used in some cases as estate freezing devices. Under IRC Section 2036(c), the IRC would endeavor to include the excess of the fair market value of the assets transferred over the buy-sell agreement price in the estate of the seller.

The new statutes supplanting IRC Section 2036(c) provide that, for transfer tax purposes, the value of the property is determined without regard to any option, agreement, or other right to acquire or use property at less than fair market value or any restriction on the right to sell or use the property.

Unless the buy-sell agreement is a bona fide business arrangement and not a disguised testamentary disposition that transfers property to members of a decedent's family for less than adequate consideration.

Practice Tip. Care should be taken not to substantially modify buy-sell agreements entered into before October 9, 1990, because the new rules generally are not applicable to such agreements unless substantially modified after that date.

Practice Tip. The new estate freeze rules will probably stimulate an increase in estate freeze transactions provided older family members are willing to pay some additional gift taxes or to use a portion of their unified transfer tax credit at the time of the transfer. They may retain both an income interest in the business and nearly complete control and still exclude its date-of-death value from their estates. IRC Section 2036(c), now repealed, contained incentives to sell a family business to outsiders. Many of these incentives have now been eliminated.

8.2 Family Limited Partnerships (FLPs)

Family Limited Partnerships (FLPs), an old familiar vehicle, has now emerged to the forefront of estate planning techniques of the 1990s

due to the generally favorable tenor of existing tax law. The FLP can be created to accomplish the following.

- Transfer wealth to family members without giving up control.
- Save significant estate and gift taxes by generating substantial valuation discounts with respect to gifts of interests in the partnership.
- Shift taxable income among family members to save tax.
- Avoid confiscatory compressed income rates applicable to trusts.
- Provide investment flexibility.
- Reduce investment costs.
- Afford the ability to make block purchases at lower rates.
- Provide the ability to negotiate lower investment advisory fees and commissions.
- Protect one's assets from creditors.
- Protect assets given to family members from their creditors.

An FLP is a limited partnership, subject to all the rules of limited partnerships discussed in the Partnership chapter. Parents can fund the FLP with almost any asset except for S corporation stock. The assets should be related to a trade or business, investment, or income-producing venture. Parents can name themselves general partners, each with a one-percent interest and be the original sole limited partners with the remaining 98 percent. Over time, limited partnership interests can be gifted to their children.

As long as parents remain general partners, they make all decisions regarding the management of the FLP, even if most of the limited partnership interests are gifted away.

Currently, the tax law allows gifts of limited partnership interests at discounted value for gift tax purposes to account for the fact they have limited marketability and are minority interests. Typically, discounts are in the range of 25 percent to 35 percent. These discounts allow the parents to greatly reduce their estate by making gifts of FLP limited partnership interests as opposed to outright gifts of business or investment property.

Splitting income among family members can create significant tax benefits by having portions of the total amount of the family income fall into lower tax brackets. There is no requirement that the actual income be distributed so that, for wealth accumulation purposes, FLPs are superior to irrevocable trusts set up for the children. With trusts, the taxable income must be distributed annually to the children, or it will be taxed at extremely unfavorable trust income tax rates.

Another income tax benefit associated with FLPs can result in the creation of earned income, from what would normally be portfolio or passive income, by paying a salary to a family member for services rendered. IRAs can be used to shelter part of this income.

FLPs offer a degree of protection of the FLP assets against creditors of both parents and children. This protection is established by applicable state law and should be discussed in advance with a local business lawyer. Under the laws of most states, a creditor of a partner cannot obtain outright ownership of a partnership interest. *However*, the creditor may be able to obtain a “charging order”—which gives the creditor the right to receive the cash distributions that would have gone to the debtor partner. But, if the debtor is also the general partner who controls these distributions, that creditor doesn’t get too far. A creditor may have to report its share of income of the partnership income on its tax return, therefore, the creditor could be reporting the share and pay taxes without receiving any distributions. This could backfire on the creditor. The assets of the FLP are not protected from creditors of the FLP.

It is important to carefully monitor developments in this field, especially as to the position of the IRS in this rapidly evolving planning area.

8.3 Charitable Transfers

The income, estate and gift tax laws encourage charitable giving; but it is still important that the estate owner be charitable of mind before being encouraged to do so.

8.3.1 Planning considerations

Lifetime charitable gifts not only save income tax but also eliminate the property from the donor’s estate; consideration of charitable giving should therefore be made during one’s lifetime. Many people, however, want to retain the property until their death and then pass on the property to charity.

8.3.2 Types of charitable transfers

Outright donation of assets to the charity is the simplest form of charitable transfer. However, there are other methods of giving the charity an interest in property as well as giving other beneficiaries an interest in the same property.

If the estate owner wants to give the charity an income interest for a period of years and then the remainder interest to other beneficiaries,

he or she may do so by using a qualified charitable lead trust. This could also be used in a situation in which there are young beneficiaries that the estate owner feels are not capable of handling the assets for ten years or so. The qualified charitable lead trust in the will gives the charity the use of the income while the young beneficiaries are maturing and then the property passes to the beneficiaries. The value of the property left to the beneficiaries that is subject to estate tax is reduced by the value of the charitable interest for the period of time stated in the will.

The estate owner who wishes to give the income from the property to his or her beneficiaries only for a stated period of time or until their deaths and then wishes the property to pass on to a charity can do so by using a charitable remainder trust. The income interest must be stated as a fixed-sum annuity or a fixed percentage of the value of the trust (called the unitrust). The annuity rate must be at least 5 percent of the fair market value of the trust for this to qualify as a charitable remainder trust. The Taxpayer Relief Act of 1997 provides that the annual payment to the income beneficiary cannot be more than 50 percent of the initial fair market value (annuity trust) or 50 percent of the annual value of the trust (unitrust) for transfers after June 18, 1997. In addition, the act provides that the remainder interest of the charity must be at least 10 percent of the net fair market value of the property transferred to the trust for transfers made after July 28, 1997. This is a good way of passing on the income to either a surviving spouse or children and then to a charity upon their demise or after a stated period of years. A charitable remainder trust allows one to carve out the amount of the value of the remainder going to the charity to reduce the taxable value of the income interest for estate tax purposes.

A charitable remainder trust can also be used to generate income and avoid capital gains tax. A grantor with highly appreciated low-yielding investments can transfer such investments to a charitable remainder trust. The trustee can sell the investments and invest in others with a higher yield. The trust does not have to pay capital gains tax and the income interest, retained by the grantor for life or for a term of years, is increased by the higher yield of the trust's investments.

Example: An individual owns marketable securities with a cost basis of \$100,000 and a fair market value of \$500,000. The individual is presently earning \$10,000 in dividends from the stock. If the individual, who is in the 20 percent capital gains income tax bracket, sold the stock, he would have \$420,000 to invest after paying capital gain taxes of \$80,000 and would earn \$33,600 a year if he was able to get an 8 percent return.

If, instead, he transfers the property to a charitable remainder trust, the trustees of the trust can sell the securities and reinvest proceeds without incurring any tax. Assuming the same 8 percent return, the trust can pay

\$40,000 a year for his life or fixed number of years (maximum twenty years), and the donor would be entitled to a charitable deduction for the actuarial value of the charity's remainder interest.

Assume the donor, who is age seventy, selects the annuity of \$40,000 a year for a fixed term of twenty years. If the donor dies during this period, his children would receive the annuity payments for the balance of the term. The charitable value of the remainder is approximately \$112,295, which will provide the donor with a deduction worth \$34,812 at a 31 percent income tax bracket. The charitable deduction may be subject to the alternative minimum tax.

9. POSTMORTEM ESTATE PLANNING

9.1 Qualified Disclaimers

A disclaimer can be used to alter the plan or disposition. Disclaimers permit a second look at estate planning that was done previously. A disclaimer by a surviving spouse in excess of the minimum amount to reduce the estate tax to zero can be an effective way of saving tax on the spouse's subsequent death.

In order for a disclaimer or renunciation not to be treated as a taxable gift when the interest is passed from a disclaimant to the recipient, the disclaimer must meet the definition of "qualified disclaimer" (IRC Section 2518). A qualified disclaimer is an irrevocable, unqualified refusal to accept an interest in property and must satisfy the four following conditions:

- The refusal must be in writing.
- The written refusal must be received by the transferor, his or her legal representative, or holder of legal title to the property no later than nine months after the date of transfer creating interests or upon the disclaimant obtaining age twenty-one, whichever is later.
- The disclaimant must not accept an interest or the benefits (dividends, interest, or rents are benefits).

(Text continued on page 40.7)

- The disclaimant cannot have the authority to direct the transfer to another person.

When the surviving spouse receives an inheritance greater than is necessary to eliminate the estate tax, the surviving spouse can disclaim a portion of his or her inheritance. If so directed in the will, the disclaimed portion could then pass over to a trust of which he or she is income beneficiary. When the inheritance to the spouse is insufficient to eliminate the estate tax, the beneficiaries other than the spouse can disclaim a portion of their inheritance and, if under local law or the governing instrument, the disclaimed property passes to the surviving spouse, there can be estate tax savings. All or an undivided portion (fraction or percentage) of any separate interest can be disclaimed. Each interest in property separately created by a transferor is a separate interest.

The time period for filing a disclaimer for revocable joint tenancy, such as a joint brokerage account or a joint bank account, normally runs from the date the gift becomes complete, that is, at the grantor's death, assuming the surviving joint tenant did not contribute to the joint account and did not accept any benefits of the property (Regs. Sec. 25.2518-2(c) (5) Ex. (9)).

For jointly held real estate, the disclaimer must be made within nine months after the "interest was created" (Regs. Sec. 25.2518-2(c) (4)). If the joint tenants were not married to each other, or if they were married and tenancy was created after 1981 and nine months have passed since the creation of joint tenancy, there can be no qualified disclaimer.

If the joint tenants were married, there is a limited exception to the above rule. If the tenancy was created after 1976 and before 1982 and no election was made under IRC Section 2515 to treat the creation of the tenancy as a gift, then one-half of the value of joint interest can be disclaimed within nine months of a joint tenant's death (Regs. Sec. 25.2518-2(c) (4)(ii)).

9.2 Timing Distributions

If the estate is going to be in a lower bracket than that of the beneficiaries of the estate, the executor could accumulate the income of the estate in order to have it taxed as the income of the estate. If the beneficiaries are in a lower bracket than the estate, the executor could accelerate the distributions of income from the estate in order to have it taxed as income of the beneficiaries.

The Tax Reform Act of 1986's tax-rate schedule applicable to retained income of estates is compressed as compared with the rates

applicable to individuals. For the first \$1,600 of taxable income of estates, a tax rate of 15 percent is used, with any excess taxed from 28 percent to 39.6 percent (see the chapter on Trusts); in most cases the estate will therefore be in a higher or equal income tax bracket and there would be no advantage to accumulate income over \$1,600. In addition, estates begin paying estimated tax in a tax year ending two or more years after the date of the decedent's death. Therefore, estates will be able to file two returns without estimated tax payments. The Tax Reform Act of 1986 repealed the rule that had allowed estates to pay their tax over four equal quarterly installments.

9.3 Deductions of Administration Expenses

The administration expenses can be deducted either from the gross estate or on the estate income tax return. The executor must make an election with respect to the administrative expenses—the executor's commissions, attorney's and accountant's fees, court charges, and other expenses incurred in the administration of the estate—by claiming the expenses either on Form 706 or in Form 1041.

REFERENCES

- Adams, Roy M. *Estate Planning Manual for Trust Officers*, 3d ed. Washington, D.C.: American Bankers Association, 1992.
- American Bar Association staff. *The ABA Guide to Wills and Estates: Everything You Need to Know About Wills, Trusts, Estates and Taxes*. New York: Random House, 1995.
- Avedisian, James, et al. *Estate Planning for the 90's*. (CPE course.) New York: American Institute of Certified Public Accountants, Inc., 1995.
- Bittker, Boris. *Federal Taxation of Income, Estates & Gifts*, 2d ed. Boston: Warren, Gorham & Lamont, Vols I–IV, 1993.
- Blattmachr, Jonathan G., and Arthur M. Michaelson. *Income Taxation of Estates and Trusts*, 14th ed. New York: Practising Law Institute, 1995.
- Brosterman, Robert. *The Complete Estate Planning Guide*. New York: NAL Dutton, 1994.
- Cady, Donald F. *Field Guide to Estate Planning, Business Planning and Employee Benefits*, 5th ed. Cincinnati, Ohio: National Underwriter Co., 1993.

- Christianson, Stephen G. *How to Administer an Estate: A Step-by-Step Guide for Families and Friends*. New York: Carol Publishing Group, 1993.
- Clifford, Denis and Cara Jordan. *Plan Your Estate*, 3d ed. Berkeley, Calif.: Nolo Press, 1996.
- Closely Held Business, the 1992 Estate Freezes, Buy-Sell Agreements, Corporate & Tax Planning*. New York: Practising Law Institute, 1992.
- Cohn, Mike. *Passing the Torch: Succession, Retirement, and Estate Planning in Family-Owned Businesses*, 2d ed. New York: McGraw-Hill, 1992.
- Crumbley, D. L. and Edward E. Milam. *Keys to Estate Planning and Trusts*, 2d ed. Hauppauge, N.Y.: Barron's Educational Series, Inc., 1993.
- Elliott, W. C., Jr., et al. *Valuation Practice in Estate Planning and Litigation*. New York: Clark Boardman Callaghan, 1994.
- Esperti, Robert A., and Renno L. Peterson. *Legacy Plan, Protect and Preserve Your Estate*. Denver: Esperti Peterson Institute, Inc., 1996.
- Federal Estate and Gift Taxes*. Publication No. 448. Washington, D.C.: Department of the Treasury—Internal Revenue Service. Annual.
- Gingrich, Jay H. *Wills, Estates and Trusts for Legal Assistants*. Albany: Delmar Publications, 1996.
- Greisman, Bernard, and J.K. Lasser Institute Staff. *Estate Tax Techniques*. New York: Matthew Bender, 1955. Looseleaf service.
- Harrington, Carol A., et al. *Generation-Skipping Transfer Tax: Analyses With Forms*. Boston: Warren, Gorham & Lamont, 1995.
- Hoops, Frederick. *Family Estate Planning Guide*. 2 vols., 4th ed. New York: Clark Boardman Callaghan, 1994.
- Kasner, Jerry A. *Post-Mortem Tax Planning*. Colorado Springs: Shepard's McGraw-Hill, Inc., 1995.
- Kurlowicz, Ted. *Estate Planning Applications*. Bryn Mawr, Penn.: American College, 1996.
- Lynn, Robert J. *Introduction to Estate Planning in a Nutshell*, 4th ed. St. Paul, Minn.: West Publishing Company, 1992.
- Mitchell, William. *Estate and Retirement Planning Answer Book*. New York: Panel Publishers, 1994.
- Moy, Doug H. *Estate Planning Simplified*. 2 vols. New York: John Wiley & Sons, Inc., 1995. Looseleaf.
- Nadelman, Barry, and Lewis Solomon. *Estate Planning: Complete Guide and Workbook*. Columbia, S.C.: Professional Tax and Business Publications, 1996.

- Nolfi, Edward A. *Basic Wills, Trusts, and Estates*. Westerville, Oh.: Glencoe (a division of MacMillan, McGraw-Hill School Publishing Co.), 1994.
- Peat, W. Leslie. *Federal Estate and Gift Taxation*. St. Paul, Minn.: West Publishing Company, 1991.
- Pendleton, Wendell. *Estate Planning With the Living Trust*. Fuquay Varina, N.C.: Research Triangle Publishing, 1995.
- Phillips, David T. and Bill S. Wolfkiel. *Estate Planning Made Easy*. Chicago: Dearborn Financial Publishing, Inc., 1994.
- Reeves, James F., et al. *Guide to Practical Estate Planning*. 2 vols. Fort Worth, Tex.: Practitioners Publishing Company, 1996.
- Runde, Robert H. *The Commonsense Guide to Estate Planning*. Burr Ridge, Ill.: Irwin Professional Publishing, 1993.
- Schindel, Donald. *Estate Administration and Tax Planning for Survivors*. New York: John Wiley & Sons, Inc., 1996. Supplemented.
- Shattuck, George. *Estate Planning for Small Business Owners*. New York: Prentice Hall, 1993.
- Smith, Blake T., et al. *Guide to Business Succession Planning*. Fort Worth, Tex.: Practitioners Publishing Co., 1996.
- Sutkowski, Edward F. *Estate Planning: A Basic Guide*. Chicago: American Bar Association, 1993.
- Tax Information for Survivors, Executors and Administrators*. Publication No. 559. Washington, D.C.: Department of the Treasury—Internal Revenue Service. Annual.
- Understanding Basic Estate Planning*. New York: Practising Law Institute, 1993.
- Westfall, David. *Estate Planning Law and Taxation*. Boston: Warren, Gorham & Lamont, 1989. Supplemented semiannually.
- Williamson, John. *The Wills, Trusts and Estate Planning Handbook*. Lakewood, Colo.: Argyle Publishing Company, 1994.
- Zabel, William. *The Rich Die Richer: And You Can Too*. New York: William Morrow & Company, Inc., 1996.
- Zaritsky, Howard. *Structuring Estate Freezes Under Chapter 14: Final Regulations*. 2d ed. Boston: Warren, Gorham & Lamont, 1992.

APPENDIX: Estate Planning Practice Aids**Contents****Initial Client Contact Materials (Forms and Checklists)****Part One—Family Data Inventories****Part Two—Income Data—Present Cash Flow—Future Requirements****Part Three—Summary of Assets & Liabilities****Part Four—Estate Planning Objectives****Part Five—Checklist of Documents & Family Advisors****Attachment A—Liquid Intangible Assets****Attachment B—Closely Held Business Interests****Attachment C—Real Estate****Attachment D—Life Insurance****Attachment E—Executive Compensation and Employee Benefits****Attachment F—Miscellaneous Assets****Attachment G—Personal Liabilities****Periodic Review of Estate Plans****Information About Family Finances and Estate Planning****Form Letter to Donees****Inventory of Furniture, Collections, Jewelry, and Fine Art****Checklist for Estate and Gift Planning**

APPENDIX: Estate Planning Practice Aids

Forms reproduced from the AICPA CPE course manual *Managing Today's Tax Practice*,
(New York: AICPA, 1986)

INITIAL CLIENT CONTACT MATERIALS

Factual Analysis and Inventory

PART ONE FAMILY DATA

1. Basic Information

| <u>Name</u> | <u>Date of Birth</u> | <u>Social Security Number</u> | <u>Status of Health</u> |
|---------------|----------------------|-------------------------------|-------------------------|
| Husband _____ | | | |
| Wife _____ | | | |

2. Residence

Permanent home address _____

Business address _____

Other temporary residences _____
(possibility of treatment as permanent residence?)

Period of residence in present state _____

Prior residences _____
(e.g., community property states?)

3. Citizenship

Husband: U.S. _____ Other _____

Wife: U.S. _____ Other _____

4. Children, Grandchildren and Other Dependents

| <u>Name</u> | <u>Address</u> | <u>Date of Birth</u> | <u>Marital Status</u> |
|-------------|----------------|----------------------|-----------------------|
| _____ | _____ | _____ | _____ |

5. Marital History

Date of marriage _____

Prior marriages & divorces, including terms of settlements _____
(Text continued on page 41)

PART TWO

INCOME DATA—PRESENT CASH FLOW—FUTURE REQUIREMENTS

I. Present Net Income Data

| <u>A. Income Sources</u> | <u>Husband</u> | <u>Wife</u> | <u>Others</u> |
|--------------------------|----------------|-------------|---------------|
| Salaries | _____ | _____ | _____ |
| Other Compensation | _____ | _____ | _____ |
| Dividends | _____ | _____ | _____ |
| Interest | _____ | _____ | _____ |
| Net Rents | _____ | _____ | _____ |
| Royalties | _____ | _____ | _____ |
| Business Profits | _____ | _____ | _____ |
| Trusts | _____ | _____ | _____ |
| Other | _____ | _____ | _____ |
| <u>Total</u> | ===== | ===== | ===== |

B. Current Expenditures

| | | | |
|-----------------------------------|-------|-------|-------|
| Living Expenses | _____ | _____ | _____ |
| Insurance Premiums | _____ | _____ | _____ |
| Tax Liabilities | _____ | _____ | _____ |
| Mortgage & Other Debt Payments | _____ | _____ | _____ |
| Other | _____ | _____ | _____ |
| <u>Total</u> | ===== | ===== | ===== |

C. Amount Available for Savings

| | | | |
|---|-------|-------|-------|
| (Income Sources Less Current Expenditures) | _____ | _____ | _____ |
|---|-------|-------|-------|

II. Future Annual Cash Requirements

A. Future Income Sources (after retirement)

| | | | |
|-----------|-------|-------|-------|
| Dividends | _____ | _____ | _____ |
| Interest | _____ | _____ | _____ |

| | <u>Husband</u> | <u>Wife</u> | <u>Others</u> |
|--|----------------|-------------|---------------|
| Other Investment Income | _____ | _____ | _____ |
| Annuities & Insurance | _____ | _____ | _____ |
| Social Security | _____ | _____ | _____ |
| Employer Retirement Benefits | _____ | _____ | _____ |
| Other Employee Benefits (e.g., Deferred Compensation Arrangements) | _____ | _____ | _____ |
| Trusts | _____ | _____ | _____ |
| Other | _____ | _____ | _____ |
| <u>Total</u> | ===== | ===== | ===== |
| B. <u>Future Income Needs</u> (after retirement) | | | |
| Living Expenses | _____ | _____ | _____ |
| Tax Liabilities | _____ | _____ | _____ |
| Other Obligations | _____ | _____ | _____ |
| <u>Total</u> | ===== | ===== | ===== |
| C. <u>Amount Available for Savings</u> | | | |
| (Future Income Sources less Future Income Needs) | _____ | _____ | _____ |

PART THREE
SUMMARY OF ASSETS & LIABILITIES

| I. <u>Assets</u> | <u>Husband</u> | <u>Wife</u> | <u>Joint</u> (Identify Contributor) |
|---|----------------|-------------|--|
| A. Cash and Bank Accounts (see Attachment A) | _____ | _____ | _____ |
| B. Notes, Accounts Receivable, Mortgages (see Attachment A) | _____ | _____ | _____ |
| C. Bonds (see Attachment A) | _____ | _____ | _____ |
| D. Listed Stocks (see Attachment A) | _____ | _____ | _____ |
| E. Closely-Held Business Interests (see Attachment B) | _____ | _____ | _____ |

| | <u>Husband</u> | <u>Wife</u> | <u>Joint</u> (Identify Contributor) |
|--|----------------|-------------|--|
| F. Real Estate (see Attachment C) | _____ | _____ | _____ |
| G. Insurance (see Attachment D) | _____ | _____ | _____ |
| H. Employee Benefits (see Attachment E) | _____ | _____ | _____ |
| I. Miscellaneous (see Attachment F) | _____ | _____ | _____ |
| <u>Total</u> | ===== | ===== | ===== |
| II. <u>Liabilities (see Attachment G)</u> | | | |
| A. Real Estate Mortgages | _____ | _____ | _____ |
| B. Notes to Financial Institutions | _____ | _____ | _____ |
| C. Loans on Insurance Policies | _____ | _____ | _____ |
| D. Other Obligations | _____ | _____ | _____ |
| E. Charitable Pledges | _____ | _____ | _____ |
| F. Tax Liabilities | _____ | _____ | _____ |
| <u>Total</u> | ===== | ===== | ===== |
| III. <u>Net Worth</u> | ===== | ===== | ===== |

PART FOUR
ESTATE PLANNING OBJECTIVES

- A. Retirement Objectives
- B. Provisions for Spouse at Death
- C. Provisions for Children at Death
- D. Gift Program for Spouse and the Children
- E. Gifts to Charities

PART FIVE
CHECKLIST OF DOCUMENTS & FAMILY ADVISORS

A. Safe Deposit Box

Location _____

B. Present Documents (if any)

1) Will: dated _____

2) Trusts:

i) created by client _____

ii) created for client by others _____

3) Gift Tax Returns—filed? location?

4) Income Tax Returns—filed? location?

5) Other pertinent documents

C. Advisors (names and addresses)

Accountant _____

Trust Officer _____

Commercial Banker _____

Investment Advisor _____

Stockbroker _____

Life Insurance Agent _____

Casualty Insurance Agent _____

Attachment A
Liquid Intangible Assets

A. Cash and Bank Accounts

| | <u>Bank</u> | <u>Amount</u> | | |
|------------------|-------------|----------------|-------------|--------------|
| | | <u>Husband</u> | <u>Wife</u> | <u>Joint</u> |
| Cash | _____ | _____ | _____ | _____ |
| Checking Account | _____ | _____ | _____ | _____ |
| | _____ | _____ | _____ | _____ |
| Savings Account | _____ | _____ | _____ | _____ |
| | _____ | _____ | _____ | _____ |

B. Accounts Receivable, Notes & Mortgages

| <u>Debtor</u> | <u>Nature of Debt</u> | <u>Security</u> | <u>Maturity</u> | <u>Face Amount</u> | <u>Present Value</u> |
|---------------|-----------------------|-----------------|-----------------|--------------------|----------------------|
| _____ | _____ | _____ | _____ | _____ | _____ |
| _____ | _____ | _____ | _____ | _____ | _____ |
| _____ | _____ | _____ | _____ | _____ | _____ |

C. Bonds

| <u>Description of Bonds</u> | <u>Ownership</u> | <u>Face Value</u> | <u>Cost</u> | <u>Current Value</u> | <u>Current Yield</u> |
|-----------------------------|------------------|-------------------|-------------|----------------------|----------------------|
| _____ | _____ | _____ | _____ | _____ | _____ |
| _____ | _____ | _____ | _____ | _____ | _____ |
| _____ | _____ | _____ | _____ | _____ | _____ |
| _____ | _____ | _____ | _____ | _____ | _____ |

D. Stocks

| <u>Description</u> | <u>Ownership</u> | <u>Cost</u> | <u>Current Value</u> | <u>Current Yield</u> |
|--------------------|------------------|-------------|----------------------|----------------------|
| _____ | _____ | _____ | _____ | _____ |
| _____ | _____ | _____ | _____ | _____ |
| _____ | _____ | _____ | _____ | _____ |
| _____ | _____ | _____ | _____ | _____ |

E. Mutual Fund Shares

| <u>Description</u> | <u>Ownership</u> | <u>Cost</u> | <u>Current Value</u> | <u>Current Yield</u> |
|--------------------|------------------|-------------|----------------------|----------------------|
| _____ | _____ | _____ | _____ | _____ |
| _____ | _____ | _____ | _____ | _____ |
| _____ | _____ | _____ | _____ | _____ |

Attachment B
Closely Held Business Interests

A. Basic Information

1. Name of Business _____
2. Business Address _____

3. **Type of Business Organization** _____
 (e.g., regular corporation, subchapter S corporation, partnership, sole proprietorship)

4. **Business advisors, accountants, etc.** _____

B. Capitalization (if corporation)

| | <u>Common</u> | <u>Preferred</u> | <u>Debentures</u> |
|---------------|---------------|------------------|-------------------|
| Outstanding | _____ | _____ | _____ |
| Authorized | _____ | _____ | _____ |
| Dividend Rate | _____ | _____ | _____ |

C. Distribution of Ownership

| | <u>Common</u> | <u>Preferred</u> | <u>Debentures</u> |
|-------------------|---------------|------------------|-------------------|
| Client | _____ | _____ | _____ |
| Spouse | _____ | _____ | _____ |
| Children | _____ | _____ | _____ |
| Unrelated parties | _____ | _____ | _____ |

D. Buy-Sell Agreement

1. Does buy-sell agreement exist? _____
2. If so, what type? _____
 (e.g., cross-purchase, stock redemption, combination)
3. How funded and amount _____
4. Method for determining value _____
 (e.g., book value, earnings multiple, appraisal, agreed value)

E. Other Commitments of the Business

1. Stock option agreement _____
2. Deferred compensation agreement _____
3. Other employee benefit plans _____
4. Key-man insurance _____

**F. Anticipated Disposition of Stock
 (assuming no buy-sell agreement)**

Attachment CReal Estate

(Including cooperative apartments and condominiums)

| | <u>Parcel One</u> | <u>Parcel Two</u> |
|--|-------------------|-------------------|
| A. <u>Basic Information</u> | | |
| 1. Location | _____ | _____ |
| 2. Type of property (e.g., residential, commercial, unimproved land) | _____ | _____ |
| 3. Form of ownership | _____ | _____ |
| 4. If joint property, contribution by each joint tenant | _____ | _____ |
| 5. Date acquired | _____ | _____ |
| 6. Cost basis | _____ | _____ |
| 7. Present fair market value | _____ | _____ |
| B. <u>Mortgage Obligation</u> | | |
| 1. Original mortgage | _____ | _____ |
| 2. Current amount of mortgage | _____ | _____ |
| 3. Maturity and payment schedules | _____ | _____ |
| C. <u>Cash Flow</u> | | |
| 1. Annual gross income | _____ | _____ |
| 2. Annual maintenance costs | _____ | _____ |
| 3. Annual real estate taxes | _____ | _____ |
| 4. Annual depreciation | _____ | _____ |
| 5. Annual mortgage payments (principal and interest) | _____ | _____ |
| 6. Net positive (or negative) cash flow | _____ | _____ |
| D. <u>Farm</u> | | |
| 1. Farm machinery and equipment | _____ | _____ |
| 2. Excess of value of land over value as operating farm | _____ | _____ |

Attachment D
Life Insurance

| | <u>Face Value</u> | <u>Type of Policy</u> | <u>Annual Premium</u> | <u>Cash Surrender Value</u> | <u>Designated Beneficiary</u> | <u>Settlement Option</u> |
|--|-------------------|-----------------------|-----------------------|-----------------------------|-------------------------------|--------------------------|
| A. Policies Owned by Client on His Life | | | | | | |
| _____ | _____ | _____ | _____ | _____ | _____ | _____ |
| _____ | _____ | _____ | _____ | _____ | _____ | _____ |
| (Company & Policy Number) | | | | | | |
| B. Policies Owned by Others on Client's Life | | | | | | |
| _____ | _____ | _____ | _____ | _____ | _____ | _____ |
| _____ | _____ | _____ | _____ | _____ | _____ | _____ |
| (Company & Policy Number) | | | | | | |
| C. Policies Owned by Client on Lives of Others | | | | | | |
| _____ | _____ | _____ | _____ | _____ | _____ | _____ |
| _____ | _____ | _____ | _____ | _____ | _____ | _____ |
| (Company & Policy Number) | | | | | | |

Attachment E
Executive Compensation and Employee Benefits

Employer's name and address _____

| <u>A. Type of Plan</u> | <u>Retirement Benefit</u> | <u>Amount Vested</u> | <u>Death Benefits</u> |
|--------------------------------------|---------------------------|----------------------|-----------------------|
| 1. Pension | _____ | _____ | _____ |
| 2. Profit-sharing | _____ | _____ | _____ |
| 3. Deferred Compensation Arrangement | _____ | _____ | _____ |

| | <u>Retirement Benefit</u> | <u>Amount Vested</u> | <u>Death Benefits</u> |
|------------------------------------|-------------------------------|--------------------------|-----------------------------|
| 4. H.R. 10 (Keogh Plan) | _____ | _____ | _____ |
| 5. Individual Retirement Account | _____ | _____ | _____ |
| 6. Other | _____ | _____ | _____ |
| B. <u>Stock Option Plan</u> | <u>Option Price</u> | <u>Current Value</u> | <u>Summary of Terms</u> |
| 1. Incentive Stock Plan | _____ | _____ | _____ |
| 2. Nonqualified Stock Option Plan | _____ | _____ | _____ |
| C. <u>Other Benefits</u> | <u>Company</u> | <u>Benefits</u> | <u>Beneficiary</u> |
| 1. Group term life insurance | _____ | _____ | _____ |
| 2. Accident insurance | _____ | _____ | _____ |
| 3. Health and medical insurance | _____ | _____ | _____ |
| 4. Other | _____ | _____ | _____ |

Attachment F
Miscellaneous Assets
(at current fair market value)

| | <u>Client</u> | <u>Spouse</u> | <u>Joint</u> |
|--|---------------|---------------|--------------|
| A. <u>Personal Effects</u> | | | |
| 1. Clothing | _____ | _____ | _____ |
| 2. Furs | _____ | _____ | _____ |
| 3. Jewelry | _____ | _____ | _____ |
| 4. Home furnishings | _____ | _____ | _____ |
| 5. Other | _____ | _____ | _____ |
| B. <u>Other Tangible Personal Property</u> | | | |
| 1. Collections (e.g., art, book, stamp, coin) | _____ | _____ | _____ |
| 2. Automobiles | _____ | _____ | _____ |
| 3. Other (e.g., boats, aircraft, office contents) | _____ | _____ | _____ |

| | <u>Client</u> | <u>Spouse</u> | <u>Joint</u> |
|--|---------------|---------------|--------------|
| C. <u>Intangible Assets & Royalties</u> | _____ | _____ | _____ |
| D. <u>Limited Partnership Interests</u> | _____ | _____ | _____ |
| E. <u>Mineral Interests</u> | | | |
| 1. Oil and gas | _____ | _____ | _____ |
| 2. Other | _____ | _____ | _____ |
| F. <u>Estates and Trusts</u> | | | |
| 1. Anticipated benefits under estates and trusts | _____ | _____ | _____ |
| 2. Powers of appointment (general or limited?) | _____ | _____ | _____ |
| G. <u>Social Club Bonds and Stock</u> | _____ | _____ | _____ |
| H. Cemetery Plot | _____ | _____ | _____ |

Attachment G
Personal Liabilities

| | <u>Obligee</u> | <u>Amount</u> | <u>Interest Rate</u> |
|------------------------------------|----------------|---------------|----------------------|
| A. Real estate mortgages | _____ | _____ | _____ |
| | _____ | _____ | _____ |
| B. Notes to financial institutions | _____ | _____ | _____ |
| | _____ | _____ | _____ |
| C. Loans on insurance policies | _____ | _____ | _____ |
| | _____ | _____ | _____ |
| D. Other obligations | _____ | _____ | _____ |
| | _____ | _____ | _____ |
| E. Charitable pledges | _____ | _____ | _____ |
| | _____ | _____ | _____ |
| F. Tax liabilities | _____ | _____ | _____ |
| | _____ | _____ | _____ |
| G. Contingent liabilities | _____ | _____ | _____ |
| | _____ | _____ | _____ |

PERIODIC REVIEW OF ESTATE PLANS

The goal of the practitioner in preparing any estate plan is to effectuate the testator's desires and to maximize tax savings. Changing conditions (changes as a result of marriage, divorce, or remarriage; changes in family responsibilities; changes in the law; change of residence to another state; inflation; a bull or bear market; etc.) necessitate a periodic review and reexamination of estate plans. How do these factors affect estate plans? Why must estate plans be updated? What should be done now? The following discussion is designed to alert practitioners and their clients to the need for a periodic review of estate plans. The checklist is designed to aid in updating them.

A will, life insurance, and retirement plan all comprise an estate plan. They are all vital elements of such a plan. All are important but a will, particularly, must be timely, it must be periodically reviewed in order to effectuate the testator's desires in light of changing circumstances and in order to maximize tax savings.

Market fluctuations: Stock market fluctuations have been dramatic and necessitate a reexamination of many estate plans. Almost concurrent with the increases or decreases in the stock market are parallel movements in worth of real estate, art objects, and antiques. Changes in the value of assets require a recomputation of the federal estate and any of the state death taxes that will ultimately become due. These taxes, debts, and the estate's administration expenses must be paid.

Reexamine legacies and bequests: Changing circumstances, changes not merely in the testator's personal life, but market changes and proposed tax changes necessitate a reexamination of some legacies and bequests in the will. Specific bequests of certain assets or bequests of specific amounts of stocks may no longer effectuate the testator's desires because of inflation and/or fluctuations in the market. Substantial increases in the value of paintings and antiques may suggest a change in the will to prevent an unintended windfall.

Family support needs: An individual when planning his estate, is concerned with supporting his widow and dependent children. He is concerned with assuring his family's standard of living. These calculations must be revised. The amount of income anticipated several years ago from the testator's portfolio may no longer be applicable today. Changes in the overall estate plan may be required—additional life insurance may have to be purchased, investments may have to be switched, etc.

Charitable bequests: Bequests to charity should be reviewed with the following factors stressed: (1) Is the testator still able to make the bequest? and (2) If yes, should the amount of the bequest remain the same?

Legislation: Congressional action may affect estate planning.

Section 303: Can the benefits of IRS § 303 be utilized? This section is available to those having a substantial stockholding in a closely held corporation. Briefly, this section provides that a redemption of stock included in a decedent's estate for federal estate tax purposes will be considered a distribution in exchange for stock and will not be considered to be a taxable dividend, to the extent that the distribution does not exceed the amount of federal estate and death taxes, interest on those taxes, and the deductible funeral and administration expenses. However, since the value of the stock to be redeemed must be more than 35 percent of the value of the gross estate, a change in the value of assets may disqualify what originally had been considered to be a qualified § 303 redemption. On the other hand, the benefits of § 303 may now be available. Therefore, an estate plan review will indicate the current applicability of § 303.

It is the responsibility of every practitioner planning estates to keep his or her clients aware of changes that may require a review and possible revision.

Checklist for Updating an Estate Plan

| | Yes | No | N/A | | Yes | No | N/A |
|--|--------------------------|--------------------------|--------------------------|-------------------------------------|--------------------------|--------------------------|--------------------------|
| Family | | | | Valuation Changes | | | |
| ● Marriage | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | ● Change specific legacies | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| ● New child (birth or adoption) | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | ● Add new legacies | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| ● Separation | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | ● Alter trust income and conditions | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| ● Divorce | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | ● Consider additional insurance | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| ● Remarriage | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | ● Consider investment charges | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| ● New grandchild | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | Change of State of Residence | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| ● Death of member of family | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | ● New will | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| ● Marriage of member of family | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | ● New lawyer | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| | | | | ● Another executor | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| Tax Laws | | | | Miscellaneous | | | |
| ● Pension legislation | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | ● Change bequest to charity | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| ● Increase in income taxes | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | ● Add new charities | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| ● Gift tax rates more advantageous now | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | ● Change trusts | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| ● Trusts | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | ● Change legacies to gifts | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> |
| ● Applicability of § 303 | <input type="checkbox"/> | <input type="checkbox"/> | <input type="checkbox"/> | | | | |

INFORMATION ABOUT FAMILY FINANCES AND ESTATE PLANNING**(A Checklist for Your Spouse)****1) General knowledge of family's worth and possessions**

- a. Are you clear about the mortgage (if any) on your home? Yes ___ No ___
- b. Do you know the location of important papers? (deed, social security information, marriage and divorce papers) Yes ___ No ___
- c. Do you know the composition of your yearly inflow of money? Yes ___ No ___
- d. Are you aware of any trust funds which have been set up for you or the family? Yes ___ No ___
- e. The name of your attorney? Your CPA? Yes ___ No ___
- f. Do you have a list and location of all tangible property, including jewelry, autos, savings bonds, etc.? Yes ___ No ___

2) Investments

- a. Do you know what securities and mutual funds are owned by you and your spouse? Yes ___ No ___
- b. Do you know the location of securities & records? Yes ___ No ___
- c. Do you know the purchase price and present value of the securities you hold? Yes ___ No ___
- d. Do you know the name of your stockbroker? Financial advisor, if any? Yes ___ No ___

3) Insurance coverage

- a. Are you familiar with your family's life, health, accident or income protection insurance? Yes ___ No ___
- b. Do you know the extent and type of coverage of your fire, automobile, public liability insurance? Yes ___ No ___
- c. Do you know the location of these policies and receipts for premiums? Yes ___ No ___
- d. Do you know the names of your insurance advisors? Yes ___ No ___

4) Banking arrangements

- a. Do you know the location and contents of your safe deposit box? Yes _____ No _____
- b. Do you have access to it? Yes _____ No _____
- c. Do you know of all banks in which you have accounts or where this information can be obtained? Yes _____ No _____
- d. Do you know the location of records & passbooks? Yes _____ No _____

5) Will and estate plan

- a. Do you know the location of your wills? Yes _____ No _____
- b. Do you know if your wills are up to date and the estate plan contemplated by them? Yes _____ No _____
- c. Are you aware of the function you have in the administration of your spouse's estate (if any) and do you understand it? Yes _____ No _____
- d. Are you aware of the effect of your spouse's death on your present standard of living? Yes _____ No _____
- e. Do you know what the projected costs will be for administration and taxes on the estates of both you and your spouse? Yes _____ No _____

FORM LETTER TO DONEES

Dear _____:

Our client(s), _____
 has (have) requested that we submit the following information concerning his
 (her) recent gift to you(r) _____

1. Property given: _____

2. Date of gift: _____
3. Acquisition date for "tax" purposes: _____
4. Basis to donor: \$ _____
5. Fair market value at date of gift: \$ _____
6. Gift tax paid by donor: \$ _____
7. Portion of gift tax paid by donor attributable to the appreciation in value
 to date of gift: _____

Should you sell all or a portion of this property, your accountant will need this information to properly compute your tax gain or loss on such sale.

Should you gift all or a portion of the property to a donee other than a charity, the donee will need this information to enable him to calculate his tax basis upon a future disposition.

Should you bequeath all or a portion of this property, the executor of your estate may, depending on the then existing tax laws, need this information to calculate its tax basis to your heirs.

Should you have any questions concerning any of the above, please feel free to contact me. With kindest regards, I remain,

Very cordially yours,

cc: To donor

Instructions: (1) This form is to be completed for each item given to a donee other than a charity.

- (2) This form is merely a draft from which a formal letter will be typed after approval by supervisor or partner in charge.

**INVENTORY OF FURNITURE,
COLLECTIONS, JEWELRY AND FINE ART**

1. Description of Item: (e.g., painting, chair, etc.)

2. Detailed Description: (e.g., weight (in the case of diamonds, size, color, etc.))

3. Date Acquired by Present Owner:

4. Name of Present Owner:

5. How Acquired & Basis Information:
 - a. If purchased: insert cost
 - b. If acquired by gift: insert tax basis (tax basis of donor plus any gift tax paid by donor)
 - c. If inherited: insert the fair market value as of the date of death—obtain from estate tax return or executor of the estate.

6. Appraisal Information:

| <u>Date</u> | <u>Name of Appraiser</u> | <u>Amount of Appraisal</u> | <u>Reason for Appraisal</u> |
|-------------|--------------------------|----------------------------|-----------------------------|
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |
| | | | |

CHECKLIST FOR ESTATE AND GIFT PLANNING

Client Name _____ Date _____

| | <u>Definite Planning Opportunity</u> | <u>Need More Information</u> | <u>No Action Required</u> |
|--|--|----------------------------------|-------------------------------|
| A. Is the client's estate large enough to be concerned about estate taxes? | _____ | _____ | _____ |
| B. Should the client utilize annual gift tax exclusions? | _____ | _____ | _____ |
| C. Does the client have sufficient life insurance to make an insurance trust advantageous? If so, should Crummey provisions be included to qualify premium payments for the annual gift tax exclusion? | _____ | _____ | _____ |
| D. Should gifts be made to use unified gift and estate tax credits of client and spouse? | _____ | _____ | _____ |
| E. Should generation-skipping transfers be used? | _____ | _____ | _____ |
| F. Should any of the following techniques be used? | _____ | _____ | _____ |
| 1. Charitable remainder trusts | _____ | _____ | _____ |
| 2. Charitable lead trusts | _____ | _____ | _____ |
| 3. Grantor retained annuity trust | _____ | _____ | _____ |
| 4. Qualified personal residence trust | _____ | _____ | _____ |
| 5. Family limited partnership | _____ | _____ | _____ |
| G. Is the client subject to the 15 percent excise tax on excess retirement accumulations? | _____ | _____ | _____ |
| H. Has the client's will been revised to reflect the latest change in estate tax laws? | _____ | _____ | _____ |
| I. Should the unlimited marital deduction be used? | _____ | _____ | _____ |

CHECKLIST FOR ESTATE AND GIFT PLANNING *(continued)*

| | <u>Definite Planning Opportunity</u> | <u>Need More Information</u> | <u>No Action Required</u> |
|--|--|----------------------------------|-------------------------------|
| J. Should a qualified Terminal Interest Trust be used? | _____ | _____ | _____ |
| K. Is any inheritance expected which should be directed to a younger generation? | _____ | _____ | _____ |
| L. Should inter vivos trusts be established to shift income and eliminate estate growth? | _____ | _____ | _____ |
| M. Should life insurance policies be gifted to children? | _____ | _____ | _____ |
| N. Is the legal form of ownership of assets by spouses appropriate to enable use of a trust to avoid inclusion of such assets in the taxable estate of the second spouse to die? | _____ | _____ | _____ |
| O. Could the estate be planned to allow special use valuation on farm or closely held business realty? | _____ | _____ | _____ |
| P. Has the effect of the federal estate plan on state inheritance or state estate tax been considered? | _____ | _____ | _____ |
| Q. Could the estate be planned to qualify for installment payments of estate taxes? | _____ | _____ | _____ |
| R. Will the client's estate include significant items of income in respect of a decedent which could be directed to beneficiaries expected to be in low income tax brackets or which are exempt? | _____ | _____ | _____ |

SOCIAL SECURITY AND OTHER ISSUES FACING ELDERLY OR DISABLED CLIENTS

1. INTRODUCTION

2. SOCIAL SECURITY

- 2.1 Introduction
- 2.2 Funding
 - 2.2.1 Employees
 - 2.2.2 Self-employed persons
- 2.3 Retirement Benefits
 - 2.3.1 Eligibility
 - 2.3.2 Amount of benefit
 - 2.3.2.1 Annual earnings limitation
 - 2.3.2.2 Early or delayed retirement
 - 2.3.2.3 Maximum family benefit
 - 2.3.3 Dependent coverage
 - 2.3.3.1 Spouse
 - 2.3.3.2 Former spouse
 - 2.3.3.3 Child
 - 2.3.4 Taxation of retirement benefits
 - 2.3.5 Applying for retirement benefits
- 2.4 Survivor's Benefits
 - 2.4.1 Lump-sum death benefit
 - 2.4.2 Surviving spouse
 - 2.4.3 Surviving divorced spouse
 - 2.4.4 Surviving child
 - 2.4.5 Surviving parent
- 2.5 Disability Benefits
 - 2.5.1 Eligibility
 - 2.5.2 Disability benefits
 - 2.5.3 Definition of disability

3. SUPPLEMENTAL SECURITY INCOME

- 3.1 Introduction
- 3.2 Resources
- 3.3 Income
- 3.4 Reporting Requirements

4. MEDICARE

- 4.1 Introduction

- 4.2 Medicare Hospital Insurance (Part A)
 - 4.2.1 Eligibility
 - 4.2.2 Coverage
- 4.3 Medicare Medical Insurance (Part B)
 - 4.3.1 Eligibility
 - 4.3.2 Coverage
- 4.4 What Medicare Does Not Cover
- 4.5 Filing a Medicare Appeal
 - 4.5.1 Appealing decisions by peer review organizations
 - 4.5.2 Appealing all other hospital insurance (Part A) decisions
 - 4.5.3 Appealing decisions on medical insurance (Part B) claims
 - 4.5.4 Appealing decisions by health maintenance organizations and competitive medical plans
- 4.6 Supplemental Health Insurance
- 4.7 Medicare + Choice MSA Plan

5. MEDICAID

- 5.1 Introduction
- 5.2 Eligibility
 - 5.2.1 Categorically needy
 - 5.2.2 Optional categorically needy
 - 5.2.3 Medically needy
- 5.3 Medicaid Benefits
- 5.4 Resource Requirements
 - 5.4.1 Excluded resources
 - 5.4.2 Spousal resources
 - 5.4.3 Transferring excess resources

6. PLANNING FOR SUBSTITUTE DECISION MAKING

- 6.1 Durable Power of Attorney
- 6.2 Living Will (Advance Directive)
- 6.3 Health Care Surrogate

REFERENCES

1. INTRODUCTION

As of March 1998, there were over 27 million retired workers receiving Social Security retirement benefits, compared to approximately 25 million at the end of 1990 and approximately 19.5 million at the end of 1980. Senior citizens represent one of the fastest growing segments of the U.S. population. In addition, as of March 1998, there were approximately 4.5 million workers receiving Social Security disability benefits.¹ This chapter presents an overview of the U.S. Social Security system and certain other issues of increasing relevance to the practitioner representing elderly or disabled clients.

2. SOCIAL SECURITY

2.1 Introduction

The Social Security Act, published as Chapter 7 of Title 42 of the United States Code, governs a wide variety of programs that presently cover nine out of ten workers in the United States. The administration of the Social Security Act is the responsibility of the Social Security Administration, an independent federal agency headquartered in Baltimore, Maryland, with approximately 1,300 local offices located throughout the United States, the U.S. Virgin Islands, Puerto Rico, Guam, and American Samoa. Information regarding the Social Security Administration can be obtained by calling (800) 772-1213 or by visiting the Social Security Administration's Web site at <http://www.ssa.gov>.

The Social Security Act provides for programs such as old age, survivors, and disability insurance benefits (commonly referred to as OASDI or Social Security benefits), Supplemental Security Income benefits, Medicare benefits, and Medicaid benefits, each of which is discussed further below. While the future of the Social Security system remains the subject of great controversy and concern, Social Security provides the primary source of retirement and disability benefits for many Americans.

2.2 Funding

Social Security benefits are generally funded by the withholding of taxes from employees and contributions by employers pursuant to the Federal

¹Source: Social Security Administration.

Insurance Contributions Act (FICA) and by the collection of self-employment taxes from self-employed individuals.

2.2.1 Employees

The FICA tax imposed on employees consists of the following two components:

- A tax of 6.20 percent of wages up to the “Social Security wage base” (\$72,600 for 1999) which is used to fund OASDI benefits (retirement, survivor, and disability benefits)
- A tax of 1.45 percent of total wages which is used to fund Medicare hospital insurance benefits

FICA taxes are collected from the employee through withholding from the employee’s paycheck. The employer also pays a tax equal to the total FICA tax collected from the employee.

Example. For an employee earning \$400,000 per year, total FICA taxes will be calculated as follows:

| | |
|--------------------------------|---------------------|
| Employee Portion: | |
| $6.20\% \times \$ 72,600 = \$$ | 4,501.20 |
| $1.45\% \times \$400,000 = \$$ | <u>5,800.00</u> |
| Total | \$ 10,301.20 |
| Employer Portion: | <u>\$ 10,301.20</u> |
| Total: | \$ 20,602.40 |

2.2.2 Self-employed persons

Self-employed persons having “net earnings from self employment” in excess of \$400 annually are subject to self-employment tax consisting of the following two components:

- A tax of 12.4 percent on net earnings from self-employment up to the Social Security wage base (\$72,600 for 1999) to fund OASDI benefits
- A tax of 2.9 percent on total net earnings from self-employment to fund Medicare hospital insurance benefits

For purposes of calculating net earnings from self-employment, an individual is entitled to a deduction equal to the product of (a) net earnings from self-employment (computed without the deduction) up to the Social Security wage base, multiplied by (b) 50 percent of the total self-employment tax rate.

Example. For an individual having net earnings from self-employment of \$53,000, the self-employment tax is calculated as follows:

| | |
|------------------------|----------------------|
| Net Earnings: | \$53,000.00 |
| Less: \$53,000 × 7.65% | <u>(\$ 4,054.50)</u> |
| | \$48,945.50 |
| Times: Total Tax Rate | <u>× 15.3%</u> |
| Self-Employment Tax | \$ 7,488.66 |

Nonfarm optional method. Self-employed taxpayers who are not engaged in farming may elect to compute net earnings from self-employment under the nonfarm optional method for any year if

- Actual earnings for the year are less than \$1,600.
- Net earnings from nonfarm self employment constitute less than two-thirds of the taxpayer's gross income from nonfarm self employment for the year.
- The taxpayer had net earnings from self-employment of \$400 or more in at least two of the three years immediately preceding the year in question.

If a taxpayer is eligible to elect the nonfarm optional method, he or she can elect to treat two-thirds of his or her gross nonfarm income (up to \$1,600 per year) as his or her net earnings from self-employment for the year. The advantage of the election is that it allows taxpayers to pay into the Social Security system based on a higher earnings level (thereby potentially increasing benefits payable). A taxpayer may elect to use the nonfarm optional method no more than five times.

Example. Farley, who is otherwise eligible to elect the nonfarm optional method, has gross nonfarm self-employment income of \$2,000, with net earnings of \$500. Farley can elect to report self-employment earnings of \$1,333 (two-thirds of \$2,000) rather than \$500.

Farm optional method. Taxpayers with gross self-employment earnings from farming of not more than \$2,400 can elect to report as net earnings from self-employment two-thirds of gross earnings. If gross earnings exceed \$2,400, the taxpayer may elect to report as net earnings from self-employment the greater of actual net earnings or \$1,600. There is no limit on the number of times an eligible taxpayer may elect to use the farm optional method.

2.3 Retirement Benefits

2.3.1 Eligibility

Eligibility for Social Security retirement benefits is determined by the number of “Social Security credits” (previously called “quarters of coverage”) earned by a worker from employment or self-employment subject to Social Security. The maximum number of Social Security credits that can be earned during a calendar year is four. For years prior to 1978, an individual generally earned one Social Security credit for each calendar quarter during which the individual earned \$50 or more. Beginning in 1978, the amount of quarterly earning required to earn a Social Security credit has increased annually, from \$250 per calendar quarter in 1978 to \$740 per calendar quarter in 1999.

In order to achieve “fully insured status,” which is required in order to receive Social Security retirement benefits, workers must earn the following number of Social Security credits:

| <u><i>A worker reaching age sixty-two in:</i></u> | <u><i>Is fully insured if he or she has earned at least the following number of Social Security credits:</i></u> |
|---|--|
| 1983 | 32 |
| 1984 | 33 |
| 1985 | 34 |
| 1986 | 35 |
| 1987 | 36 |
| 1988 | 37 |
| 1989 | 38 |
| 1990 | 39 |
| 1991 or later | 40 |

Certain employees of nonprofit organizations who were at least fifty-five years old on January 1, 1984, can achieve “deemed fully insured status” with less than the number of Social Security credits set forth above.

Practice Tip. A worker or a worker’s authorized representative can obtain a printout of his or her Social Security credits, and an estimate of the worker’s future Social Security retirement benefits, known as a Personal Earnings and Benefit Estimate Statement or PEBES, by completing Form SSA-7004-SM, Request for Earnings and Benefit Estimate. Copies of Form SSA-7004-SM can be obtained and submitted on the Internet at <http://www.ssa.gov>.

2.3.2 Amount of benefit

The amount of a worker's OASDI benefits is based on the worker's "primary insurance amount" or PIA. A worker's PIA is calculated based on average taxable earnings over the worker's career and is designed to partially replace the income lost as a result of retirement, disability, or death. The actual mechanics of the PIA calculation are quite complicated and beyond the scope of this chapter. The Social Security Administration has produced a software program, known as ANYPIA, that will perform the calculations. Copies of ANYPIA can be obtained for \$47 by calling (703) 605-6000, or can be downloaded free of charge from the Social Security Administration's Web site. For 1999, the average monthly Social Security retirement benefit for an individual worker is \$780. For married couples both receiving benefits, the average monthly retirement benefit is \$1,310.

2.3.2.1 Annual earnings limitation

Workers under age sixty-five. A worker receiving Social Security retirement benefits who has not reached age sixty-five by the end of 1999 can receive up to \$9,600 of earned income without a reduction of benefits. For each \$2 of earned income above \$9,600, the worker's retirement benefit will be reduced by \$1.

Workers age sixty-five through sixty-nine. A worker receiving Social Security retirement benefits who has reached age sixty-five prior to 1999, or who reaches age sixty-five during 1999, can receive up to \$15,500 of earned income without a reduction of benefits. Earnings received during the month in which the worker reaches age seventy or thereafter are not counted towards the earnings limit. For each \$3 of earned income above \$14,500, the worker's retirement benefit will be reduced by \$1.

Workers age seventy and older. The annual earnings limitation does not apply from and after the month in which a worker reaches age seventy.

Planning Tip. Self-employed individuals receiving retirement benefits at age sixty-nine should consider postponing receipt of income in excess of the annual limitation until the month of their seventieth birthday or later.

Special rules for year of retirement. For the year in which a worker retires, the earnings limitation is computed on a monthly basis. A worker retiring in 1999 who will not have attained age sixty-five prior to the end of 1999 can have earned income of up to \$800 per month following retirement without reduction of benefits for such month (regardless of how much income the worker earned for the portion of the year prior to retirement). A worker retiring in 1999 who has attained age

sixty-five, or who will attain age sixty-five during 1999, can have earned income of up to \$1,292 per month following retirement without reduction of benefits. Amounts earned during the month in which a worker attains age seventy and thereafter are not counted toward the monthly limitation.

In order to qualify for the special monthly benefit, a worker cannot perform substantial services in self-employment following retirement. Substantial services are judged based on amount of time devoted to business, type of service rendered, and how services rendered compare to those performed in the past. Work totaling more than forty-five hours in a month is generally considered substantial. Work of fewer than fifteen hours in a month is not considered substantial. Consulting services of fifteen hours or more per month performed by the former owner of a business are generally treated as substantial services.

What counts as earnings. For purposes of the limitations on earned income discussed above, the following amounts are treated as earnings:

- Gross wages earned by an employee during the year (regardless of when received by the employee)
- Net earnings from self-employment received during the year (regardless of when they are earned)
- Cash tips of \$20 or more per month
- Director's fees

For purposes of the limitations on earned income discussed above, the following amounts are generally *not* treated as earnings:

- Passive income (such as interest, dividends, and rent from real estate activities in which a nondealer did not materially participate)
- Gain from the sale of capital assets
- Retirement income (such as payments from an IRA, pension plan, certain trusts and annuity plans that are exempt from tax, and so on)
- Retirement payments received by retired partners from a partnership if:
 - The retirement payments are to continue for life under a written agreement that provides for payments to all partners (or to a class or classes of partners)
 - The partner's share of capital was paid in full before the end of the partnership's taxable year and there is no obligation from the partnership to the partner except to make retirement payments
- Social Security benefits

- Sick pay received more than six months after the last month in which the worker performed services
- Workers' compensation and other unemployment compensation benefits

2.3.2.2 *Early or delayed retirement*

Full retirement age. The amount of a worker's Social Security retirement benefit depends on whether the worker retired before, at, or after the worker's "full retirement age" as listed on the following chart:

| <u>For a worker born in:</u> | <u>Full retirement age is:</u> |
|------------------------------|--------------------------------|
| 1937 or earlier | 65 |
| 1938 | 65 and 2 months |
| 1939 | 65 and 4 months |
| 1940 | 65 and 6 months |
| 1941 | 65 and 8 months |
| 1942 | 65 and 10 months |
| 1943 through 1954 | 66 |
| 1955 | 66 and 2 months |
| 1956 | 66 and 4 months |
| 1957 | 66 and 6 months |
| 1958 | 66 and 8 months |
| 1959 | 66 and 10 months |
| 1960 and later | 67 |

Early retirement. A worker who has achieved fully insured status can elect to begin receiving reduced Social Security retirement benefits for the first month following the month of his or her sixty-second birthday. If a worker elects to receive early retirement benefits, the retirement benefit payable to the worker is permanently reduced by a percentage that is determined based on the number of months between the month in which the worker first elects to receive early retirement benefits and the month in which the worker will attain full retirement age. The number of intervening months is then divided by 180 (up to a maximum of 36 intervening months). Any intervening months in excess of 36 are then divided by 240.

Example. Adams, a worker born in 1962, plans to begin receiving retirement benefits for the first full month following his sixty-second birthday. Adams' full retirement age is sixty-seven. Accordingly, there are sixty months between the month of his first payment and the month in which he will attain full retirement age. Thus, Adams' retirement benefits will be permanently reduced by 30 percent, calculated as follows: 36 months divided by 180 (20 percent), plus 24 months divided by 240 (10 percent).

Delayed retirement. A worker electing to delay receipt of Social Security retirement benefits beyond full retirement age is entitled to a “delayed retirement credit” which permanently increases the retirement benefit payable to the worker. The delayed retirement credit is earned for each month during which a fully insured worker has attained full retirement age, but has not yet attained age seventy, and elects not to receive Social Security retirement benefits. The amount of the delayed retirement credit that can be earned by a worker is set forth on the following chart and depends on the year in which the worker attains age sixty-five.

| <u>If a worker attains age 65:</u> | <u>The monthly delayed retirement credit is:</u> |
|------------------------------------|--|
| Prior to 1982 | 1/12 of 1% |
| 1982 to 1989 | 1/4 of 1% |
| 1990 to 1991 | 7/24 of 1% |
| 1992 to 1993 | 1/3 of 1% |
| 1994 to 1995 | 3/8 of 1% |
| 1996 to 1997 | 5/12 of 1% |
| 1998 to 1999 | 11/24 of 1% |
| 2000 to 2001 | 1/2 of 1% |
| 2002 to 2003 | 13/24 of 1% |
| 2004 to 2005 | 7/12 of 1% |
| 2006 to 2007 | 5/8 of 1% |
| 2008 or later | 2/3 of 1% |

Example. Baker, a worker who attained age 65 in 1991, elects not to receive retirement benefits until the month in which he attains age seventy. Baker’s full retirement age is sixty-five. Baker’s retirement benefit will be permanently increased by 17.5 percent, calculated as follows: 60 months multiplied by 7/24 of 1 percent (.0029).

Planning considerations. The decision of whether to take reduced early retirement benefits, normal retirement benefits, or the delayed retirement benefit will depend on a number of factors, the most important being whether the benefit will be reduced or eliminated because of the annual earnings limitations described above. Another important consideration is that a worker electing to receive early retirement benefits will receive benefits for a longer period of time than a worker who waits until full retirement age or beyond. As a general rule of thumb, it will be twelve to fifteen years after full retirement age before the aggregate increased benefit payable at full retirement age exceeds the aggregate benefit payable at the reduced early retirement rate.

Example. Carter is entitled to receive retirement benefits of \$600 per month beginning at his full retirement age of sixty-five. Carter can elect to receive reduced retirement benefits of \$480 per month (80 percent of \$600) beginning at age sixty-two. If Carter elects to receive full retirement benefits, then by age seventy-seven he will have received total benefits of \$86,400 (144 months times \$600 per month). If Carter elects to receive reduced early retirement benefits, then by age seventy-seven he will have received the same amount of total benefits (180 months times \$480 per month).

2.3.2.3 Maximum family benefit

The maximum retirement benefit payable to a retired worker and his or her family is computed based on the worker's PIA. For 1998, the maximum family benefit is equal to:

- 150 percent of the first \$609 of the worker's PIA, plus
- 272 percent of PIA over \$609 up to \$880, plus
- 134 percent of PIA over \$880 up to \$1,147, plus
- 175 percent of PIA over \$1,147.

2.3.3 Dependent coverage

The spouse, former spouse, and children of a worker may be entitled to Social Security retirement benefits based on the earnings history of the worker.

2.3.3.1 Spouse

The spouse of a worker may be entitled to Social Security retirement benefits based on the earnings history of the worker in the following circumstances:

- The worker has achieved fully insured status.
- The spouse has filed an application for spouse's benefits.
- The spouse is not entitled to a retirement benefit based on a PIA that equals or exceeds one-half of the worker's PIA.
- The spouse is either (a) age sixty-two or over; or (b) caring for a child under age sixteen or a disabled child who is entitled to benefits based on the worker's earnings history.
- The spouse meets one of the following requirements:
 - The spouse has been married to the worker for at least one year at the time of the application for benefits.
 - The spouse is the natural parent of a natural child of the worker.
 - The spouse was entitled or potentially entitled to certain benefits under the Social Security Act or the Railroad Retirement Act.

The retirement benefit payable to an eligible spouse is generally one-half of the worker's PIA, subject to the limitation on annual earnings of the worker and the limitation on maximum family benefits discussed. In addition, if the worker has elected to take reduced early retirement benefits, the spouse's benefit will be reduced in a similar (but not identical) fashion.

2.3.3.2 Former spouse

The former spouse of a worker may be entitled to Social Security retirement benefits on the basis of the worker's earnings history in the following circumstances:

- Either (a) the worker has achieved fully insured status, or (b) the former spouse has achieved fully insured status and has been divorced from the worker for at least two continuous years
- The former spouse has filed a claim for former spouse's benefits
- The former spouse is not entitled to a retirement benefit based on a PIA that equals or exceeds one-half of the worker's PIA
- The former spouse is age sixty-two or over
- The former spouse is not married
- The former spouse had been married to the worker for at least ten years prior to the date of divorce

2.3.3.3 Child

A natural or adopted child of a worker (and, in some cases, a grandchild or stepgrandchild of a worker) may be entitled to Social Security retirement benefits on the basis of the worker's earnings history in the following circumstances:

- The worker has achieved fully insured status
- The child is dependent upon the worker
- An application for child's insurance benefits is filed
- The child is unmarried
- The child is either (a) under age eighteen; (b) age eighteen to nineteen and a full-time elementary or secondary school student; or (c) age eighteen or over and disabled.

2.3.4 Taxation of retirement benefits

The taxation of Social Security retirement benefits (and Tier 1 Railroad Retirement Benefits) is governed by Section 86 of the Internal Revenue Code.

50 percent inclusion. Section 86 generally provides that a worker is taxable on the lesser of:

- One-half of the retirement benefits received during the year
- One-half of the excess of (a) the worker's "provisional income" for the year over (b) the "base amount"

A worker's "provisional income" is equal to the sum of:

- The worker's adjusted gross income for the year; plus
- Any tax-exempt interest earned by worker during the year; plus
- Any amounts earned by the worker during the year in a foreign country, U.S. possession, or Puerto Rico that are excluded from gross income; plus
- One-half of the worker's Social Security benefits for the year.

For 1999, the base amount is:

- \$32,000 for a married worker filing jointly.
- \$0 for a worker who is married at the end of the year, does not file a joint return, and lives with his or her spouse at any time during the year.
- \$25,000 for any other worker.

Example: Davis is an unmarried worker receiving annual Social Security retirement benefits of \$10,000. Davis has adjusted gross income for the year of \$21,000 and receives \$4,000 of tax-exempt interest during the year. Davis' provisional income for the year is \$30,000 (\$21,000 + \$4,000 + 1/2 of \$10,000). Accordingly, Davis is taxable on the lesser of (a) \$5,000 (1/2 of his retirement benefits) or (b) \$2,500 (1/2 of the excess of \$30,000 provisional income over \$25,000 base amount).

85 percent inclusion. Workers with provisional income in excess of the "adjusted base amount" are subject to inclusion of up to 85 percent of Social Security retirement benefits. For 1999, the adjusted base amount is:

- \$44,000 for a married worker filing jointly.
- \$0 for a worker who is married at the end of the year, does not file a joint return, and lives with his or her spouse at any time during the year.
- \$34,000 for any other worker.

For those workers, the amount of Social Security retirement benefits includable in gross income is equal to the lesser of:

- 85 percent of the retirement benefits received during the year
- The sum of:
 - 85 percent of the excess of provisional income over the adjusted base amount; plus
 - The lesser of (x) the amount that would be taxable under the 50 percent inclusion test, or (y) one-half of the difference between the adjusted base amount and the base amount (currently \$6,000 for married workers filing jointly, \$4,500 for unmarried workers).

Example: Evans is an unmarried worker receiving Social Security retirement benefits of \$12,000 for the year. She has adjusted gross income of \$40,000 for the year and receives \$5,000 of tax-exempt interest for the year. Because Evans has provisional income in excess of \$34,000, she is subject to the 85 percent inclusion provisions. Nonetheless, the first step in calculating the portion of Evans' retirement benefits that are subject to tax is to calculate the result under the 50 percent inclusion provisions as follows:

| | |
|----------------------------|-----------------|
| Provisional income | \$51,000 |
| Less base amount | <u>(25,000)</u> |
| Excess provisional income | \$26,000 |
| Divided by 2 | \$13,000 |
| 1/2 of retirement benefits | \$ 6,000 |

Thus, under the 50 percent inclusion provisions, Evans is subject to tax on \$6,000 of retirement benefits. Under the 85 percent inclusion provisions, Evans is subject to tax on the lesser of (a) \$10,200 (85 percent of retirement benefits) or (b) \$18,950 (the sum of (x) \$14,450 [85 percent of the excess of \$51,000 provisional income over \$34,000 adjusted base amount] plus (y) the lesser of (i) \$6,000 [as determined above under the 50 percent inclusion rules] or (ii) \$4,500). Thus, Evans is taxable on \$10,200 of retirement benefits.

2.3.5 Applying for retirement benefits

In order to receive Social Security retirement benefits before full retirement age, a worker must file an application with the Social Security Administration. The application, which should be filed by the last day of the first month for which the worker desires to receive benefits, can generally be completed over the telephone by calling a local Social Security office. A worker who chooses not to apply for retirement benefits prior to reaching full retirement age should contact the Social Security Administration two to three months prior to reaching full retirement age, even if he or she is not planning to retire.

2.4 Survivor's Benefits

In addition to the retirement benefit discussed above, Social Security benefits may also be payable to a spouse, former spouse, child, or parent of a deceased worker in the circumstances described below.

2.4.1 Lump-sum death benefit

Upon the death of a worker who is fully insured or “currently insured,” a lump-sum payment of \$255 is payable to a surviving spouse of the worker who was living in the same household as the worker at the time of the worker's death or was eligible for or entitled to survivor's benefits (as discussed below) based on the worker's earnings history at the time of the worker's death. If there is no eligible surviving spouse of the worker, the lump-sum death benefit is payable to children of the worker who are eligible for or entitled to survivors' benefits based on the worker's earnings history at the time of his or her death. The lump-sum death benefit is payable in addition to any other survivor's benefits that may be payable to the recipient. A surviving spouse or child generally must apply to receive the lump-sum death benefit within two years after the worker's death.

For purposes of the Social Security Act, a worker is “currently insured” if he or she has earned at least six Social Security credits during the full thirteen-quarter period ending with the calendar quarter in which the worker:

- Died.
- Most recently became entitled to Social Security disability benefits.
- Became entitled to Social Security retirement benefits.

2.4.2 Surviving spouse

A surviving spouse of a deceased worker may be entitled to a survivor's benefit based on the worker's earnings history if:

- The spouse is age sixty or over (or age fifty or over and disabled).
- The worker was fully insured at the time of death.
- The spouse is not entitled to a Social Security retirement benefit that is equal to or larger than the worker's PIA.
- The spouse has filed a claim for survivor's benefits.
- The spouse is not married (waived if the marriage occurs after the spouse is age sixty [or after age fifty if disabled]).
- One of the following conditions (the “survivors conditions”) is satisfied:

- The spouse was married to the worker for at least nine months prior to the worker's death.
- The spouse is the biological parent of a child of the worker.
- The spouse legally adopted a child of the worker during the marriage and before the child reached age eighteen.
- The spouse was married to the worker at the time they both adopted a child under age eighteen.
- The worker legally adopted a child of the spouse during the marriage and before the child reached age eighteen.
- The spouse was potentially entitled to Social Security benefits during the month before the spouse married the worker.

The amount of a surviving spouse's benefit is 100 percent of the worker's PIA subject to reduction or elimination by the maximum family benefit limitation or the limitation on annual earnings. In addition, if a surviving spouse elects to receive spouse's benefits prior to full retirement age, the amount of the benefit is permanently reduced by a certain percentage for each month that benefits are payable prior to full retirement age.

If a surviving spouse does not qualify for a survivor's benefit based on the worker's earnings history, the spouse may still be entitled to a mother's or father's benefit based on the worker's earnings history if:

- The spouse is caring for a child of the deceased worker who is under age sixteen or disabled and who is entitled to child's benefits based on the worker's earnings history.
- The worker was fully insured or currently insured at the time of death.
- The spouse has filed an application for mother's or father's benefits.
- The spouse is not entitled to a Social Security retirement benefit that is equal to or larger than the amount of the mother's or father's benefit.
- The spouse is not married.
- One of the "survivors conditions" described above is satisfied.

The amount of the father's or mother's benefit is equal to 75 percent of the worker's PIA, subject to reduction or elimination by the maximum family benefit limitation or the limitation on annual earnings.

2.4.3 Surviving divorced spouse

A surviving divorced spouse of a deceased worker may be entitled to a survivor's benefit based on the worker's earnings history if:

- The former spouse is age sixty or over (or age fifty or older and disabled).
- The worker was fully insured at the time of death.
- The former spouse is not married at the time of the worker's death (waived in the case of certain accidental deaths or if remarriage occurs after age sixty [age fifty if disabled]).
- The former spouse is not entitled to a Social Security retirement benefit that is equal to or greater than the worker's PIA.
- The former spouse filed a claim for survivor's benefits.
- The former spouse was married to the worker for at least ten years at the time the divorce became final.

The amount of the former spouse's benefit is calculated in the same manner described above for a surviving spouse.

If a surviving divorced spouse does not qualify for a former spouse's benefit based on the worker's earnings history, the former spouse may still be entitled to a mother's or father's benefit based on the worker's earnings history if:

- The former spouse is caring for a child of the deceased worker who is the natural or legally adopted child of the former spouse and who is under age sixteen or disabled and who is entitled to child's benefits based on the worker's earnings history.
- The worker was fully insured or currently insured at the time of death.
- The former spouse has filed an application for mother's or father's benefits.
- The former spouse is not entitled to a Social Security retirement benefit that is equal to or larger than the amount of the mother's or father's benefit.
- The former spouse is not married.
- One of the "survivors conditions" described above is satisfied.

The mother's or father's benefit payable to a surviving former spouse is calculated in the same manner described above for a surviving spouse who is entitled to mother's or father's benefits.

2.4.4 Surviving child

A surviving child of a deceased worker may be entitled to a survivor's benefit based on the worker's earnings history if:

- The worker was fully insured or currently insured at the time of death.
- The child was dependent on the deceased worker.
- The child is not married.
- A claim for child's insurance benefit is filed on behalf of the child.
- One of the following conditions is satisfied:
 - The child is under age eighteen.
 - The child is under age nineteen and a full-time elementary or secondary school student.
 - The child is age eighteen or older and under a disability that began before age twenty-two.

The amount of the child's benefit is 75 percent of the worker's PIA, subject to reduction or elimination by the maximum family benefit limitation.

2.4.5 Surviving parent

A surviving parent of a deceased worker may be entitled to a survivor's benefit based on the worker's earnings history if:

- The worker was fully insured at the time of death.
- The parent files an application for parent's benefits.
- The parent has reached age sixty-two.
- The parent is not entitled to a Social Security retirement benefit that is equal to or larger than the amount of the parent's insurance benefit payable.
- The parent was receiving at least one-half support from the worker (evidence of such support must be filed with the Social Security Administration within a specified time period).
- The parent has not remarried following the worker's death.
- One of the following conditions is met:
 - The parent is the natural parent of the worker.
 - The parent had legally adopted the worker before the worker reached age sixteen.
 - The parent became the worker's stepparent by a marriage ended before the worker reached age sixteen.

The amount of the parent's benefit is 82½ percent of the worker's PIA if only one parent is entitled to parent's benefits. If more than one parent is entitled to parent's benefits, the amount is 75 percent of the worker's PIA for each parent. In each case, the amount of the parent's

benefit is subject to reduction or elimination by the maximum family benefit limitation or the limitations on excess earnings.

2.5 Disability Benefits

2.5.1 Eligibility

Disabled worker. A worker who is “disabled” within the meaning of the Social Security Act (as discussed below) may be entitled to Social Security disability benefits if the worker has achieved “disability insured status.” To achieve that status, a worker must satisfy each of the following conditions:

- The worker has earned at least twenty Social Security credits during the forty-quarter period that ends with the quarter in which the worker is determined to be disabled.
- The worker has earned at least one Social Security credit for each calendar year after 1950 (or, if later, after the year in which the worker attained age twenty-one).

In addition to achieving disability insured status, a disabled worker must file an application for disabled worker’s benefits and complete a waiting period of five consecutive full calendar months before receiving disability benefits. The five-month waiting period is waived for certain worker’s who had been entitled to disabled worker’s benefits within the previous five years.

Disabled child or surviving spouse. Under certain circumstances, a disabled child of a worker may be entitled to Social Security disability benefits if the child became disabled before age twenty-two. In addition, a disabled surviving spouse or surviving former spouse of a worker may be entitled to disability benefits.

Nondisabled dependents. Social Security benefits may be available to nondisabled dependents of a disabled worker (a) if an unmarried child of a disabled worker is under age eighteen; or (b) if a spouse of disabled worker is caring for a child of the disabled worker who is under age sixteen (or disabled) and is receiving benefits based on the worker’s earnings history.

2.5.2 Disability benefits

The Social Security disability benefit is generally equal to the full amount of the worker’s PIA. The benefit may be reduced, however, in any of the following circumstances:

- The sum of the Social Security disability benefit plus any worker’s compensation benefits or other disability benefits payable to the

worker under a federal, state, or local public law program exceeds 80 percent of the worker's "average current earnings."

- The worker becomes disabled after electing to receive reduced Social Security retirement benefits.
- The benefit is limited by the maximum family benefit limitation.

Social Security disability benefits generally continue until the earliest of:

- The second month after the disability ceases.
- The month before the month in which the recipient attains age sixty-five (after which the benefits are converted into Social Security Retirement benefits).
- The month before the month in which the recipient dies.

2.5.3 Definition of disability

For purposes of the Social Security Act, a disability is defined as "the inability to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months."

Substantial gainful activity. Substantial gainful activity must involve the performance of physical or mental activities that are productive in nature and that are performed for remuneration or profit. A special definition of substantial gainful activity applies to individuals disabled by blindness. The determination of whether an individual has engaged in substantial gainful activity is generally made by reference to the amount of earnings received from the performance of the activity. As a rule of thumb, earnings of \$500 or more per month from an activity generally demonstrate that the activity is substantial and gainful. Earnings of less than \$300 per month from an activity demonstrate that the activity is not substantial and gainful.

Physical or mental impairment. The regulations issued under the Social Security Act contain a "Listing of Impairments" that identifies physical or mental conditions that, absent evidence to the contrary (such as excess earnings), generally establish that an individual is unable to engage in substantial gainful activity. Examples of such conditions include:

- Diseases of the heart, lung, or blood vessels that have resulted in serious loss of heart or lung reserves as shown by X-ray, electrocardiogram, or other tests and, in spite of medical treatment, there is breathlessness, pain, or fatigue.

- Severe arthritis that causes recurrent inflammation, pain, swelling, and deformity in major joints so that the ability to get about or use the hands is severely limited.
- Mental illness resulting in marked constriction of activities and interests, deterioration in personal habits or work-related situations, and seriously impaired ability to get along with other people.
- Damage to the brain or brain abnormality that has resulted in severe loss of judgment, intellect, orientation, or memory.
- Cancer that is progressive and has not been controlled or cured.
- Diseases of the digestive system that result in severe malnutrition, weakness, and anemia.
- Acquired immunodeficiency syndrome (AIDS).
- Progressive diseases that have resulted in the loss of a leg or have caused it to become useless.
- Loss of major function of both arms, both legs, or a leg and an arm.
- Serious loss of function of the kidneys.
- Total inability to speak.

Trial work period. An individual receiving Social Security disability benefits who continues to be disabled is entitled to a trial work period of nine months (which need not be consecutive). During that period, any work and earnings are disregarded for purposes of determining whether the individual continues to be disabled. Any month during which the individual performs “insignificant work” does not count as part of the nine-month trial work period. For these purposes, an individual is considered to have performed insignificant work for any month in which (a) the individual’s earnings from employment are \$200 or less, or (b) the individual’s earnings from self-employment are \$200 or less and the individual spends forty hours or less in the performance of self-employment.

Determination of disability. The determination of whether a person is disabled for purposes of the Social Security Act is made by the Disability Determination Services (DDS) office in the person’s home state. The DDS employs physicians and other specialists to evaluate the person’s condition. If the DDS determines that a person is not disabled, the person can appeal the decision in writing to any Social Security office within sixty days after receipt of notice from the DDS.

If the DDS determines that a person is disabled, the DDS will review the person’s condition periodically to determine whether the disability has ceased. Reviews are generally scheduled as follows:

- If improvement is expected: first review scheduled six to eighteen months after initial disability determination
- If improvement is possible: once every three years
- If improvement is not expected: once every five to seven years

If, following a review, the DDS determines that a person is no longer disabled, disability benefits will cease after the second month following the month in which the disability terminated. If the person disagrees with the determination, he or she can file an appeal in writing with any Social Security office within sixty days after the determination. If the person appeals within ten days after the determination, disability benefits will continue during the appeal. If the appeal is denied, the person may be required to return payments received during the appeal period.

3. SUPPLEMENTAL SECURITY INCOME

3.1 Introduction

In addition to the other benefits described in this chapter, the Social Security Act provides for Supplemental Security Income (SSI) for individuals with limited income and resources who are age sixty-five or older, blind, or disabled. Unlike OASDI benefits, which are financed through FICA and self-employment taxes, SSI is funded from general funds of the U.S. Treasury. SSI benefits are available to elderly, blind, or disabled individuals having “resources” (as discussed below) of \$2,000 or less (\$3,000 or less for married couples) and having monthly income that is less than the maximum federal monthly SSI benefit payable. The amount of SSI benefits payable to an eligible recipient depends on the income and living arrangements of the recipient. For 1999, the maximum monthly federal SSI benefit is \$500 for an individual without an eligible spouse and \$751 for an eligible married couple. In addition, some states supplement federal SSI benefits payable to state residents.

3.2 Resources

For purposes of SSI, resources generally include cash and other liquid assets and any other property that an individual or the individual’s spouse could convert to cash to obtain support and maintenance. The following items, however, are not counted as resources:

- An individual's principal place of residence (regardless of value)
- One wedding ring and one engagement ring (regardless of value)
- Items needed because of a person's physical condition (such as a wheelchair or prosthetic devices)
- Other household goods having an aggregate value of less than \$2,000
- One automobile, regardless of value, if used to provide necessary transportation, or, if not so used, to the extent its current market value does not exceed \$4,500
- Certain life insurance
- Burial spaces and certain burial funds of up to \$1,500

3.3 Income

For SSI purposes, monthly income generally includes all earned or unearned income, and the value of property or services, actually or constructively received by an individual during the month. The following items, however, are generally not treated as income:

- Medical care and services
- Social services
- Gain from the sale, exchange, or replacement of a resource
- Income tax refunds
- Loan proceeds

Even if an item is treated as income for SSI purposes, there are numerous exclusions for items of income that are not counted for purposes of SSI monthly income limitation (including most payments under federal assistance programs).

3.4 Reporting Requirements

Persons receiving SSI benefits are responsible for reporting changes that could affect the amount of their benefits. Reports can be made by phone, by mail, or in person and must be made by within ten days after the end of the month in which the change occurred. Fines of up to \$100 are imposed for failing to report changes timely. In addition, criminal penalties (including imprisonment) can be imposed on a person who intentionally makes false statements on an SSI report.

An individual must file a report if he or she:

- Moves or changes address.
- Has a change in his or her household.
- Has a change in income.
- Has a change in resources.
- Receives help with living expenses.
- Leaves the United States.
- Marries or ends a marriage.
- Has a change in citizenship or alien status.
- Improves in condition while receiving benefits based on disability or blindness.
- Starts or stops attending school.
- Violates a condition of parole.
- Becomes eligible for any other benefits.

In addition, many states impose additional SSI reporting requirements.

4. MEDICARE

4.1 Introduction

Medicare is a federal health insurance program for people sixty-five or older, people of any age with permanent kidney failure, or people with certain other disabilities. Medicare is administered by the Health Care Financing Administration (HCFA) and covers eligible recipients receiving medical or hospital care anywhere in the United States (including the District of Columbia, Puerto Rico, the Virgin Islands, Guam, and American Samoa). Medicare is divided into two parts: hospital insurance (Part A) and medical insurance (Part B). Hospital insurance helps pay for inpatient hospital care and certain outpatient follow-up care and is financed by the hospital insurance portion of the FICA and self-employment tax. Medical insurance helps pay for doctors' services and other medical services and is financed by the monthly premiums paid by people enrolled in the program (see section 4.3.1, below) and by general federal revenues.

4.2 Medicare Hospital Insurance (Part A)

4.2.1 Eligibility

To be eligible for Medicare hospital insurance coverage, people age sixty-five or older must meet at least one of the following criteria:

- They are entitled to monthly Social Security or railroad retirement benefits.
- They have worked long enough to be insured under Social Security or the railroad retirement system.
- They have worked long enough in federal employment (see the table at the end of this section) to be insured for Medicare purposes.

People are entitled to coverage before sixty-five if they meet one of the following conditions:

- They have been entitled to Social Security disability benefits for twenty-four months.
- They have worked long enough in federal employment and meet the requirements of the Social Security disability program.

People are eligible at any age if they need maintenance dialysis or a kidney transplant for permanent kidney failure and:

- Are insured or getting monthly benefits under Social Security or the railroad retirement system.
- Have worked long enough in federal employment.

Spouses and children of workers may also be eligible for maintenance dialysis or kidney transplant. Under certain conditions spouses, divorced spouses, widows, widowers, or dependent parents of a worker may be eligible for hospital insurance at age sixty-five based on the worker's earnings history. This may also apply to disabled widows or widowers under sixty-five, disabled surviving divorced spouses under sixty-five, and disabled children eighteen or older.

WORK CREDITS NEEDED FOR FEDERAL EMPLOYEES

| <i>If you reach age 65 in</i> | <i>Years you need</i> |
|-----------------------------------|-------------------------------|
| 1983 | 7 ¹ / ₄ |
| 1984 | 7 ¹ / ₂ |
| 1986 | 8 |
| 1990 | 9 |
| 1994 or later | 10 |

People receiving Social Security or railroad retirement checks do not have to apply for hospital insurance; it will begin automatically at age sixty-five (except for federal employees, who should apply three months before their sixty-fifth birthday). People who plan to keep working after

age sixty-five should also file an application three months prior to turning sixty-five. Those not eligible for coverage at sixty-five because they do not have enough work credits or are not receiving benefits can purchase hospital insurance for a monthly premium of \$309 for workers with less than thirty Social Security credits; \$170 per month for workers with thirty to thirty-nine Social Security credits in 1999 (provided that they also purchase medical insurance). People with permanent kidney failure should apply for Medicare as soon as the condition appears. There is a twenty-four-month waiting period for disabled workers under sixty-five and a two-month waiting period for people receiving maintenance dialysis treatment.

4.2.2 Coverage

Hospital coverage provides benefits for inpatient care, skilled-nursing-facility care, home health care, and hospice care. If a person needs inpatient hospital care, Medicare hospital insurance covers the first ninety days of a hospital stay and includes sixty additional lifetime reserve days that can be used at the discretion of the patient. Coverage includes:

- Semiprivate room and board.
- General nursing service.
- Lab tests, X-rays, other radiology services, and radiation therapy.
- Drugs furnished by the hospital.
- Medical supplies.
- Rehabilitation services.
- Cost of special-care units.

For patients requiring home health services, Medicare coverage includes:

- Part-time skilled nursing care.
- Physical and speech therapy.
- Medical supplies and services provided by an agency.
- Occupational therapy.

Skilled nursing facility care and hospice care are also available to patients whose conditions require these services.

The following chart summarizes the hospital insurance-covered services, and the patient's financial obligations for 1999.

MEDICARE (PART A): HOSPITAL INSURANCE-COVERED SERVICES

| <i>Services</i> | <i>Benefit</i> | <i>Medicare Pays</i> | <i>Patient Pays</i> |
|--|--|--|---|
| HOSPITALIZATION | First 60 days | All but \$768 | \$768 |
| Semiprivate room and board, general nursing, and miscellaneous hospital services and supplies. (Medicare payments based on benefit periods.) | 61st to 90th day | All but \$192 a day | \$192 a day |
| | 91st to 150th day* | All but \$384 a day | \$384 a day |
| | Beyond 150 days | Nothing | All costs |
| SKILLED NURSING FACILITY CARE | First 20 days | 100% of approv. amt. | Nothing |
| Patient must have been in a hospital for at least 3 days and must enter a Medicare-approved facility generally within 30 days after hospital discharge.† (Medicare payments based on benefit periods.) | Additional 80 days | All but \$96.00 a day | \$96.00 a day |
| | Beyond 100 days | Nothing | All costs |
| HOME HEALTH CARE | Part-time or intermittent care for as long as patient meets Medicare conditions. | 100% of approved amount; 80% of approved amount for durable medical equipment. | Nothing for services; 20% of approved amount for durable medical equipment. |
| Medically necessary skilled care. | | | |
| HOSPICE CARE | As long as doctor certifies need. | All but limited costs for outpatient drugs and inpatient respite care. | Limited cost sharing for outpatient drugs and inpatient respite care. |
| Pain relief, symptom management, and support services for the terminally ill. | | | |
| BLOOD | Unlimited if medically necessary. | All but first 3 pints per calendar year. | For first 3 pints.‡ |

* This 60-reserve-days benefit may be used only once in a lifetime.

† Neither Medicare nor private Medigap insurance will pay for most nursing home care.

‡ To the extent that the blood deductible is met under one part of Medicare during the calendar year, it does not have to be met under the other part.

Source: U.S. Department of Health and Human Services, Social Security Administration.

4.3 Medicare Medical Insurance (Part B)

4.3.1 Eligibility

People eligible for hospital insurance will automatically be enrolled for medical insurance unless they specifically refuse it at the time they

become eligible for hospital insurance. The monthly premium for 1999 is \$45.50 (for 1998, it was \$43.80). People who must apply for medical insurance include:

- People planning to work past age sixty-five.
- People age sixty-five who are not eligible for hospital insurance.
- People with permanent kidney failure.
- People eligible for Medicare on the basis of federal employment.

Planning Tip. Low income individuals may be eligible for the Qualified Medicare Beneficiary Program which pays for all out-of-pocket expenses (premiums, deductibles, copayments) for which the individual would otherwise be responsible.

4.3.2 Coverage

Medical insurance coverage provides for doctors’ services and outpatient care and includes:

- Medical and surgical treatment.
- Services of a doctor’s nurse.
- Drugs and biologicals that cannot be self-administered.
- Medical supplies and equipment (does not include basic first-aid equipment).
- Medically required ambulance services.
- Blood transfusions provided on an outpatient basis.

The following chart summarizes medical insurance-covered services, and the patient’s financial obligations, for 1998.

MEDICARE (PART B): MEDICAL INSURANCE-COVERED SERVICES

| <i>Services</i> | <i>Benefit</i> | <i>Medicare Pays</i> | <i>Patient Pays</i> |
|--|---|--|--|
| MEDICAL EXPENSES Doctors’ services, inpatient and outpatient medical and surgical services and supplies, physical and speech therapy, ambulance, diagnostic tests, and more. | Medicare pays for medical services in or out of the hospital. | 80% of approved amount (after \$100 deductible). | \$100 deductible,* plus 20% of approved amount and limited charges above approved amount.† |
| CLINICAL LABORATORY SERVICES Blood tests, biopsies, urinalyses, and more. | Unlimited if medically necessary. | 100% of approved amount. | Nothing for services. |

| <i>Services</i> | <i>Benefit</i> | <i>Medicare Pays</i> | <i>Patient Pays</i> |
|--|--|--|---|
| HOME HEALTH CARE Medically necessary skilled care. | Part-time or intermittent skilled care for as long as patient meets conditions for benefits. | 100% of approved amount; 80% of approved amount for durable medical equipment. | Nothing for services; 20% of approved amount for durable medical equipment. |
| OUTPATIENT HOSPITAL TREATMENT Services for the diagnosis or treatment of illness or injury. | Unlimited if medically necessary. | 80% of approved amount (after \$100 deductible). | \$100 deductible, plus 20% of billed charges. |
| BLOOD | Unlimited if medically necessary. | 80% of approved amount (after \$100 deductible and starting with 4th pint). | First 3 pints plus 20% of approved amount for additional pints (after \$100 deductible).‡ |

* Once patient has had \$100 of expenses for covered services, the Part B deductible does not apply to any covered services patient receives for the rest of the year.

† Physicians who do not accept assignment of Medicare claims are limited by law as to the amount they can charge a Medicare beneficiary for covered services. The charge cannot be more than 120% of the Medicare fee schedule amount for physicians who do not participate in Medicare.

‡ To the extent that the blood deductible is met under one part of Medicare during the calendar year, it does not have to be met under the other part.

Source: U. S. Department of Health and Human Services, Social Security Administration.

4.4 What Medicare Does Not Cover

Services and supplies not covered by either hospital insurance or medical insurance include:

- Custodial care such as help with bathing, eating, and taking medicine.
- Dentures and routine dental care.
- Eyeglasses, hearing aids, and examinations to prescribe or fit them.
- Personal-comfort items such as a phone or TV in a hospital room.
- Prescription drugs and patent medicines.
- Routine physical checkups and related tests.

4.5 Filing a Medicare Appeal

Decisions on the amount Medicare will pay on a claim, or on whether services received are covered by Medicare, may be appealed.

The notices sent from Medicare telling of the decision made on a claim will also tell exactly what appeal steps can be taken. Claimants have at least 60 days from the date they receive the notice in which to file their appeals. For more information about appeal rights claimants should call any Social Security office, the Medicare intermediary or carrier, or the peer review organization (PRO) in their states. The following is a brief summary of the different Medicare appeals processes.

4.5.1 Appealing decisions by peer review organizations

Peer review organizations are groups of doctors in each state who are paid by the federal government to help Medicare decide when hospital care is necessary and whether such care meets standards of quality accepted by the medical profession. Medicare-participating hospitals can provide a brochure, "An Important Message From Medicare," which describes a hospital patient's appeal rights and supplies the name, address, and phone number of the PRO in that state.

If claimants disagree with the decision of a PRO, they can appeal by requesting a reconsideration. Then, if they disagree with the PRO's reconsideration decision and the amount in question is \$200 or more, claimants can request a hearing by an Administrative Law Judge.

Cases involving \$2,000 or more can eventually be appealed to a Federal Court.

4.5.2 Appealing all other hospital insurance (Part A) decisions

Appeals of decisions on all other services covered under Medicare hospital insurance (skilled-nursing-facility care, home health care, and hospice services) are handled by Medicare intermediaries. If claimants disagree with the intermediary's initial decision, they may request a reconsideration. The request can be submitted directly to the intermediary or through the claimant's Social Security office. If there is further disagreement with the intermediary's reconsideration decision and the amount in question is \$100 or more, the claimant can request a hearing by an Administrative Law Judge. Cases involving \$1,000 or more can eventually be appealed to a Federal Court.

4.5.3 Appealing decisions on medical insurance (Part B) claims

Under Medicare medical insurance, either the claimants, their doctors or their suppliers submit the claim for payment. Medicare will send the claimant an explanation of the decision of the claim on a form called

“An Explanation of Medicare Benefits” (EOMB). The EOMB also explains how the claimant can appeal denials or payment decisions with which he or she disagrees, and gives the name, address, and state-wide toll-free number of the carrier (the names and addresses of the carriers and areas they serve are also listed in the back of *Your Medicare Handbook*).

If a claimant disagrees with the decision on the claim, he or she can ask the carrier to review it. Claimants have up to six months from the date on the EOMB to request the review and the request must be sent to the carrier in writing.

If there is further disagreement with the carrier’s written explanation of its review decision and the amount in question is \$100 or more, the claimant can request a hearing by the carrier. (Other claims that have been reviewed within the previous six months can be counted towards the \$100 amount.)

If there is disagreement with the carrier hearing decision and the amount in question is \$500 or more, claimants are entitled to a hearing before an Administrative Law Judge. Cases involving \$1,000 or more can eventually be appealed to a Federal Court.

4.5.4 Appealing decisions by health maintenance organizations and competitive medical plans

If the claimant is a member of a Medicare-certified health maintenance organization (HMO) or competitive medical plan (CMP), the same appeal rights that all other Medicare beneficiaries have apply. However, the initial steps of the grievance or appeals procedure may vary from plan to plan. Federal law requires Medicare-certified HMOs and CMPs to provide a full, written explanation of appeal rights to all members at the time of enrollment. If claimants are members of such a plan and have not received a written explanation of appeal rights, they should request one from their plan’s membership office or write to: Health Care Financing Administration, Office of Prepaid Health Care, Humphrey Bldg., 200 Independence Ave., S.W., Washington, D.C. 20201.

4.6 Supplemental Health Insurance

Insurance companies offer supplemental (or MediGap) policies designed to provide coverage for amounts in excess of the amounts covered by Medicare and for services that are excluded from Medicare coverage. By law, Medicare supplemental insurance policies must follow a uniform format and must provide certain minimum coverage. You can obtain more information about Medicare supplemental insurance policies from the state insurance commissioner’s office of the relevant

state. In addition, many employers offer group health insurance for retired workers that supplements the coverage provided by Medicare.

Medicare beneficiaries can assign their Medicare benefits to an HMO or a managed care organization (MCO). HMOs and MCOs are required by law to provide all Medicare benefits. Many HMOs and MCOs also offer additional benefits, such as prescription drug coverage, to encourage enrollment. Beneficiaries who choose to assign their Medicare benefits to an HMO or MCO are, however, generally required to obtain health care services from “participating” doctors and hospitals.

4.7 Medicare + Choice MSA Plan

Effective for taxable years beginning after December 31, 1998, the Balanced Budget Act of 1997 provides that individuals who are eligible for Medicare are permitted to choose either the traditional Medicare program or a new type of plan called Medicare + Choice MSA (medical savings accounts). See the Insurance chapter, herein, for a detailed discussion of using medical savings accounts.

If the individual chooses the Medicare + Choice MSA plan, the Secretary of Health and Human Services (not the individual) makes specified contributions directly into the Medicare + Choice MSA, and the individual is not eligible for regular Medicare.

Under a Medicare + Choice MSA plan, the individual must have a high-deductible medical insurance policy (no more than \$6,000 in 1999). Medicare will not pay for any medical expenses. The individual’s medical expenses will be paid out of the Medicare + Choice MSA funds, plus any amount the high-deductible insurance plan pays.

5. MEDICAID

5.1 Introduction

The Medicaid program, first established by Congress in 1965, is a federal program operated at the state level to provide medical assistance to families with aged, blind, or disabled members who cannot afford necessary medical services. The federal Health Care Financing Administration (HCFA) is responsible for the administration of the Medicaid program, but has delegated that authority to the departments of health (or equivalent agency) of the individual states. The individual states set eligibility requirements and determine the scope of Medicaid services provided within the state, provided that such requirements and services meet

certain federally established minimum guidelines. Funding for the Medicaid program comes from both the federal government and the individual states.

While Medicaid benefits are available only to persons who satisfy certain need-based criteria, Medicaid has become an important resource for paying for nursing home care (even for middle-income Americans). Given that the Medicare program (discussed in section 4 above) only pays for a limited amount of nursing home care, and given the high cost of long-term nursing home care, more and more Americans must look to the Medicaid program to provide for their nursing home care needs. This, in turn, has led to an increase in personal financial planning designed to create Medicaid eligibility for elder clients.

5.2 Eligibility

All states must provide Medicaid benefits to persons who are “categorically needy.” In addition, states may elect to provide Medicaid benefits to persons who qualify as “optional categorically needy” or “medically needy.”

5.2.1 Categorically needy

General requirements. The categorically needy generally include the following:

- Aged, blind, or disabled persons who are eligible for SSI benefits (see Section 3 above)
- Individuals qualified for Medicare hospital insurance (Part A) benefits whose income does not exceed 120 percent of the federal poverty guideline and whose resources do not exceed the SSI limits
- Qualifying lower-income pregnant women and their infants

Section 209(b) states. Because the SSI program is more liberal than the assistance programs offered by several states prior to the enactment of SSI, states are allowed to elect to apply standards that are more restrictive than the SSI standards for purposes of determining eligibility for Medicaid assistance. The states making such an election (known as “Section 209(b) states”) are:

Connecticut
Hawaii
Illinois
Indiana
Minnesota
Missouri

Nebraska
New Hampshire
North Dakota
Ohio
Oklahoma
Utah
Virginia

5.2.2 Optional categorically needy

The optional categorically needy generally include the following:

- Persons eligible for SSI (but who are not actually receiving benefits)
- Persons receiving optional state supplements to SSI benefits (but not receiving federal SSI benefits)
- Persons who are ineligible for SSI benefits because they reside in certain medical institutions

5.2.3 Medically needy

Spend-down states. In so-called “spend-down” states, a person is considered medically needy if his or her income (after deducting medical expenses) is below a threshold level and his or her countable resources are below a threshold level. Accordingly, a person must “spend-down” his or her income each month on medical expenses in order to qualify as medically needy for the month.

Income cap states. In so-called “income cap” states, a person is considered medically needy if such person’s income is below a threshold level. If the person’s income for a month exceeds the threshold, then the person is not considered medically needy even if the person’s medical expenses exceed his or her income for the month.

5.3 Medicaid Benefits

For eligible recipients, Medicaid benefits generally include the following:

- Nursing home care
- Inpatient and outpatient hospital care
- Physician’s services
- Laboratory and X-ray services
- Nursing services
- Home health services

- Dental services
- Prescription drugs
- Hospice services
- Physical therapy services

5.4 Resource Requirements

In order to qualify for Medicaid benefits, a person must not have “countable resources” in excess of a prescribed threshold amount.

5.4.1 Excluded resources

For Medicaid purposes, the following resources are generally excluded from the determination of eligibility:

- An individual’s principal place of residence (regardless of value)
- One wedding ring and one engagement ring (regardless of value)
- Items needed because of a person’s physical condition (such as a wheelchair or prosthetic devices)
- Other household goods having an aggregate value of less than \$2,000
- One automobile, regardless of value, if used to provide necessary transportation, or, if not so used, to the extent its current market value does not exceed \$4,500
- Certain life insurance and burial insurance
- Certain business property essential to the individual’s ability to support himself or herself

For an unmarried person living in a nursing home, the person’s home is an exempt resource only if the person expects to return to the home after release from the nursing home (regardless of the likelihood that the person will ever be released from the nursing home).

Planning Tip. A person may be able to obtain eligibility by converting countable resources into exempt resources. Examples include paying off a mortgage, purchasing a car, or making home improvements. The conversion of resources to exempt resources is a far less risky method of creating Medicaid eligibility than the transfer of ownership of assets, discussed in section 5.4.3.

5.4.2 Spousal resources

For Medicaid purposes, the resources of each spouse are generally counted in determining the Medicaid eligibility of one spouse (although

the income of a spouse is generally not counted in determining the eligibility of the other spouse if the other spouse enters a nursing home after September 29, 1989). For 1998, if one spouse is institutionalized, the other spouse (referred to as the “community spouse”) may retain resources equal to the greater of \$16,152 or one-half of the total resources of the couple up to a maximum of \$80,760. The value of any resources of either spouse above that limit is deemed to be available for the support of the institutionalized spouse.

5.4.3 Transferring excess resources

In order to achieve Medicaid eligibility (especially in the case of a person in a nursing home), many clients may wish to transfer ownership of “excess resources.”

Warning. Practitioners must be extremely cautious when counseling clients to transfer assets in order to obtain Medicaid eligibility. As discussed below, such transfers may result in criminal sanctions against the client and any professional that counsels the client to transfer assets.

Effective August 12, 1993, the transfer of assets without adequate consideration within thirty-six months prior to applying for Medicaid benefits leads to a period of ineligibility for benefits for a period of months equal to the total value of the assets transferred divided by the average monthly cost for a private nursing home patient in the transferor’s state of residence.

The thirty-six month look-back period is increased to sixty months in the following circumstances:

- In the case of an irrevocable trust that is funded by the applicant but does not provide benefits for the applicant or his or her spouse, any transfer of property by the trust is subject to a sixty-month look-back period.
- In the case of an irrevocable trust that is funded by the applicant and provides benefits to the applicant or his or her spouse, any transfer of property by the trust to a third party will be subject to a sixty-month look-back period only if the trust prohibits the distribution of principal to the applicant or the applicant’s spouse.
- In the case of a revocable trust funded by the applicant, any transfer of property by the trust to a person other than the grantor is subject to a sixty-month look-back period.

A period of ineligibility will not result, however, if the transfer was made to any of the following:

- The transferor’s spouse

- The sole benefit of the transferor's spouse
- A child of the transferor under age twenty-one
- A blind or disabled child of the transferor
- A trust that is solely for the benefit of a disabled individual under age sixty-five

If a transfer of assets results in a period of ineligibility, however, the transferor and, arguably, any professional advising the transferor to make the transfer, may be subject to criminal sanctions. The Health Insurance Portability and Accountability Act enacted in August 1996 makes it a crime for any person to “knowingly and willfully dispose of assets (including by any transfer in trust) in order for an individual to become eligible for medical assistance under a [State Medicaid plan] if disposing of the assets results in a period of ineligibility for such assistance.” While the precise scope of that provision is unclear, and has been subject to great controversy and criticism, practitioners must use extreme caution when advising clients to transfer assets if the transfer will result in a period of Medicaid ineligibility under the rules discussed above.

6. PLANNING FOR SUBSTITUTE DECISION MAKING

There are situations in which an elderly or disabled client may no longer be competent to make important decisions regarding his or her own care or the management of his or her assets. Even a young, able-bodied client may suffer an injury or disability that renders him or her incapable of making decisions. In such an event, it is important that the substitute decision maker be someone acting solely in the client's best interest. Accordingly, the professional advisor should recommend that clients consider the legal documents described below whereby they can designate the substitute decision maker in the event of incapacity. Note that the following legal documents are subject to the provisions of state law governing such documents (and that the laws of the different states vary widely) and should be prepared only by an attorney familiar with the laws of the relevant states.

6.1 Durable Power of Attorney

A durable power of attorney allows a client to designate an attorney-in-fact to manage his or her assets and affairs in the event of an incapacity. A

durable power of attorney generally lists broad powers that the attorney-in-fact may exercise on behalf of the grantor, such as:

- The power to manage or sell assets of the grantor
- The power to bring lawsuits, and defend against lawsuits, in the name of the grantor
- The power to deal with the grantor's pension plans, retirement benefits, and insurance policies
- The power to vote with respect to stocks and other securities owned by the grantor
- The power to make gifts of the grantor's assets

A durable power of attorney can be revoked by the client at any time (except during periods of legal incapacity).

6.2 Living Will (Advance Directive)

A living will (also known as an "advance directive") is a legal document in which the patient expresses his or her wishes to receive (or not to receive) certain artificial life-prolonging medical treatments, such as artificial feeding, mechanical breathing devices, and kidney dialysis. A living will is only effective in the event that the patient is incapable of communicating his or her present desire to the treating physician, and can be revoked or amended by the patient at any time. A living will directing that life-prolonging procedures be withheld will generally not be respected if the patient is pregnant. There are certain legal formalities that must be respected when executing a living will and, at present, not all states recognize a living will as a legally binding document.

6.3 Health Care Surrogate

A health care surrogate is a legal document whereby a person appoints another individual to make health care decisions in the event the person is incapable of providing informed consent. The designated surrogate is generally prohibited from consenting to treatment such as the following:

- The withholding or withdrawing of life-prolonging medical treatment (which is why it is necessary to have both a health care surrogate and a living will)
- Abortion
- Sterilization

- Electroshock therapy
- Voluntary admission to a mental health facility

A health care surrogate generally can address subjects such as:

- Whether or not the patient wishes to make anatomical gifts (organ donation).
- Whether the surrogate has the power to consent to an autopsy with respect to the patient.
- The manner in which the patient wishes to have his or her remains disposed of (burial versus cremation).

REFERENCES

- The Appeals Process*. SSA Publication No. 05-10041. Washington, D.C.: U.S. Department of Health and Human Services—Social Security Administration, 1996.
- An Employer's Investment in Social Security*. SSA Publication No. 05-10059. Washington, D.C.: U.S. Department of Health and Human Services—Social Security Administration. Updated annually.
- Bender's Tax Staff. *Bender's Payroll Tax Guide*. New York: Matthew Bender & Company, Inc., 1982. Supplemented annually.
- CCH Editorial Staff. *Medicare Explained*. Riverwoods, Ill.: CCH, Inc., 1997.
- . *Social Security Explained, 1998*. Riverwoods, Ill.: CCH, Inc., 1998.
- Detlefs, Dale R., and Robert J. Myers. *1998 Mercer Guide to Social Security and Medicare*, 2d ed. Louisville, Ky: William M. Mercer, Inc., 1997.
- Disability*. SSA Publication No. 05-10029. Washington, D.C.: U.S. Department of Health and Human Services—Social Security Administration, 1996.
- Disability Practice Manual, 1993: SSI and Social Security*. Washington, D.C.: Legal Counsel for the Elderly, 1993.
- The Disability Workbook for Social Security Applicants: Managing Your Application for Disability Insurance Benefits*, 4th ed. Arnold, Md.: Physicians' Disability Services, Inc., 1997.
- Evicci, Fred, ed. *The Complete Social Security Handbook*. Rocklin, Calif.: Prima Publishing, 1993.

- Frolik, Lawrence A., and Melissa C. Brown. *Advising the Elderly or Disabled Client*. Boston: Warren, Gorham & Lamont, 1992 (1998 Supplement).
- A Guide to Social Security and SSI Disability Benefits for People With HIV Infection*. SSA Publication No. 05-10020. Washington, D.C.: U.S. Department of Health and Human Services—Social Security Administration, 1997.
- Guide for Representative Payees*. SSA Publication No. 05-10076. Washington, D.C.: U.S. Department of Health and Human Services—Social Security Administration, 1997.
- Hall, Charles T. *Social Security Disability Practice 1997*. St. Paul, Minn.: West Publishing Company, 1997.
- How Work Affects Your Social Security Benefits*. SSA Publication No. 05-10069. Washington, D.C.: U.S. Department of Health and Human Services—Social Security Administration. Updated annually.
- If You're Self-Employed*. SSA Publication No. 05-10022. Washington, D.C.: U.S. Department of Health and Human Services—Social Security Administration, Updated annually.
- Inlander, Charles B. *Medicare Made Easy*. Allentown, Penn.: People's Medical Society, 1998.
- Kingson, Eric R., and James H. Schulz, eds. *Social Security in the 21st Century*. New York: Oxford University Press, 1996.
- Knaus, Denise, and James B. Davis, *Medicare Rules and Regulations, 1998*. Los Angeles: Practice Management Information Corporation, 1998.
- LaVere, William. *Social Security Disability: A Comprehensive & Practical Guide to the Effective Representation of Claimants*. Alexandria, Va.: Bydand Corporation, 1995.
- Matthews, Joseph L., and Dorothy M. Berman. *Social Security, Medicare, and Pensions: Get the Most Out of Your Retirement and Medical Benefits*. 7th ed. Berkeley, Calif.: Nolo Press, 1998.
- Medicare*. SSA Publication No. 05-10043. Washington, D.C.: U.S. Department of Health and Human Services—Social Security Administration, 1996.
- National Organization of Social Security Claimants' Representatives. *Social Security Practice Guide*. 4 vols. New York: Matthew Bender & Company, Inc., 1984. Loose-leaf service.
- National Underwriter Staff. *Social Security Manual, 1996*. Cincinnati: National Underwriter Company, 1996.

- O'Hare, Thomas, and Sherry Schlossnagle, eds. *Disability Income Insurance*, 2d ed. Washington, D.C.: Health Insurance Association of America, 1994.
- Retirement*. SSA Publication No. 05-10035. Washington, D.C.: U.S. Department of Health and Human Services—Social Security Administration, 1997.
- Reviewing Your Disability*. SSA Publication No. 05-10068. Washington, D.C.: U.S. Department of Health and Human Services—Social Security Administration, 1997.
- Social Security and Medicare Answer Book*. Gaithersburg, Md.: Aspen Publishers, 1997.
- Social Security Handbook*, 12th ed. SSA Publication No. 05-10135. United States Government Printing Office, 1995.
- Social Security Handbook*. New York: Gordon Press Publishers, 1997.
- Social Security: Law and Practice*. 9 vols. St. Paul, Minn.: West Group, 1987. Loose-leaf service.
- Social Security Laws*. 3 vols. New York: Gordon Press Publishers, 1994.
- Social Security Update*. SSA Publication No. 05-10002. Washington, D.C.: U.S. Department of Health and Human Services—Social Security Administration. 1996.
- Supplemental Security Income*. SSA Publication No. 05-11000. Washington, D.C.: U.S. Department of Health and Human Services—Social Security Administration, 1996.
- Tomkiel, Stanley, III. *Social Security Benefits Handbook*, 2d ed. Naperville, Ill.: Sourcebooks, Inc., 1998.
- Understanding Social Security*. SSA Publication No. 05-10024. Washington, D.C.: U.S. Department of Health and Human Services—Social Security Administration. Updated annually.
- Van Langendonck, Jef, ed. *Social Security Law*. Cambridge, Mass.: Kluwer Law & Taxation Publishers, 1992.
- When You Get Social Security Disability Benefits*. SSA Publication No. 05-10153. Baltimore, Md.: U.S. Department of Health and Human Services—Social Security Administration. Updated annually.

HUMAN RESOURCES

1. RECRUITMENT

- 1.1 Policy and Objectives
- 1.2 Determining Needs
- 1.3 Development of a Job Description

2. RECRUITMENT SOURCES

- 2.1 Unsolicited Applications
- 2.2 Print Advertisements
- 2.3 Open Houses
- 2.4 Job Fairs
- 2.5 Campus Recruiting
- 2.6 Employment Agencies

3. INTERVIEWING

- 3.1 The Process of Elimination
 - 3.1.1 Related skills
 - 3.1.2 Basic qualifications
 - 3.1.3 Work experience
 - 3.1.4 Education
 - 3.1.5 Personal characteristics
 - 3.1.6 The application itself
- 3.2 Preparing for the Interview
 - 3.2.1 Know the job
 - 3.2.2 Determine the objective of the interview
 - 3.2.3 Plan the format
 - 3.2.4 Learn about the applicant in advance
 - 3.2.5 Provide for privacy

4. REFERENCE CHECKING AND TESTING

- 4.1 References
- 4.2 Testing

5. COMMUNICATION WITH APPLICANTS

- 5.1 Job Offers
- 5.2 Informing Rejected Applicants
- 5.3 Responding to and Retaining Applications and Resumes

6. NEW EMPLOYEE ORIENTATION

7. PERFORMANCE EVALUATIONS

8. COMPENSATION

- 8.1 Compensation Objectives
- 8.2 Job Analysis—Job Descriptions
 - 8.2.1 How are job descriptions used
 - 8.2.2 Responsibility planning
- 8.3 Job Evaluation
 - 8.3.1 Internal equity
 - 8.3.2 External competitiveness
- 8.4 Salary Ranges
- 8.5 Performance Reviews
 - 8.5.1 Setting goals with subordinates
 - 8.5.2 Measure results against goals
- 8.6 Merit Guides

9. BENEFIT PROGRAMS

- 9.1 Objectives of a Benefit Plan
- 9.2 What You Can Afford
- 9.3 Cafeteria Plans

10. TERMINATION

- 10.1 Performance Evaluation and Documentation
- 10.2 Guidelines for Termination
- 10.3 Prior to Finalizing a Termination Decision
- 10.4 After the Decision to Terminate has been Finalized
- 10.5 During the Termination Interview
- 10.6 After the Termination Interview

REFERENCES

APPENDIX 1: Sample Firm Hiring Policy

APPENDIX 2: Sample Personnel Requisition

APPENDIX 3: Sample Job Descriptions

APPENDIX 4: Sample Job Posting Request

APPENDIX 5: Sample Application for Employment

APPENDIX 6: Standard Interview Questions Form

APPENDIX 7: Interview Rating Reports

APPENDIX 8: Reference Check

APPENDIX 9: Job Offers and Rejections

APPENDIX 10: Orientation Checklist

APPENDIX 11: Job Description Outline

APPENDIX 12: Predischarge Checklist

APPENDIX 13: Exit Interview Form

APPENDIX 14: Separation Interview Checklist

APPENDIX 15: Termination Checklist

1. RECRUITMENT

Given the expansion of laws and regulations affecting business today, companies should establish recruitment and hiring policies that are clear and concise and that take into consideration the internal environment as well as the objectives and goals of the organization. These should include procedures and guidelines that clearly identify the approach the organization intends to use in identifying the potential employees who will best meet the long-term needs of the organization.

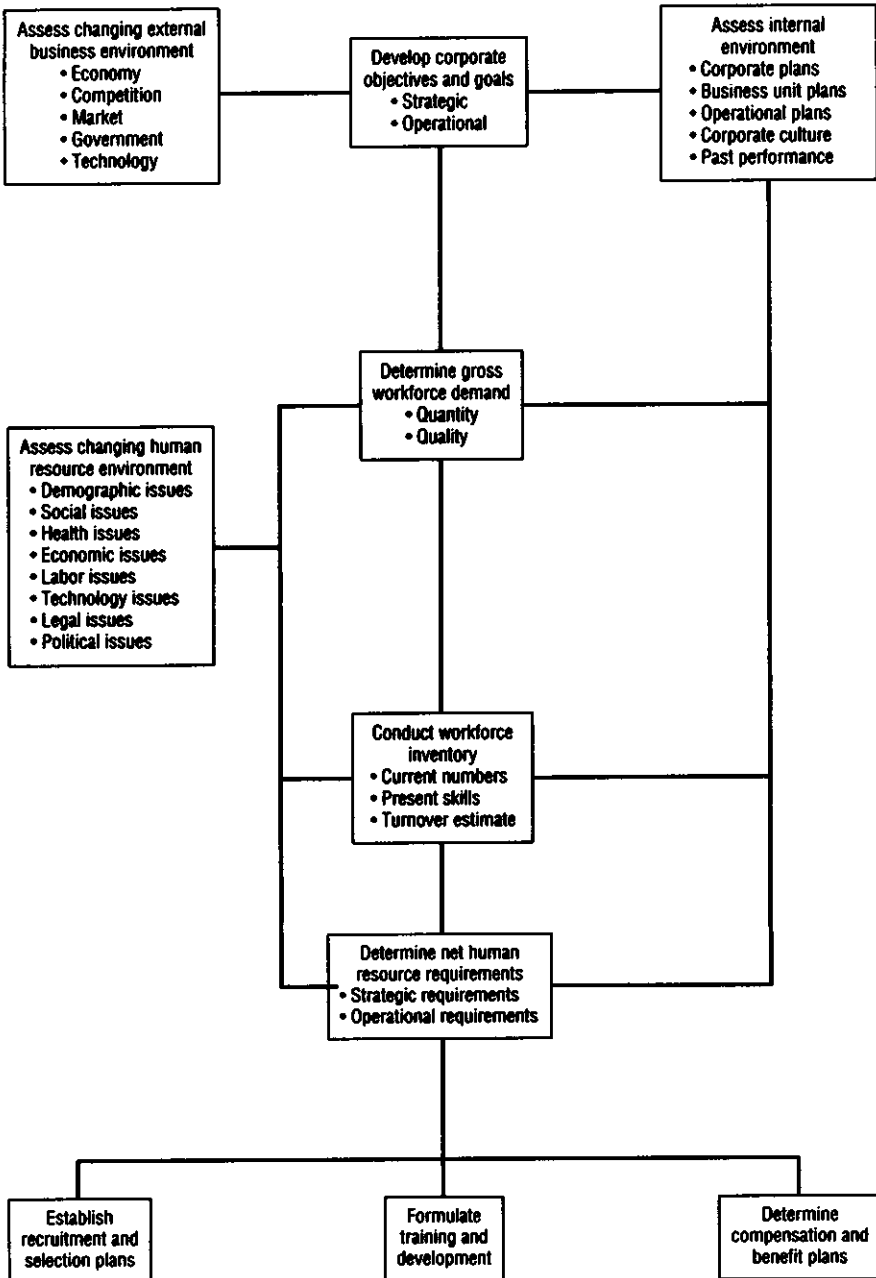
Most people would agree that planning for the firm's human resources is as important for an organization's success as is planning for its physical and financial resources. Human resource planning is a process by which a firm ensures that it has the right number of people, the right kind of people, in the right places, at the right time, doing what is economically most useful. However, if a business is to join the ranks of the most progressive organizations, it must expand beyond mere head-count planning.

Today, businesses are expected to plan, develop, and implement an integrated set of policies and programs designed to improve productivity, boost quality, and control costs, while managing diverse issues such as corporate culture and business ethics. To be fully effective, the overall business strategic plan needs to be integrated with the human resource plan. Effective human resource planning is a process that determines how the organization will move from its current to its desired human resource position as defined by its business plan and the changing environment. Exhibit 1 depicts a flowchart of human resource planning.

1.1 Policy and Objectives

If an organization recognizes people as key to its success, then the recruitment and selection of employees is likely to become the most important management function. Recruitment and selection policies and practices can make the difference between a workforce that is mediocre and one that is exemplary. That, in turn, can have a major impact on operations, growth, and profitability. The process of identifying and hiring personnel entails labor costs that add to the importance of making sure that recruitment is conducted carefully and results in the selection of quality people. Hiring costs have been skyrocketing, not only because of advertising, but also because of the time involved in campus interviewing, in-house interviewing, relocation, benefits and, most importantly, the time of the organization consumed by these activities.

Exhibit 1: Human Resource Planning



Another compelling reason to be concerned with recruitment and selection methods is the danger of employment discrimination charges. Complaints of discrimination in employment, whether justified or not, are very costly in terms of time, money, and reputation. Lawsuits can be devastating to growth and profitability. Therefore, the many pitfalls that can lead to charges of discrimination must be avoided in hiring practices.

Finally, companies today are faced with the erosion of the “employment at will principle”—the idea that employers have the right to discharge an individual at any time and for any reason. The conflict surrounding this issue is sufficient warning that the decision to hire an individual should be made with extreme caution and care, since dismissals can engender protracted and costly litigation.

The key to successful recruitment and selection practices and procedures is a clear, consistent, and well-thought-out corporate policy. A recruitment policy ensures a greater degree of uniformity in position approval and hiring practices, which is becoming more important as society becomes increasingly intolerant and suspicious of favoritism, nepotism, and other forms of personal preferences among employers.

Without a company policy, managers and supervisors act hesitantly, indecisively and sometimes with regard only to expedience. Uncertain of what the corporate policy is, they grope for answers, and the result is inconsistent recruitment practices, contradictory procedures, exposure to regulatory discipline, and threats of litigation.

A sample firm hiring policy is shown in appendix 1.

1.2 Determining Needs

As stated in the AICPA management consulting service Practice Administration Aid¹ on human resource planning, seven areas should be considered before beginning the employment process:

- Identify the purpose of the position and justify its cost.
- Draft a job description detailing areas of accountability, responsibility, and specific duties.
- Evaluate the pros and cons relative to the utilization of part-time, full-time, seasonal, and potential “shared jobs.”
- Consider internal promotions and transfers.
- Evaluate the labor market with an eye to future employment needs.

¹AICPA, MCS Practice Administration Aid, *Human Resource Planning and Management for an MAS Practice*. New York: AICPA, 1991.

- Understand specifically what the company is looking for in background, skill level, qualifications, salary range, and so forth.
- Research opportunities and obligations that take advantage of federal and local programs, grants, and other legal obligations the company may have.

In larger organizations, administrators or human resource departments may require the completion of a personnel requisition form for additional or replacement staff. The form summarizes the impact on budget and organizational functioning as well as all approvals required for hiring. A sample staffing requisition form is shown in appendix 2.

1.3 Development of a Job Description

Job descriptions have increased in their relative importance to an organization primarily because of the Americans with Disabilities Act (ADA), 1990, which gives their existence or absence greater weight when deciding whether an employer's decisions to hire were reasonable or discriminatory. A job description enables interviewers to understand all parameters of a job before the recruitment process begins and allows the applicants to know specifically what the responsibilities, duties, and accountabilities for a given position will be. Appendix 3 provides sample job descriptions.

2. RECRUITMENT SOURCES

Once a determination has been made regarding the need for a given position, the specific criteria have been developed, and the job description is in place, the specific recruiting mechanism must take over. Inevitably, there are two resources for recruitment: internal and external.

Internally, by means of manpower and career development planning, individuals may be selected for given positions as promotions or transfers. Employers can only benefit when they allow employees to grow within their careers and capabilities. The more knowledge and skills employees possess, the greater their potential contribution. Training, combined with transfers or promotions to different responsibilities, enables employees to accumulate more knowledge so that their talents can be developed to meet the employers' needs. For this reason, many employers identify employees with potential for promotion early on and actively encourage them to pursue advanced training. Likewise, when a job posting system is in place, employees can be notified of all

job vacancies. Job openings should be announced through a variety of methods—and current employees should be adequately informed—to minimize any appearance of discrimination. In order to take advantage of the value of knowledge of “Corporate Culture,” all businesses should establish an internal job posting system. This allows current, valued employees with an understanding of the company’s direction and mission to become aware of job vacancies, assess their *own* skill level in response to the dictates of the job description, and make applications accordingly. Internal posting has a positive impact not only on the firm but on employees that recognize the commitment that a company is making to the growth and development of its staff. A sample job posting request is shown in appendix 4.

External recruitment can take many avenues:

- Walk-ins
- Unsolicited resumes received in the mail
- Advertising in newspapers and industry publications
- Resumes received through college placement offices
- On-campus interviews
- Personal referrals
- Employment agencies and professional recruiters

Before launching a search for a suitable applicant, all unsolicited applications and resumes that have been received (as well as those of people who have been rejected for previous positions) should be reviewed. It simply is not cost-effective to start every search from scratch.

2.1 Unsolicited Applications

Often unsolicited applications are an effective and inexpensive source of potential candidates. People who apply directly often turn out to be good candidates. They probably applied because the company is conveniently located or is in an industry in which they have experience. They may have heard of the company or have familiarized themselves with it. Many firms meet the majority of their workforce needs in this way. At the very least, receipt of the resume or application should be acknowledged, as a matter of courtesy; in most cases, a follow-up letter should be sent.

2.2 Print Advertisements

When it is necessary to extend a search for candidates, the most common method is to place a newspaper advertisement. Recruitment ads should

be viewed as part of the company's overall effort to sell a job to prospective employees. The aim of this ad, as with an entire recruitment program, is not to attract the largest number of applicants, but to attract the most qualified applicants. The ideal candidate should want to answer the ad as soon as possible.

Where advertisements are published affects the time and money spent in recruiting. The key is not to select publications with the largest readership, but ones that are most likely to be read by the kinds of applicants being sought.

Newspapers' help wanted sections are read by nearly everyone who is looking for a position. A newspaper ad is easy to place, and often appears within days of its submission. Ads in trade and professional journals are usually cost-effective, since they are normally read by people with precisely the qualifications for those trades or professions. The problem is that many of these publications are published infrequently, monthly at best, and have long lead times. Thus, it can take weeks and even months for an ad to appear and for suitable candidates to respond.

2.3 Open Houses

When a company is seeking to employ several individuals in the same job category, or planning a rapid expansion into a new service area or locale for which it may be considering a substantial number of people, it may want to consider the feasibility of holding an open house. This is a cost-effective way of screening a large number of applicants over a one- to two-day period. It is also a good way to get managers and supervisors to meet large numbers of prospective employees and to discuss the vacancies with them personally. For the potential employees, an open house can serve to introduce them to the company and its staff and effect some self-selection among applicants.

2.4 Job Fairs

Though similar to an open house mentioned earlier, this involves many companies located within a geographical area. By exhibiting at job fairs, a company can learn whether or not its salaries are competitive, and about employment trends and changes in the labor market. Participation in a job fair is normally very cost-effective since advertising and rental costs for the site are shared with other employers. The major cost is the expenditure of time.

2.5 Campus Recruiting

It is useful to maintain an ongoing relationship with administrators, faculty members, and counselors at local schools, colleges, and universities. This kind of recruitment offers many advantages over the other techniques. One significant advantage is that people are recruited with recent state-of-the-art knowledge. New graduates can often make significant contributions because of their enthusiasm. College students are particularly interested in getting their careers off to a good start and they normally want to work for a good company. For them, this generally means one with growth potential, opportunities for advancement and personal development, and a good reputation in the community.

2.6 Employment Agencies

Many employment agencies are part of a nationwide recruiting network. These agencies have the capability to recruit from outside the immediate labor market area. This is particularly important if you are trying to fill positions that require special skills and talents that are not easily available locally. Fees of employment agencies, particularly for key, highly paid personnel, can be high. Agencies usually charge a fee of anywhere from 10 percent to 15 percent of the placed applicant's annual salary, with some fees as high as 30 percent.

3. INTERVIEWING

How many people need to be interviewed to fill a job opening? Ideally, one—if that person meets all the job requirements. It is not true—although many people believe otherwise—that the greater the number of applicants interviewed, the better the chance of finding the ideal employee. One person with the right qualifications is all it takes. And the best interview candidates can be identified before any meetings take place, through an effective screening process.

3.1 The Process of Elimination

3.1.1 Related skills

Although it may be important to be critical in evaluating resumes and other applicant information, it is also necessary to be able to recognize the transferability of skills and abilities. The failure to do the latter may

result in bypassing individuals who lack exactly the ideal experience or education, but who nevertheless have excellent capabilities. Applicants with less experience than desired in a certain field may have other qualities that could prove suitable for the job.

3.1.2 Basic qualifications

The resumes or job applications received should indicate which individuals are sufficiently qualified to be given further consideration. The first step is to check for the *minimum* requirements that have been established for the job. These may include minimum skills, basic levels of education, or the same or related experience. Only those applicants having at least these basic qualifications should be considered. This screening process prevents wasted time spent interviewing unsuitable applicants.

3.1.3 Work experience

The best way to evaluate work experience is to design a checklist of job specifications and duties and compare the applicants' experience against the established job criteria. The more experience an applicant has in a greater number of specified areas, the better prospect he or she may be.

The applicant's job history, including the frequency of job change, should be used to evaluate growth, development, and achievement over a period of time. There is substantial evidence that an individual's employment history is a major predictor of tenure—how long an individual will remain with the company. These factors should all be used to rate the applicant in terms of related work experience.

3.1.4 Education

An applicant's academic, vocational, or professional education should be examined in terms of how it relates to a job's requirements. First, check the degree earned, if any, and the major area of study, and determine whether they are relevant to the job. In many cases, an applicant's educational background will help to assess not only a candidate's ability to perform a job, but his or her intellectual ability to cope with difficult situations or to prioritize a number of different kinds of assignments. Educational background should have more importance for jobs that require specialized knowledge or for applicants with little or no related work experience.

3.1.5 Personal characteristics

When screening applicants who are still good prospects at this stage, look for factors that are potentially significant indicators of success in

the job, such as personality, motivation, and interests. Consider the amount of independent action and judgment required, the pressures of the job, and the future potential of the job and the employee. There may be, as well, long-term consideration of the applicant's potential for future promotion.

3.1.6 The application itself

The appearance of the resume or application says something about the applicant.

- Is the resume or application neat and legible?
- Is the information presented well?
- Are there inconsistencies or contradictions?

Observe whether there are any omissions in the application, or questions that have been left unanswered. Although an applicant should not be rejected because of failure to answer a question, it should be noted that if the applicant is invited to interview, these gaps should be filled in. A sample application is found in appendix 5.

3.2 Preparing for the Interview

There are five major steps in preparing for interviews, and each plays a critical role in the selection process.

3.2.1 Know the job

The most important part of preparing for an interview is to know the job. The interviewer should carefully review the job description to understand the job to be filled and the qualifications it requires. The interviewer needs to review the job duty specifics and know how the job fits into the specific function or department of the organization. The interviewer will also need to know relevant information, such as travel and overtime requirements, opportunities for promotion, and working conditions.

3.2.2 Determine the objective of the interview

Although the general purpose of interviewing is to select a candidate for a position, each particular interview should have a specific objective. Screening interviews are intended to select potential candidates for further consideration. Once several good candidates have been selected, the objective of the next interview may be to determine the best-qualified candidates. In this instance, individuals are judged against each other in an attempt to establish which ones have overall superiority.

In a number of circumstances, individuals may be interviewed to determine whether they have potential for later hiring.

3.2.3 Plan the format

Planning is an important part of preparing to interview. Things to be determined in advance include:

- The number of interviews to be conducted and by whom before making the final decision
- The approximate time allotment for each interview
- The specific issues to be covered

Appendix 6 is a sample form for listing interview questions. Maintaining a standard set of core questions and topics ensures that all important job-related issues will be covered in the interview and establishes a uniform set of topics on which an array of candidates' responses can be judged.

3.2.4 Learn about the applicant in advance

An essential part of the interview strategy is for the interviewer to carefully review in advance each candidate's job application or resume. This practice precludes using interview time to ask for information that has already been provided, as well as giving the interviewer a chance to get acquainted with the applicant before the meeting. The application form or resume provides some clues about the candidate. Specific questions to be asked by the interviewer may be based on aspects of the person's background.

3.2.5 Provide for privacy

Make sure that there will be no interruptions during an interview. Arrange for privacy. If a private office is not available, reserve a conference room. Inform the receptionist that there are to be no telephone calls, messages, or other interruptions during the interview. Intrusions can distract attention and destroy the momentum of an interview.

In order to establish a controlled, objective evaluation procedure, it is useful to prepare an interview report following each candidate's interview. The report helps to standardize evaluation criteria so that, regardless of each candidate's personal differences in expression, experience, and bearing, the interviewer can characterize responses in standardized terms to permit comparative evaluation. Appendix 7 shows a sample interview rating report and a sample interviewer's evaluation form.

4. REFERENCE CHECKING AND TESTING

4.1 References

Due to the legal ramifications of the release of information received from a reference check, all employers are cautioned to check with applicable state statutes, which vary widely. A number of states restrict employers from releasing information without written authorization from the applicant.

Because most companies are reluctant to give any information other than name, dates of employment, and positions held, it is advantageous for all employers to have a *consent to release employment information* form prepared for all employees to sign when they leave the organization. Likewise, you may wish to develop a form to include in the interviewing packet that all applicants will sign, which is a release of information to you from the respective applicant's prior employers. Appendix 8 is a form to use in collecting telephone reference check information.

4.2 Testing

After reviewing all the information contained on an application or resume, having conducted the interview itself, and having performed any reference checking that was feasible, an employer may also choose to test candidates for their ability to perform certain key job duties.

Some standardized ability tests measure the candidate's relative skill levels in typing, keyboarding, and calculating. Employers can themselves devise tests of particular specific job skills, such as written communication, logical problem solving, proofreading, or aptitude for specific complex tasks. These measure how well an individual may perform an activity on the job.

A second kind of test is called a "screening test." Screening tests include those for drug and alcohol abuse, polygraph or written integrity or honesty tests, and medical examinations. The administration of any of these tests entails a legal concern about whether negative results are attributable to race, sex, nationality, religious affiliation, age, or disability.

It should be noted that under the new ADA, businesses employing fifteen or more persons can ask medical questions or require a medical examination of job candidates only after a conditional job offer has been made.

It should be noted that although personality tests, aptitude tests, drug tests, and so forth, are still prevalent in the employment process, studies indicate that their use is waning.

5. COMMUNICATION WITH APPLICANTS

5.1 Job Offers

Candidates should be notified whether or not they have been selected for a position within a week or two of having been interviewed. A person is either right or wrong for a job, and procrastination in the decision-making process is counterproductive. There is no reason to think that a better candidate will appear next week; that other person almost never materializes, and in the meantime, a good candidate who has been kept waiting may no longer be available.

When a decision is made to hire an individual, one person within the firm should be designated to respond with a job offer. Job offers are usually made verbally, followed by a letter of confirmation stating the starting date and salary agreed upon by the firm and the candidate. Appendix 9 contains a sample job offer letter.

It is wise to set up a special file for all application forms from applicants who were rejected for employment. This should include not only the application forms, but a record of all correspondence between the company and the applicants and all reputable telephone contacts. If, at some future date, the firm is called upon to explain why a certain candidate was not hired, these records will provide all the necessary information.

5.2 Informing Rejected Applicants

As soon as applicants are no longer under consideration, they should be informed. If a candidate is interviewed and immediately eliminated from consideration, a letter should be sent out the next day. Appendix 9 also contains a sample rejection letter.

Every individual who has been interviewed should receive a response. Not to do so is unprofessional and creates a poor image. People who receive no response will communicate this to their friends and other potential employees.

5.3 Responding to and Retaining Applications and Resumes

All businesses who have an image to maintain in the community should respond to all requests for employment—be these walk-in candidates, telephone inquiries, or unsolicited resumes. A firm should preserve a good positive image in the event that these candidates become viable at the time of the next vacancy.

Retain potentially viable resumes and applications. As stated earlier, the second step in any recruitment process, once needs have been defined, is to review all the resumes and applications that are on file. This pool of potential candidates can reduce additional costs in advertising and preliminary screening.

6. NEW EMPLOYEE ORIENTATION

In order for the employee and the company to start out well together, it is imperative that a proper orientation program be established. Specific objectives of this program should be—

- Making the employee comfortable in the new work environment.
- Developing and maintaining a positive attitude on the part of the employee toward the organization, the supervisor, and the job.
- Making the employee productive in terms of quantity, quality, safety, and dependability.
- Developing an employee who will be a team player as well as an individual performer.
- Enabling the employee to work independent of close supervision as soon as possible.

In order to accomplish the preceding objectives, good communication will be required from the first day of employment. Employees will obviously need to learn more about the employer than can be communicated in an interview. They will need to know how to “sense the environment” and become aware of the political pitfalls that impact all organizations. Much is being written about “coaching” or “mentoring.” It is a time-tested way to ensure that all new employees are trained in the culture of the organization as well as in the technical aspects of the job. According to the AICPA’s *Management of an Accounting Practice Handbook*, “The firm is the biggest winner in a mentoring program.” Three parties are involved in any such program—the protege, the mentor, and the firm. While all parties grow, the firm benefits in very tangible ways.

It is essential that an organization have a checklist specifically designed to cover the necessary aspects that all new employees will be expected to learn. Appendix 10 contains a sample orientation checklist.

7. PERFORMANCE EVALUATIONS

Each employee has a right to know how he or she is performing. Likewise, each business has an obligation to inform employees of their

performance. This becomes more important not only at the time of salary or promotion determination, but also at the time of the potential discharge of an employee. As such, performance evaluations need only be as long as required to outline an employee's responsiveness to the requirements of the job. All performance evaluations should be documented, dated, and signed by the employee and respective supervisor.

Similarly, it is important that employees being transferred or promoted into a new department or a new function be given an orientation to that area. All too often, employers take for granted that transferred employees know all about the company and all its departments. However, new supervisors, colleagues, and responsibilities should all be introduced to the transferred employee by means of an informal period of orientation.

8. COMPENSATION

8.1 Compensation Objectives

The fundamental objective of a salary administration plan is to ensure that employees are paid in relation to the value of the work they perform. The company should receive a fair return on its salary investments and, in turn, individual employees should receive a fair compensation for their abilities and efforts.

The specific objectives of any plan should be—

- To pay competitive salaries as an attraction to superior people and motivation for them to do their best.
- To establish and maintain a logical, consistent scheme of value relationships among positions that represent an objective analysis of the division of responsibility.
- To pay individuals fairly according to their relative contribution to the effectiveness of operations, the objective measurement of which is considered to be the relative value of the work each individual performs and the results achieved.
- To establish and maintain a competitive, sound salary structure—one that provides strong inducement to individuals to advance and to assume greater responsibilities.
- To establish and maintain salary ranges for the respective salary grades that afford ample latitude for recognizing and rewarding performance improvement and superior performance.

- To establish and maintain logical earnings relationships between supervisors and their subordinates.
- To maintain a competitive compensation structure that is applied subject to various economic pressures such as inflation, salaries at other companies, and the profitability of the organization.
- To establish meaningful differentials in compensation between individuals performing at significantly different levels and administer adjustments so as to recognize these differentials.
- To comply fully with provisions of all government regulations regarding compensation.
- To plan and implement all compensation expenditures through the budget system.
- To communicate to all employees the compensation policy and the methods of administering this policy.

8.2 Job Analysis—Job Descriptions

The advantage of having carefully prepared, properly used job descriptions should be obvious to anyone in the management field. But because so many organizations have not prepared and used their job descriptions properly, many of these benefits have been lost or overlooked. Consider the following:

1. Job descriptions clarify who is responsible for what within the organization. They also help define relationships between individuals and between departments. When used to advantage, they can settle grievances, nip conflicts in the bud, and improve communications.
2. Job descriptions help the jobholder understand the responsibilities of the position. This not only enables the employee to assess the relative importance of everything he or she is accountable for, but also provides a sense of where the job fits into the larger responsibilities of the organization as a whole.
3. Job descriptions are helpful to job applicants, to employees, to supervisors, and to human resources staff at every stage in the employment relationship, from recruitment to retirement. They provide information about the knowledge, training, education, and skills needed for each job. They prevent unnecessary misunderstandings about responsibilities and duties. They can guide both a new employee who may have forgotten or misunderstood some aspects of the job, and a supervisor who may think the new hire does not fully understand the job. Best of all, they provide this information in a completely objective and impersonal manner.

4. Job descriptions help management analyze and improve the organization's structure. They reveal whether all company responsibilities are adequately covered and where these responsibilities should be reallocated to achieve a better balance.
5. Accurate job descriptions provide a basis for job evaluation, wage and salary surveys, and an equitable wage and salary structure. (Job descriptions can be used to either support or discredit comparable worth and other job description complaints, and for this reason they should reflect only the truth about the job in question.)

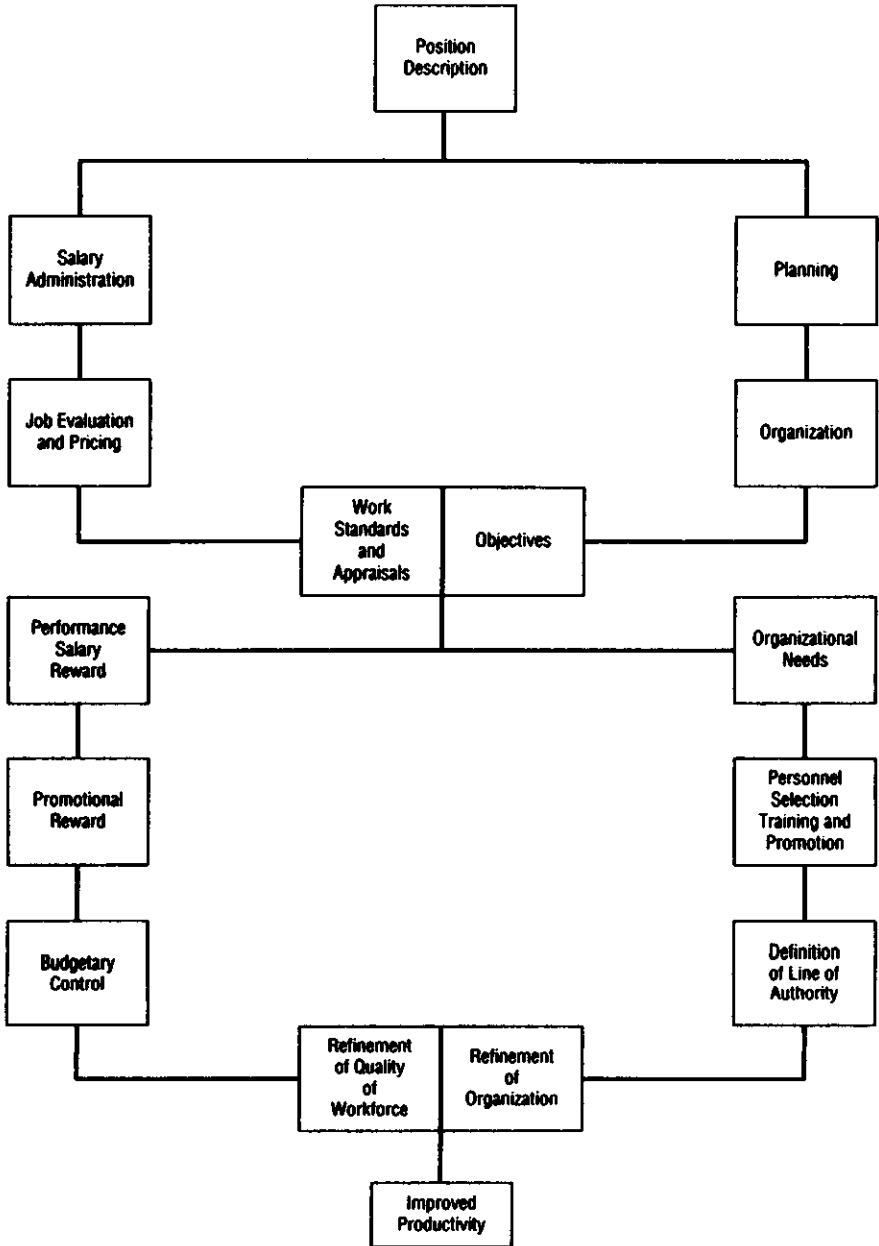
Despite these and many other potential benefits, job descriptions have traditionally suffered a poor reputation among managers and supervisors. In fact, even companies that have spent a great deal of time and money preparing job descriptions often end up ignoring or underutilizing them. Exhibit 2 depicts uses of the position descriptions.

8.2.1 How are job descriptions used

One of the reasons that so many organizations have job descriptions that are not used is that they are simply unaware of their many uses. Many employers think of job descriptions only in terms of wage and salary administration, or as a necessary evil in complying with certain employment laws. But these are only two of the many practical uses for job descriptions, most of which can be grouped under the following four headings.

1. **Personnel Administration.** There is probably no better tool when it comes to human resource planning than a well-written set of job descriptions. Consider their usefulness in the following areas:
 - Responsibility planning
 - Recruitment and screening
 - Hiring and replacement
 - Orientation
 - Training and development
 - Career ladders
2. **Wage and Salary Administration.** Any compensation system requires that jobs be classified and evaluated in terms that make comparisons possible. This is where good job descriptions come in. They are especially valuable in the following compensation-related activities:
 - Job evaluation
 - Job classification
 - Wage and salary surveys

Exhibit 2: Use of the Position Description



- Pay structure
 - Performance appraisal
3. **Legal Guidance.** Changes in employment legislation have been frequent in recent years, and new issues—such as comparable worth—are always being tested in the courts. Job descriptions are important in complying with a number of the major pieces of government legislation, including the following:
- Fair Labor Standards Act
 - Equal Pay Act
 - Title VII of the Civil Rights Act of 1964
 - Occupational Safety and Health Act
 - Age Discrimination in Employment Act
 - Employment Security Act
4. **Collective Bargaining.** The issue of varying pay rates for similar work has often been raised by unions, who may point to job descriptions as a basis for standardizing these pay rates. Job descriptions have also been used by employers to defend themselves against what they believe are unjustified union demands for uniform rates. Good job descriptions can clarify which jobs are truly similar, and which jobs warrant different pay levels because they require different levels of skill, knowledge, or responsibility, or because they contribute to the organization goals in different ways.

8.2.2 Responsibility planning

Actually, the process of preparing job descriptions serves a useful purpose in itself, particularly if it starts at the upper levels of the organizational hierarchy. The preliminary drafts of managerial and executive job descriptions can be used as a basis for productive group discussion in which managers and executives get together to talk about each other's responsibilities. Such discussions often reveal areas in which overlapping responsibilities or confusion about the limits of responsibility are a problem, or where the organizational structure is faulty. When these problems have been solved, each manager can then repeat the process with his or her own subordinates in reviewing and discussing their job descriptions. A side benefit of this approach is that managers and supervisors are more likely to feel committed to supporting a system that they have helped to create. They are also more likely to use job descriptions for a number of the purposes outlined above, rather than letting them collect dust in a drawer.

Other uses for job descriptions are the following:

- Job posting
- Management by objective programs
- Grievance procedures
- Work flow analysis
- Organizational studies

See Appendix 11 for job description preparation forms.

8.3 Job Evaluation

By definition, job evaluation is the consistent, logical, and equitable analysis and measurement of job responsibilities and duties. The emphasis is put on the *job* since the focus is on duties and responsibilities relative to the firm's goals—*not* on the employees currently holding the job.

The objectives of job evaluation are to—

- Eliminate or decrease wage and salary inequities.
- Provide accurate data for hiring new employees.
- Assist supervisors in determining which employees qualify for promotion.
- Determine whether employees are qualified for their current jobs.
- Help train supervisors to counsel employees in order to improve job performance.

To properly introduce a job evaluation program, it is important that the details and objectives be communicated first to the managerial and supervisory group and then to the employees whose positions will be evaluated. This communication should be written and should carry the endorsement of top management.

There are various kinds of evaluation plans or systems in use in industry today. The most popular plan is termed “the point factor technique.” For the sake of brevity, this chapter only comments on the following three predominant evaluation techniques:

- Point factor
- Factor comparison
- Ranking

The point factor evaluation is based on well-defined factors or so-called common denominators that apply to the group of jobs being evaluated.

The factor of education, for example, is important in determining job worth for any position. Education, as it is commonly used in job evaluation, measures the trade-training or formal knowledge (in terms of years of education) required to perform the job duties under normal supervision. This may have been acquired by education, by outside study, or by training received on jobs of lesser rank. Under this factor are varying degrees, numerically cited, that indicate the levels of education required. Under the point factor plan, when a job is rated on education, a specific numerical score is applied to indicate the required job education. The same procedure is followed in reviewing other factors required by the job as rated.

The factor comparison evaluation technique compares jobs by making judgments concerning which jobs contain more of certain appropriate factors than others. Jobs are compared to one another, one factor at a time. In one such factor comparison plan, certain *universal factors* are used: mental requirements, physical requirements, skill requirements, responsibility, and working conditions. This technique is similar to that of point factor, except that no numerical scores are used. This may prove to be a potential disadvantage because more guesswork is involved.

The third evaluation technique used is that of ranking. Under this technique, jobs are ranked without regard either to factors or to point values. Usually, the determination of job rank is based on its worth to the organization. To assist an organization wishing to rank its jobs, key or benchmark jobs are first ranked. These key jobs are ones that are common throughout industry and are more readily understood by the members involved—jobs, such as janitor, punch-press operator, or clerk/typist.

8.3.1 Internal equity

The objectives of establishing a pay structure are to maintain competitive rates of pay and to maintain differentials between jobs within the organization. This ladder is often called internal equity.

Job evaluation, which has already been discussed, has as its objective the establishment of proper job differentials. The next step then is to analyze and apply competitive pay rates to these jobs—referred to as external competitiveness.

8.3.2 External competitiveness

The approach usually taken is to make a wage or salary survey of the organization's industry and area of operation by benchmark jobs. Benchmark jobs are those that are similar enough in content to allow similar industry comparisons. In making a survey of this kind, it is very

important that the comparison be made not on the basis of job title alone, but on careful consideration of job responsibilities as well.

There are many wage and salary surveys available. Employers' associations, chambers of commerce, trade associations, and consulting organizations make such surveys on a periodic basis.

Once an external comparison is completed and compared to the worth in which the evaluation measured the internal equity, a salary range can be developed.

8.4 Salary Ranges

A salary range is established to allow an individual room for growth within a job classification based on job performance over the years. Each individual range moves on an annual basis. Employee performance should be evaluated to be consistent with the company's ability to pay an appropriate salary that is commensurate with performance and that moves the individual up the salary range of the position. The ultimate goal is to ensure that a solid, competent performer is maintained at or near the average (midpoint) of a salary range that is both internally equitable and externally competitive.

8.5 Performance Reviews

The need for emphasis on performance appraisals has already been discussed. Performance appraisals serve more day-to-day purposes outside the human resources function than is generally recognized. For purposes of compensation, the performance appraisal system should help employees and managers set goals for themselves and for the organization. Goals should be measurable and should be reassessed throughout the year, as summarized in the following sections.

8.5.1 Setting goals with subordinates

Identify goals that are commonly set within the organizational unit for the upcoming budget period. Such goals often relate to profitability, competitive position, and productivity. In addition, the goals can be educational devices to encourage and promote staff development in the following areas:

- Technological leadership
- Employee development
- Public responsibility
- Employee relations

Working organization charts should be prepared that illustrate titles, duties, relationships, and impending changes. As objectives are set for the next budget year with each person, the following should be completed:

- Subordinates should be asked to make notes on their objectives for the coming year. These objectives should cover routine duties, problem-solving goals, creative goals, and personal goals.
- Lists should be prepared of the objectives that subordinates should include, noting innovations and improvements that are needed in each function.
- In personal conferences, subordinates' objectives should be reviewed in detail, and suggestions or changes should be offered.
- Three copies of the employees' objectives should be prepared: one for the employee, one for the firm's records, one for the supervisor.
- Working from the final document, supervisors should ask what they can do to help employees accomplish their goals. Suggestions should be kept with the supervisor's copy of the goals, becoming part of the supervisor's goals.

During the year, each subordinate's goals should be checked as promised milestones are reached.

- Is the employee meeting targets?
- Should the targets be amended?
- Is the supervisor helping the subordinate?
- Use jointly agreed upon goals as tools for coaching, developing, and improving the subordinate's performance on a continuous basis. Reinforce good results by feedback of success.

8.5.2 Measure results against goals

- Near the end of a budget year, subordinates should be asked to prepare a brief statement of performance against budget using their copies of the performance budget as a guide, supplying relevant figures where applicable. Individuals should give reasons for variances and list additional accomplishments not budgeted for.
- A date should be set to go over reports in detail with subordinates.
- The evaluator and subordinate should reach agreement on just how good job performance was, and where improvement should be made.
- Other concerns may be covered at this time—job, opportunity, job-related personal problems.

- Following evaluation, the stage is set for establishing the performance budget for the next year.

8.6 Merit Guides

Since the fundamental concept of the salary program is that individual pay should be based on progress and performance improvement, the performance evaluation becomes a salary recommendation or discussion. Certainly for this philosophy to be meaningful, the individual salary decisions must be appropriately related to judgments about employee performance results. The responsibility for successful achievement of this key relationship, both in actuality and as perceived by employees, rests with the immediate supervisor.

Once an employee's performance results have been measured, the next step is to select the appropriate merit treatment for that person. To assist the supervisor in this decision, a set of percentage and frequency guides should be established for each job classification. The term *guide* is used to distinguish these from rules. The indicated percentages and frequencies are intended to provide a guide for management discretion, not to establish rules within which supervisors must operate. Guides are never the reason for giving or not giving an increase.

Increase guides cannot be effectively applied simply on the basis of performance and the position of the current salary in the range. One additional piece of information is needed—the employee's rate of performance progress. This factor is important in determining when an increase should be given.

The appropriate use of any guide links performance judgments to individual salary progression. The progression through the salary range should be emphasized as a rate, and the individual's position in the salary range should depend on performance.

Those employees who consistently far exceed performance expectations progress to the upper portions of their salary range, while employees who make steady performance improvement generally retain their position within their salary range. According to this philosophy, it is necessary for the supervisor to determine each employee's performance relative to their peers in addition to their performance results against the established job standard and agreed-upon objectives. These two ingredients will determine precisely the position in the salary range to which an employee will progress and how long it will take the employee to get there. Individual salary increase decisions made by the employee's supervisor will reflect that result.

9. BENEFIT PROGRAMS

9.1 Objectives of a Benefits Plan

Employees provide valuable skills and knowledge that are essential to help a firm grow and prosper. For that work, employees are compensated not only with salary but also with a total benefits program.

The objective of a total benefits program should be able to give employees and their families three things:

1. Protection in time of financial need
2. Security to help them build their personal savings
3. An opportunity to grow in their careers and enjoy a richer life while they are away from their jobs

9.2 What You Can Afford

All payments made to employees for time not worked, along with additions to pay for the employees' benefit, are termed "benefits" or "fringe benefits." In the past, these benefits accounted for only a small part of total compensation—less than 5 percent. In recent years, benefits have become a popular means of attracting and retaining good workers. This development, along with the increase in collective bargaining activity and the advantageous treatment given to benefits under federal tax laws, has gradually given rise to an employment picture in which certain benefits are now almost universally taken for granted. Benefit costs now account for more than one-third of payroll outlays.

There are many misconceptions in the marketplace today relative to what companies must provide by way of benefits to its employees. Social Security and Medicare payments, unemployment insurance, and workers' compensation (mandated by the individual states), serve as the only required benefits. Recent legislation relative to the American with Disabilities Act and the Family Medical Leave Act stipulates certain policies relative to the granting of time off for employees, but since these are leaves "without pay," they are not considered benefits.

There are basically three types of cost considerations in structuring an employee benefit plan. The most important consideration with respect to profitability is the cost to the organization. There are also two employee-related costs. There are costs to the employee in terms of the payroll deductions required for participation in benefit programs and the amount of other out-of-pocket costs the employee incurs to purchase coverages that are not provided in the benefit and service package. Also, there is the important consideration of the value to the

employee. Any benefit program will be a waste of money if the employees perceive no usefulness from the benefits and services offered.

Any benefit program will have to include the mandatory costs of legislated programs such as social security, unemployment compensation, and workers' compensation. Nevertheless, these programs should be carefully considered to avoid any overlap in coverage. Private plans can be tailored to supplement public assistance and as the latter is increased, some reduction in organization benefits can be considered. Pension plans can be integrated with Social Security benefits. Health insurance can carve out Medicare eligibles. Disability insurance can be integrated with workers' compensation. Educational assistance can be made conditional upon the use of available veterans assistance.

A benefit plan should also be cost-effective in terms of employee contributions. This would entail the standard practice of having deductibles for health insurance coverage and schedules of maximum payments and copayments for certain coverages. In other areas, educational assistance can require that the courses taken have some relation to job duties. Also, it may not be economical to provide a standard amount of life insurance for all employees. Younger employees or single workers may not need coverage as extensive as that required by workers with families or older employees.

One way to make sure that benefits are cost-effective is to provide the benefits and services most valued by employees. Benefits systems have tended to grow and change in response to outside events rather than for the purpose of meeting changed employee needs or improving organizational effectiveness. The most frequent example of this error in thinking is illustrated by similar organizations attempting to duplicate each other's benefit packages. What is good for one company may not always hold true for the next organization.

9.3 Cafeteria Plans

According to a number of surveys, employers are offering increased flexibility to make what are termed "cafeteria plans" more valuable to employees. The cafeteria approach to employee compensation is a method of providing a flexible benefits and services program. Employees receive a specific value for the amount of benefits they may choose from a menu of different items. Usually, there is a core of benefits that the employee must accept. For most other benefits, the employee may pick and choose—or take the cash. The employee picks what benefits he or she wants, provided that the maximum dollar amount allocated to the individual is not exceeded. Some benefits, such as pensions, must be kept in the core of the mandatory benefits because the law requires it.

The advantage of the cafeteria or flexible benefits approach for meeting the demands of a changing workforce is apparent. The established, career-minded employee may be interested in pensions; the traditional one-worker family with two children may not want a lot of group health insurance; one-half of a two-worker family may not be interested in any group insurance at all; the single person may want extra vacation time.

The cafeteria-style benefit plan is highly touted among small businesses today because it enables the employees to participate by purchasing medical, dental, and optical benefits, as well as child care, while paying for these items with pretax dollars.

10. TERMINATION

10.1 Performance Evaluation and Documentation

Measurement of performance is one of the most crucial tasks performed by managers and supervisors. Although performance evaluation may seem to be directly related only to discussions that occur at salary evaluations, it is a topic relevant to many other day-to-day activities in the workplace. Performance evaluation is actually an ongoing communication effort, beginning with the initial job interview, and continuing throughout the employment cycle.

An employee's history of not meeting performance requirements is often the cause for termination. Failure to communicate performance requirements fully is often the underlying problem if a company is faced with employment-related litigation. Inability to meet performance standards must be fully documented in order to support a termination decision. In order to reduce the potential for any future problems, it is essential that performance requirements, and the employee's record of meeting or not meeting those requirements, be communicated at the time an employee is hired, regularly during employment, and again at employment termination.

10.2 Guidelines for Termination

Prior to terminating an employee, the company should consider several questions:

- Does the organization have options other than termination?

- Should management seek a voluntary resignation instead of a termination accompanied by the employee's signed release of all claims?
- How should the grounds for dismissal be worded in order to avoid any potential discrimination lawsuit?
- Should a peer review board or committee be instituted to resolve disputes over potential terminations?
- What individual within the organization should notify the employee of the impending termination?
- When should a terminated employee be physically released from the organization?
- How are inquiries from the outside handled and by whom?
- What impact will a termination have on the company image, operations, and remaining employee morale?
- What sorts of severance benefits, if any, should be offered the terminatee, and under what circumstances?
- What formula should be developed and used to compute the severance and compensation package?
- What company benefits are to continue after the termination and for how long?
- Should job outplacement be considered for the terminated employee?

10.3 Prior to Finalizing a Termination Decision

If termination is being considered due to a violation of company policy, it is imperative that the company adhere to the procedures listed below. Following these procedures will help to protect the company's position if the employee were to sue for wrongful discharge.

- Document all pertinent facts. Documentation of policy infractions is the basis for a "good cause" defense. This documentation should begin at the time infractions, and related disciplinary actions, present the possibility of dismissal. Every violation of policy, regardless of how trivial, should be recorded in the employee's personnel file. All records of violations should fully indicate the resulting disciplinary action, whether formal or informal.
- Use progressive discipline. Establish formal, written guidelines for discipline and follow them rigorously. Under a typical progressive discipline system, an employee will be given an oral warning for the

first offense, a written warning for the second, and suspension or termination for the third. If a suspension procedure is implemented, termination would not normally occur until the fourth offense. The system should also provide for immediate dismissal under certain conditions, such as gross unprofessional conduct, or other activities that management deems highly inappropriate or damaging.

If termination is considered due to repeated poor performance, the performance evaluation process must be scrutinized. In order to defend its position, management should be able to answer the following questions based upon the company's performance evaluation process as it relates to the terminated employee:

- Is it obvious what activity/job/position is being evaluated?
- Are the performance objectives explicit, fair, and realistic?
- Is the evaluation objective, fair, and unbiased as to sex, race, religion, handicap, and national origin?
- Was the employee told of the performance evaluation and notified of the functional areas where performance needed improvement?
- What performance standards are used to evaluate the employee's performance?
- Are the performance criteria and/or performance standards ever changed? If so, the following questions must also be addressed:
 - Are the changes explicitly and formally communicated to the affected employee?
 - Are copies of these communications permanently maintained?
- Are performance standards based on the job analysis?
- Are the same job performance standards applied to all employees holding similar jobs?
- Were the evaluations consistent with sound personnel practices?
- Were the evaluations done by a person thoroughly familiar with the terminated employee's performance?
- Has the employee been given appropriate assistance and guidance toward reaching objectives?
- Were the necessary resources made available to reach the established objectives and standards?
- Does the company provide necessary training to enable the employee to keep relevant knowledge up-to-date?

- Were unsatisfactory performance issues discussed with the employee at reasonable intervals?
- Was the employee advised of the consequences of continued unsatisfactory performance?
- Were deadlines provided for remedial actions?
- Is the company's performance evaluation program formal and has it been formally communicated to employees?
- Have employees ever been evaluated as satisfactory even though the performance was poor, unsatisfactory, or marginally satisfactory?
- Is a complete and accurate file of each employee's performance evaluations maintained? If so, also address the following:
- Does this file support the termination?

Answers to these questions should enable management to assess its position in potential termination based on poor or unsatisfactory performance. Questions that cannot be answered positively and explicitly must alert management to reevaluate its stand on a discharge on grounds of unsatisfactory performance. Appendix 12 gives an example of a pre-discharge checklist that may be used to document management's review.

10.4 After the Decision to Terminate has been Finalized

After the termination decision has been made, several steps should be taken to prepare for the termination interview:

- Check whether there is any employment contract for a definite term.
- Carefully review each provision in the employee handbook.
- Make sure that an impartial third party has reviewed all facts.
- Determine the reason that is to be given for the termination.
- Draft the termination letter.
- Keep a record of the termination notice and all termination-related documents.
- Notify those who are likely to be affected by the termination.
- Employees who could potentially be harmful to the company must be asked, and should be asked, to leave the premises soon after termination notice is given. Compensation in lieu of advanced notice should be arranged.
- Exercise extreme confidentiality in handling terminations.

- Be prepared to ensure a replacement for the terminated employee if the position is not being abolished.
- Scrutinize the details of the severance package.
- Be sensitive to the time in which the employee is notified.

10.5 During the Termination Interview

During the termination interview, several important steps should be followed:

- Come to the point within the first two to three minutes.
- Outline and put into a logical order all the relevant reasons for the termination.
- Keep the termination interview brief and businesslike.
- Determine the terms to be used for the employee's departure.
- Preferably, conduct the exit in a neutral territory.
- Inform the employee of the "bad news" in a way that will alleviate trauma.
- Do not try to compensate the terminated employee for the "psychological shock" of losing the job.
- Offer assistance in helping this person find another job.

10.6 After the Termination Interview

Once the termination interview is complete, be sure the following additional steps are completed:

- Notify all the departments within your organization that are apt to be affected by the employee's departure.
- Have the employee return all company property and make sure that the employee's financial obligations to the firm are cleared.
- Find out whether the employee has any vested rights to the pension, profit sharing, or other related plans.
- Inform the departing employee the kind of contact the company will allow from them after he or she leaves.
- Inform the employee what to expect in terms of future references.
- If you are to assist with outplacement, stay in contact and follow through accordingly.

Perform an exit interview, if possible. See appendixes 13 through 15 for examples of exit interview and related termination forms.

Employee terminations are an extremely serious and sensitive subject and should be treated as such by all managers, executives, and owners. Whether a termination results in a potential lawsuit for wrongful discharge will often depend on how the termination process is handled. Lawsuits are not only expensive, but are embarrassing to both the terminating organization and the terminated employee. Every effort should be made to ensure that terminations, when inevitable, have been properly handled by management.

REFERENCES

- Arthur, Diane. *Recruiting, Interviewing, Selecting, and Orienting New Employees*, 2d ed. New York: AMACOM, 1991.
- Asquith, Nancy. *Human Resources Checklists with Commentary*, 2d ed. Boston: Warren, Gorham & Lamont, 1991.
- Bureau of Business Practice Staff. *Human Resources Guide*. Englewood Cliffs, N.J.: Prentice Hall, 1993.
- Cherrington, David J. *The Management of Human Resources*, 4th ed. Needham Heights, Mass.: Allyn & Bacon, Inc., 1995.
- Cohen, S. I. *Human Resource Development and Utilization: Economic Analysis for Policy Making*. Brookfield, Vt.: Ashgate Publishing Company, 1994.
- Complete Personnel Administration Handbook for CPA Firms*. San Diego: Harcourt Brace Jovanovich, 1993.
- Ferris, Gerald R., ed. *Handbook of Human Resources Management*. Cambridge, Mass.: Blackwell Publishers, 1995.
- Fritz-enz, Jac. *How to Measure Human Resource Management*, 2d ed. New York: McGraw-Hill, Inc., 1995.
- Harris, David M., and Randy L. DeSimone. *Human Resource Development*. Orlando, Fla.: Dryden Press, 1993.
- London, Manuel, and Richard A. Wueste. *Human Resource Development in Changing Organizations*. Westport, Conn.: Greenwood Publishing Group, Inc., 1992.
- Mayers, Raymond S., et al. *Dilemmas in Human Service Management*. New York: Springer Publishing Company, 1994.
- Megginson, David, et al. *Human Resource Development*. East Brunswick, N.J.: Nichols Publishing Company, 1993.

- 1996 Guidebook to Fair Employment Practices*. Chicago: Commerce Clearing House, Inc., 1996.
- Osborne, Jane, ed. *CPA's Human Resource Administration Handbook*. San Diego: Harcourt Brace Professional Publishing, 1994.
- Page, Kogan. *Strategies of Human Resource Management*. Houston: Gulf Publishing Company, 1995.
- Rao, T. V. *Experiences, Interventions, Strategies*. Thousand Oaks, Calif.: Sage Publications, 1996.
- Riahi-Belkaoui, Ahmed. *Human Resource Valuation: A Guide to Strategies and Related Techniques*. Westport, Conn.: Greenwood Publishing Group, Inc., 1995.
- Rothwell, William J., and H. C. Kazanas. *Human Resource Development: A Strategic Approach*. Amherst, Mass.: Human Resource Development Press, 1993. Looseleaf.
- Thaxton, Van A., et al. *Personnel Compliance Guide*. Fort Worth, Tex.: Practitioners Publishing Company, 1994.
- Thomson, Rosemary and Chris Mabey. *Developing Human Resources*. Newton, Mass.: Butterworth-Heinemann, 1994.
- Topical Law Reports*. Chicago: Commerce Clearing House, Inc., 1996.
- Veres, John G. *Human Resource Management and the Americans with Disabilities Act*. Westport, Conn.: Greenwood Publishing Group, 1995.
- Ward, Dan, ed. *Human Resource Forecasting and Modeling*. New York: Human Resource Planning Society, 1994.
- Williams, Lloyd C. *Human Resources in a Changing Society: Balancing Compliance and Development*. Westport, Conn.: Greenwood Publishing Group, 1995.

APPENDIX 1: Sample Firm Hiring Policy

It is the policy of the Firm to be an equal opportunity employer and to hire individuals solely upon the basis of their qualifications for the job for which they have applied. Every effort is made to hire new employees for positions that make the best use of their abilities and in which they will be able to achieve personal satisfaction. In no event shall the hiring of an employee be considered a contractual relationship between the employee and the Firm; and, unless otherwise provided in writing, employment shall be at will, so that either party may terminate the relationship at any time and for any lawful reason.

1. PURPOSE

The purpose of this policy is to provide a controlled procedure for manpower staffing and utilization. Two general programs are outlined below: a) The hours budget system and staff plans that control staffing levels, and b) Procedures governing all personnel actions that affect staff utilization.

2. HOURS BUDGET SYSTEM AND STAFF PLAN

The hours budget and staff plan are established by employees and their supervisors and approved by shareholders during the budgeting process. Changes to the hours budget and staff plan require approval of the managing partner and director of administration.

The hours budget is maintained by the director of administration. The staff level plan is maintained by the director of administration and is distributed for shareholder review as appropriate. Specifically, it is a listing of all budgeted approved hours, whether part-time, full time, or temporary, and any additions/deletions to the original budget. Similarly, information on actual hours is provided and the differences between actual versus budgeted planned levels are explained. Supervisors are accountable for reviewing the staff level plan and reporting any changes or discrepancies to the director of administration.

The staff level plan is used as a method of communicating employment activity but primarily to control staff levels and hours. Any changes, either additions or deletions to the plan, are initiated by the supervisors through the appropriate shareholders and approved by the managing partner and director of administration. Personnel action on any change in the budgeted plan cannot begin until approval has been received.

The use of temporary additions or deletions to the staff plan will require approval and will be reflected in the staff plan.

As a supplement to the plan, an organization chart that depicts staff levels, job titles, and employee names is distributed to all employees on an as-needed basis. Any organizational chart changes should be reported to the director of administration.

3. PERSONNEL ACTION PROCEDURES

Job descriptions. Job descriptions are of key importance in successful personnel action. Supervisors are responsible for maintaining up-to-date descriptions for all jobs in their area of responsibility, with the assistance of the director of administration. Changes in job duties or requirements should be reflected in a revision of the job description and possible changes in the job title. The creation of a new job requires the completion of a new job description. Job descriptions are the basis both of an employee's position determination and performance evaluation and should be given careful consideration.

Hiring. Supervisors requiring a new employee, whether for replacement or a staff addition should—

- Insure that an accurate and current job description is in existence for the job. If the position is a new job, the supervisor should contact the director of administration for assistance in writing the job description and for job evaluation.
- Complete a personnel requisition form requesting aid for additional staff. Indicate in the comments section of the form the hours to be worked and the special conditions of employment required. For replacements, the form should be signed by the supervisor and the shareholder under whose direction this new employee would report and be forwarded to the director of administration.

Outlined below is the usual selection procedure to be followed for external recruitment.

- The director of administration or designate will screen all applicants and refer the most qualified to the supervisor for consideration.
- The director of administration or designate will check references when possible for the candidate selected by the supervisor.
- The director of administration or shareholder will extend an offer to the prospective employee and arrange a starting date.

- The director of administration will follow up with a confirmation letter to the prospective new employee officially offering the position to said employee.
- The director of administration will initiate a ‘Personnel Action form’ for new hires which will be sent to the data processing area for payroll input purposes.
- Either prior to, or on the first day of employment, the new employee will report to the director of administration or designate to fill out new hire information and benefits orientation.

Information and Procedures

- Where qualified applicants are available internally, it is the Firm’s preference to fill job openings by promoting from within. If applicants for employment are recruited from outside the organization, all available sources of qualified personnel shall be utilized. Before recruiting applicants from outside the Firm, the director of administration shall give consideration to any qualified individuals who are on layoff status.
- The Firm will accept applications for employment only for specific jobs in which openings exist.
- The Firm will not pay any employment agency fees for unsolicited referrals of individuals to fill job openings. However, for certain designated hard-to-fill professional jobs approved by the director of administration, the Firm will pay for recruiting assistance from selected employment agencies and professional recruiters.
- When a shareholder or other manager determines that there is a requirement for one or more new employees, the individual shall submit an employment requisition to the director of administration. Requisitions to fill existing jobs that are being permanently vacated will be processed routinely. All other requisitions will be reviewed by the director of administration before approval.
- To aid the process of selecting those most qualified for the job, the Firm may use employment tests as a part of normal hiring procedures for certain positions.
- If job openings are to be filled from within the Firm, the openings will be posted in accordance with the posting procedures. The director of administration will arrange interviews between the applicants and the shareholder, and the decision to accept an applicant will be made by the shareholder.
- All representatives of the Firm should be aware that employment with the Firm is at will and should exercise great care not to make any representations otherwise. Therefore, during the recruitment,

hiring, and orientation process, no statement shall be made promising permanent or guaranteed employment; and no document shall be called a contract unless, in fact, an employment contract is to be used.

- The Firm will employ a relative or cohabitant of an employee provided the individual possesses the usual qualifications for employment. However, those persons will not be given work assignments that require one to direct, review, or process the work of the other, or which permit one to have access to the personnel records of the other.
- If employees marry one another, or if two employees become cohabitants, both may retain their positions if they do not work in the same department, are not under the direct or indirect supervision of each other, and neither occupies a position of influence over the other's employment, promotion, salary administration, and other related management or personnel considerations.
- The Firm is taking affirmative action to employ, and advance in employment, qualified disabled veterans, veterans of the Vietnam era, and qualified handicapped individuals. The Firm is also taking affirmative action to employ and advance in employment qualified individuals without regard to race, sex, religion, or national origin.
- Former employees who left the Firm in good standing may be considered for re-employment. Former employees who resigned without adequate notice or who were dismissed for cause will not be considered for re-employment. A previously terminated employee who is re-employed will be considered a new employee from the date of re-employment unless the break-in service is less than thirty days, in which case the employee shall retain accumulated seniority. Length of service for the purposes of benefits is governed by the terms of each benefit plan. Employees who retire may be eligible, in certain circumstances, to be considered for rehire.

APPENDIX 2: Sample Personnel Requisition

| STAFFING REQUISITION | | | | | | | | | | | |
|--|----------|---------------------------|--|--|---|---|---|--------------------------|---|---|---|
| <i>Please type. Leave all shaded areas blank. Send form intact to Human Resources.</i> | | | | | | | | | | | |
| FROM | | | DATE NEEDED | | | <input type="checkbox"/> NEW POSITION <input type="checkbox"/> REPLACEMENT | | | IF REPLACEMENT, FOR WHOM & EFFECTIVE DATE | | |
| DIVISION/DEPARTMENT NAME | | | | DIV /DEPT CODE | | DEPT INTERVIEWER AND EXT | | | LEAVING BECAUSE OF <input type="checkbox"/> Promotion <input type="checkbox"/> Resignation <input type="checkbox"/> Transfer <input type="checkbox"/> Release | | |
| LOCATION | | BUDGETED SALARY THIS YEAR | | IS THIS JOB INCLUDED IN YOUR BUDGET FOR THIS YEAR? <input type="checkbox"/> YES <input type="checkbox"/> NO | | IF NOT, WHAT IMPACT WILL IT HAVE ON YOUR BUDGET FOR THE YEAR? | | | | | |
| Sal Admin. only JOB CODE | | JOB TITLE | | | GRADE | HIRING SALARY RANGE | | | FT PT TEMP _ _ _ | | Incentive <input type="checkbox"/> Yes <input type="checkbox"/> No |
| Pay Freq. | Pay Code | LEVEL 6 | EXEMPT? <input type="checkbox"/> Yes <input type="checkbox"/> No | Emp. Code | HOURS PER WEEK 35 37 1/2 40 _ _ _ | | <input type="checkbox"/> Bi-Wkly <input type="checkbox"/> Wkly | 8-40-4:30 OR _____ | Estimated Part Time | Overtime Required? <input type="checkbox"/> Yes <input type="checkbox"/> No | OUTSIDE ADVERT APPROVAL <input type="checkbox"/> YES <input type="checkbox"/> NO |
| JOB RESPONSIBILITIES: | | | | | | | | | | | |
| JOB REQUIREMENTS/EDUCATION/SPECIAL SKILLS AND/OR TRAINING: | | | | | | | | | | | |
| USUAL JOB PROGRESSION AND/OR ADVANCEMENT OPPORTUNITIES: | | | | | | | | | | | |
| DEPT HEAD SIGNATURE AND DATE | | | | | SALARY ADMINISTRATION | | | HUMAN RESOURCES | | | |
| DIVISION HEAD SIGNATURE AND DATE | | | | | ADDITIONAL APPROVALS | | | | | | |

Copyrighted material reprinted with permission of the Bureau of Business Practice, Waterford, CT from *BBP's Recruiting and Hiring Handbook*.

APPENDIX 3: Sample Job Descriptions

JOB DESCRIPTION

TITLE: Controller

REPORTS TO: CEO

DEPARTMENT: Accounting and Finance

SUPERVISES: Assistant Controller

CLASSIFICATION: Full-Time, Exempt

Summary of Responsibilities

The controller provides accurate and timely financial information to the chief executive officer (CEO) for decision-making purposes. The controller also serves as liaison between staff and management, and outside parties and management.

Essential Functions

1. Meet with the CEO weekly to provide financial reports and advise on financial matters.
2. Establish and maintain good banking relations, and arrange and monitor lines of credit weekly.
3. Meet with company accountants and attorneys on an as-needed basis, and advise the CEO of relative legal and financial matters.
4. Oversee the preparation of reports for the annual year-end audit, and ensure that reports are available for the outside accountants.
5. Supervise the assistant controller, and review accounting reports as needed.
6. Approve and sign checks, as needed.
7. Prepare annual budgets, monthly cash flow analyses, and monthly and annual projections of jobs in progress and cash flow.

Other Functions

Prepare other reports and projects as requested from time to time by the officers of the corporation.

Required Experience

Normally, at least five years' experience as a controller or chief financial officer (CFO) for a construction-related business is required.

Educational Requirements

1. The position requires a bachelor's degree in accounting or finance or equivalent work experience.
2. Forty hours of continuing professional education is required each year.

Required Licenses, Certificates or Knowledge

A current and valid certified public accountant's (CPA's) license is desired, but not required.

Working Conditions

1. Occasional same day, out of town travel for meetings and conferences using a personal vehicle or company vehicle.
2. Occasional overtime work required throughout the year. Heavy overtime work required at end of fiscal year for preparation of year end audit.

Safety Hazards of the Job

Minimal hazards. General office working conditions.

This job description does not list all the duties of the job. You may be asked by supervisors or managers to perform other instructions and duties. You will be evaluated in part based upon your performance of the tasks listed in this job description.

Management has the right to revise this job description at any time. The job description is not a contract for employment, and either you or the employer may terminate employment at any time, for any reason.

Dated prepared _____ Approved by _____

JOB DESCRIPTION

TITLE: Assistant Controller
DEPARTMENT: Accounting and Finance
CLASSIFICATION: Full-Time, Exempt

REPORTS TO: Controller
SUPERVISES: Accounting Staff

Summary of Responsibilities

The assistant controller helps the controller prepare financial reports and forecasts; manages the computerized accounting system; and serves as a liaison between the accounting staff and the controller.

Essential Functions

1. Prepare monthly financial statements (including job cost definition) by the 25th of each month, using a computer software program.
2. Coordinate annual year end audit with outside auditors, and oversee the preparation of appropriate schedules and reports.
3. Handle daily accounting mail, including notices and disbursements.
4. Prepare union, labor, minority and workers' compensation reports each month.
5. Prepare special reports on an as-needed basis.
6. Prepare budgets and forecasts as directed by the controller.
7. Monitor medical insurance and 401(k) plans.
8. Prepare payroll tax returns each quarter.
9. Prepare annual W-2 reports.
10. Supervise accounting staff.

Other Functions

Other duties as assigned by the controller or the CEO.

Required Experience

1. Normally, three to five years' experience working as a full charge bookkeeper or assistant controller in a construction-related business.
2. Experience preparing financial statements and job costing reports.
3. Experience with and understanding of computer software programs.

Educational Requirements

At least two years of college level courses in accounting are desired.

Required Licenses and Certificates

None required.

Working Conditions

1. Job involves in-office work, performing various tasks concurrently.
2. Moderate to low overtime required throughout the year. High level of overtime required at year end to complete year-end audit.

Safety Hazards

Minimal hazards. General office working conditions.

This job description does not list all the duties of the job. You may be asked by supervisors or managers to perform other instructions and duties. You will be evaluated in part based upon your performance of the tasks listed in this job description.

Management has the right to revise this job description at any time. The job description is not a contract for employment, and either you or the employer may terminate employment at any time, for any reason.

Dated prepared _____ Approved by _____

APPENDIX 4: Sample Job Posting Request

| | |
|--|-------------------------------------|
| JOB POSTING REQUEST | |
| (Nonbargaining Unit) _____ | Date _____ |
| Position Title _____ | Department _____ |
| This is a: New Job _____ or/Additional Job _____ | |
| or/Replacement for: _____ (Person) | |
| Payroll: Pink _____ | |
| Crew 90 _____ | |
| Starting Date _____ | Block No. _____ |
| Exempt/Nonexempt _____ | |
| Minimum Qualifications: | |
| | |
| Other Requirements: | |
| | |
| Final Selection To Be Made By _____ | |
| Requested By _____ | Approved _____ (Department Head) |
| Distribution: White—Personnel Department | |
| Yellow—Department Submitting | |

Copyrighted material reprinted with permission of the Bureau of Business Practice, Waterford, CT from *BBP's Recruiting and Hiring Handbook*.

APPENDIX 5: Sample Application for Employment

[This application is presented for illustrative purposes only. Because employment regulations vary by state and locality, any employment application the business uses should be approved by an attorney experienced in employment law.]

APPLICATION FOR EMPLOYMENT

The following information is requested to help us make the best possible placement of employees within the company. Complete all portions of this application pertaining to you. We appreciate the time you spend completing this application. The employer, in accordance with state and federal laws, does not discriminate on the basis of age, race, religion, color, sex, national origin, ancestry, mental or physical disability, or any other characteristic protected by law.

PLEASE PRINT

| | | |
|------------------|------------------|----------|
| NAME (Last) | (First) | (Middle) |
| ADDRESS (Street) | (City) | (Zip) |
| (Home Phone) | (Message Phones) | |

If hired, can you show proof of legal authorization to work in the United States? Yes No

Are you at least 18 years of age? Yes No

If under 18 years of age, can you produce a work permit upon hire? Yes No

If you are hired, when can you begin work? _____

The hours for this job are regularly 8:00 A.M. to 5:00 P.M., Monday through Friday. Are you able to comply with this job's attendance schedule? Yes No

Have you had any convictions as an adult? A conviction will not necessarily disqualify you from employment. Yes No

Reprinted with permission from *PPC's Personnel Compliance Guide*, © 1994 by Practitioners Publishing Company, Fort Worth, Texas.

EDUCATION: Do not complete the EDUCATION section unless this box is checked:

| | SCHOOL | NUMBER OF YEARS ATTENDED | DEGREE | MAJOR |
|---------|--------|--------------------------|--------|-------|
| HIGH | | | | |
| COLLEGE | | | | |
| OTHER | | | | |

EMPLOYMENT RECORD: Please account for all time over the past ten years, listing the most recent job first. Use the back of this page if additional space is necessary.

| DATE OF EMPLOYMENT (Month/Year) | NAME/ADDRESS OF EMPLOYER AND NAME OF SUPERVISOR | JOB TITLE AND RESPONSIBILITY | REASON FOR LEAVING |
|---------------------------------------|---|------------------------------|--------------------|
| From _____ To _____ Phone _____ | 1. | | |
| From _____ To _____ Phone _____ | 2. | | |
| From _____ To _____ Phone _____ | 3. | | |
| From _____ To _____ Phone _____ | 4. | | |
| From _____ To _____ Phone _____ | 5. | | |

Please indicate by number the employers we may NOT contact: _____

And the reason: _____

List special training, certificates, or licenses you have relative to the job for which you are applying: _____

List any job-related professional associations in which you participate. DO NOT INCLUDE ANY ASSOCIATIONS THAT WOULD IDENTIFY AGE, RACE, COLOR, SEX, NATIONAL ORIGIN, CITIZENSHIP, RELIGION, VETERAN'S STATUS, OR DISABILITIES: _____

PLEASE READ ALL OF THE FOLLOWING BEFORE SIGNING

I certify that the information shown on this application is correct and complete to the best of my knowledge, and that I have not knowingly withheld any fact or circumstance. I understand that falsifying or omitting information on this form may cause me to be disqualified from further consideration or dismissed from employment if hired.

All employment offers are made contingent upon satisfactory proof of legal authorization to work in the United States according to the law. I understand that failure to provide satisfactory proof of identity and authorization to work in the United States will disqualify me from employment.

I understand that, if hired, my status will be that of an employee at will, with no contractual right, express or implied, to remain employed. In consideration of my employment, I specifically agree that my employment may be terminated, with or without cause or notice, at any time, at the option of either the employer or myself. I understand that no one, other than the President of the Company, in writing, may enter any agreement for employment on my behalf or make any agreement contrary to the foregoing.

I understand that, if hired, I may be required to undergo a physical examination and drug and alcohol screening test either: If I should become involved in an accident while on duty, on company premises, on job sites, or in a company vehicle; or if a reasonable suspicion of drug or alcohol use exists based on my performance, appearance, and/or behavior. The examination and the test will be performed at the employer's expense, by the employer's choice of physician.

App.

HUMAN RESOURCES

I authorize the employer to investigate, confirm, and supplement any information contained on this application and to contact former employers unless otherwise stated.

Applicant Signature: _____

Date: _____

APPENDIX 6: Standard Interview Questions Form

INTERVIEW QUESTIONS

Instructions: A firm may use this form to list the interview questions that all candidates will be uniformly asked. This form promotes, and documents the consistent treatment of all candidates. One copy of this form should be kept in the job search file.

| Candidate: _____ Date: _____ Job: _____ | |
|---|---------------------|
| Interviewer: _____ | |
| REQUIREMENT | QUESTIONS AND NOTES |
| _____ | 1. _____ _____ |
| _____ | 2. _____ _____ |
| _____ | 3. _____ _____ |
| _____ | 4. _____ _____ |
| _____ | 5. _____ _____ |
| _____ | 6. _____ _____ |
| _____ | 7. _____ _____ |
| _____ | 8. _____ _____ |
| _____ | 9. _____ _____ |
| _____ | 10. _____ _____ |

APPENDIX 7: Interview Rating Reports

| INTERVIEW REPORT FORM | |
|--|--|
| Applicant _____ | Interviewer _____ |
| Date _____ | For Position _____ |
| Initial Impression | <u>Favorable 1 2 3 4 5 Unfavorable</u> |
| Appearance Manner Self-expression Responsiveness | |
| Work Experience | <u>Favorable 1 2 3 4 5 Unfavorable</u> |
| Relevance of work Sufficiency of work Skill and competence Adaptability Productivity Motivation Interpersonal relations Leadership Growth and development | |
| Education | <u>Favorable 1 2 3 4 5 Unfavorable</u> |
| Relevance of schooling Sufficiency of schooling Intellectual abilities Versatility Breadth and depth of knowledge Level of accomplishment Motivation, interests Reaction to authority Leadership Teamwork | |

| | | |
|---|-------------------------|--------------------------|
| <p>Early Years (Optional) <u>Favorable 1 2 3 4 5 Unfavorable</u></p> <p>Socio-economic status Parental examples Attitudes toward achievement, work and people Emotional and social adjustment Basic values and goals Self-image</p> | | |
| <p>Present Activities and Interests <u>Favorable 1 2 3 4 5 Unfavorable</u></p> <p>Vitality Management of time, energy and money Maturity and judgment Intellectual growth Cultural breadth Diversity of interests Social interests Social skills Leadership Basic values and goals</p> | | |
| <p>Summary Plus (+) and Minus (-)</p> <p>Talents, skills Knowledge Energy Motivation Interests Personal qualities Social effectiveness Character Situational factors</p> | <p>STRENGTHS</p> | <p>WEAKNESSES</p> |
| <p>Overall Summary and Recommendations <u>Favorable 1 2 3 4 5 Unfavorable</u></p> | | |

INTERVIEWER'S EVALUATION

Candidate name: _____ Position applied for: _____

1. Job Knowledge: How knowledgeable is the candidate about basic components of the job?

- Very knowledgeable Has basic job knowledge
- Requires special training Insufficient knowledge to succeed

Comments: _____

2. Education: Has the candidate completed necessary educational requirements for the position?

- Yes No Is currently attending school

Comments: _____

3. Prior Work History: Has there been evidence of successful work assignments?

- Yes No

Comments: _____

4. Goal Orientation:

a. Evaluate the candidate's basic drive to succeed. Consider whether this position will satisfy his/her need for job satisfaction, or will the candidate become dissatisfied quickly?

- Excellent Very Good

Comments: _____

b. Consider what the candidate has done to prepare himself/herself for a career in this area.

- Excellent preparation (education & experience)
- Good preparation (education & experience)
- No preparation for this position

Comments: _____

5. Considering the minimum qualifications necessary to do this job, is the candidate qualified for this position?

Yes No

To what extent?

Minimally Moderately Extremely Not at all

Comments: _____

6. Recommendation:

Hire Reject Hold

Why? _____

Signature: _____ Date: _____

APPENDIX 8: Reference Check

TELEPHONE REFERENCE CHECK FORM

Applicant's name: _____

Reference name: _____

Position: _____ Company: _____

Date called: _____ Dates of employment: from _____ to _____

Starting position: _____ Last position: _____

Starting salary: _____ Ending salary: _____

Duties of last position: _____

Ask each reference to rank the prospective employee on a scale of 1 to 10 in each category:

Technical ability: _____

Motivation/Attitude: _____

Ability to work with others (if relevant to position): _____

Attendance Record

Tardiness: _____ Absenteeism: _____

Reason for leaving: _____

Would you rehire? _____ Explain: _____

Greatest strength: _____

Greatest weakness: _____

Other pertinent information/comments: _____

Reference checked by: _____

APPENDIX 9: Job Offers and Rejections

SAMPLE JOB OFFER LETTER

Date

Dear _____,

I enjoyed our phone conversation and reiterate that we are impressed with your background. I'd like to take this opportunity to offer you a position as an _____ at *Name of Company* at a starting annualized salary of \$_____. We will review that salary consistent with our Firm-wide salary range change effective July 1, 19____, to ensure internal equity and external competitiveness.

Name of Company is proud of the service we offer our clients and we feel that this is a direct reflection on our staff. We feel that you would make a significant contribution as a member of our team.

As for benefits, the policy administration, and the day-to-day operating procedures, I can go into these in much more detail when you have time. I will be available to answer any questions you may have.

For our mutual benefit, we would like you to begin employment on _____. However, if our workload demands an earlier start date, we'll be in touch to see how your schedule could possibly accommodate such.

I would appreciate hearing from you at your earliest convenience as to the acceptability of our terms.

Sincerely,

NAME OF COMPANY

A Professional Association
Certified Public Accountants

Name

Director of Administration

SAMPLE REJECTION LETTER

Date

Dear _____,

Our selection process for the _____ position has been completed.

We received many resumes and after careful evaluation of the many qualified candidates, we have selected an individual who, in our judgment, meets the current and projected needs of our accounting firm. This is by no means a negative reflection on your fine achievements as we spoke of in the interview. Rather, it speaks to our current and future needs.

I appreciated the time you spent with me, and I wish you every success in your search for a challenging career opportunity and express my sincere appreciation for your interest in *Name of Company*.

Sincerely,

NAME OF COMPANY
A Professional Association
Certified Public Accountants

Name
Director of Administration

APPENDIX 10: Orientation Checklist**NEW EMPLOYEE ORIENTATION CHECKLIST**

Name _____ Position _____

Address _____

Person to contact in case of emergency _____

Phone _____

Date of Birth _____

Date _____ Orientation done by _____

 Full-time Part-time Temporary Date employed _____

SS# _____

A. Supply employment forms and materials Tax forms (federal, state, etc.) Independence questionnaire (refer to Sec. 8, pages 810:1–810:18 of Personnel Manual) Assign Employee Number () Verify that the following is in new associate personnel file: application form, transcripts (if any), resume, reference letter/reference check(s), office interview forms (if any) and correspondence (if any).**B. Employee benefits (explain and issue brochures and applications)** Group disability Group life insurance Group medical insurance Cafeteria plan 401(k)**C. Issue personnel manual and explain** Office hours Payroll procedures Vacation, personal time, disability and sick policy Travel reimbursement policy Meal reimbursement policy Staff evaluation policy Time and expense reporting policy Scheduling procedures Telephone procedures (long distance calls) Mailing procedures File room procedures Library and periodicals Supplies

D. Firm membership policies

- ___ AICPA and state society memberships
- ___ Other civic organizations

E. Education policy

- ___ CPA exam policies
- ___ Responsibility of a professional to keep knowledge current (state law and firm policy)
- ___ Review CPE timekeeping responsibilities (firm and individual)

F. Miscellaneous items

- ___ Confidential nature of client affairs
- ___ Policy on outside work
- ___ Firm social activities
- ___ Organizational structure (organization chart)

G. Introduction to office

- ___ Tour of office
- ___ Lunchroom
- ___ Introduction to partners/associates
- ___ Show where to obtain supplies
- ___ Show libraries and briefly explain usage and available publications

H. Notify the following departments of employment

- ___ Administrative manager
- ___ Data processing manager

I. New employee package

- ___ Accounting and auditing manual (if applicable)
- ___ Audit staff reference manual (if applicable)
- ___ Personnel manual to read
- ___ Quality control procedures manual (if applicable)
- ___ Master tax guide (if applicable)
- ___ Accounting standards—current text
- ___ Office floor plan
- ___ Insurance forms
- ___ Database information
- ___ Employment agreement
- ___ Personnel manual signature page

APPENDIX 11: Job Description Outline

JOB DESCRIPTION OUTLINE

Instructions: The Company may use this form as an outline when preparing job descriptions.

Job Title: _____

Department: _____

Reports to: _____

Supervises: _____

Salary Range: _____

FLSA exempt/nonexempt status (attach support for exemption): _____

Primary Purpose of the Job: _____

Essential duties of the job, frequency, and percentage of time on the job:

1 _____ / _____ % 2 _____ / _____ %

3 _____ / _____ % 4 _____ / _____ %

5 _____ / _____ % 6 _____ / _____ %

Non-essential duties of the job, their frequency, and percentage of time on the job:

1 _____ / _____ % 2 _____ / _____ %

3 _____ / _____ % 4 _____ / _____ %

5 _____ / _____ % 6 _____ / _____ %

Reprinted with permission of Practitioners Publishing Company, Fort Worth, Texas, from *PPC's Personnel Compliance Guide*.

Required Skills, Abilities, Licenses, Knowledge, or Experience: _____

Working Conditions of the Job: _____

Safety Hazards of the Job: _____

Prepared by: _____ Date: _____

Reviewed by: _____ Date: _____

Approved by: _____ Date: _____

Justification of Jobs

After identifying the job tasks and requirements, the business has an opportunity to rethink the reason for the job’s existence. Competitive businesses are constantly examining the rationale behind their jobs.

A job justification can consist of two parts:

- Examining the financial or business reasons to establish or maintain a job.
- Stating succinctly the job’s essential purpose, its basic reason for existence.

The end of the job description process is an effective time to examine a job’s justification because not until then does the business have updated descriptions of the jobs tasks and requirements.

Typically, job justification is done, if ever, during business “downsizings,” rapid growth, or restructurings. However, when vacancies in jobs occur, businesses should conduct a job justification. The business also should examine jobs on a period schedule (say, every two years) to consider how new technologies and work arrangements could benefit the company.

Reasons to Establish or Continue a Job

No objective score “proves” a job is or is not justified. Many justifications are intangible, so the decision to add another job isn’t just a matter of dollars and cents. While subjective, this process is still useful.

The creation or continuation of most jobs is justified by a combination of two reasons:

- **Strategic business needs.** Strategic business needs are pervasive business objectives, as determined by management. Strategic business needs often are less connected to the job's specific actions than to the job's consequences for the firm's levels of performance, working conditions, and competitive standing. For example, one firm may justify internal manufacturing jobs by citing the unacceptable consequences to sales from shortages of component parts. Another may feel that security over its mailing list justifies hiring workers to maintain it, rather than contracting the work out.
- **Financial efficiency.** Financial efficiency occurs when money is saved by having an employee perform the work, compared to alternatives. Consequently, the decision maker should know the costs of both the worker and the alternatives.

The form on the following page may be used to examine the reasons to establish or maintain a job position.

Instructions: The Company may use the following questions to examine the reasons to establish or maintain a job. Employers should answer each of the following questions with specific, supported reasons based upon business strategy or financial efficiency.

Job: _____

Preparer's Name: _____ Date: _____

| QUESTION | JUSTIFICATION |
|---|---------------|
| 1. Why can't the work just remain undone, or as currently handled? | |
| 2. Why can't the work be performed by changing existing procedures or forms, or by delegating authority? | |
| 3. Why can't the work be performed by using technological improvements? | |
| 4. Why can't the work be performed by other companies or individuals outside the company? | |
| 5. Why can't the work be assigned to existing employees in that area? | |
| 6. Why can't the work be assigned to existing employees in other departments who either precede or follow in the work flow? | |
| 7. Why can't temporary employees perform the work? | |
| 8. Why can't employees working part-time, on flexible hours, or at home perform the work? | |

Reprinted with permission of Practitioners Publishing Company, Fort Worth, Texas, from PPC's *Personnel Compliance Guide*.

APPENDIX 12: Predischarge Checklist

Instructions: The Company may use this form as a checklist to help the business assess its documentation and defense in anticipation of a contemplated discharge. "No" answers indicate an area of potential weakness that may require discussion with an experienced employment trial attorney. The Company may record additional explanations in the "Comment" column.

Employee Name: _____ Job Position Held: _____

Reason Discharge Contemplated: _____

Prepared by: _____ Date: _____

| QUESTION | YES | NO | COMMENTS |
|--|-----|----|----------|
| 1. Did the employee sign an agreement that employment was at will? | | | |
| 2. Has the business avoided any written, oral, or implied representations limiting employment at will? | | | |
| 3. Was the relevant rule or performance standard documented before the fact? | | | |
| 4. Does the documentation show that the worker knew, or should have known, the rule or performance standard? | | | |
| 5. Can the business necessity for the rule be easily explained? | | | |
| 6. Did the employee have adequate opportunities to state a case before any decisions or actions were taken? | | | |
| 7. Was the employee's point of view put in writing? | | | |
| 8. Were employee's comments and other evidence reviewed by an impartial party? | | | |
| 9. Does the business have more than a vague suspicion of misconduct or poor performance? | | | |
| 10. Were warnings, counseling, or training given before termination, and were those actions documented? | | | |
| 11. Do personnel evaluations support the business's conclusion? | | | |
| 12. Was the employee given sufficient time and opportunity to improve? | | | |

Reprinted with permission from *PPC's Personnel Compliance Guide*, © 1994 by Practitioner's Publishing Company, Fort Worth, Texas.

| QUESTION | YES | NO | COMMENTS |
|--|-----|----|----------|
| 13. Did the employer meet all the employee's reasonable requests for assistance or accommodation? | | | |
| 14. Has a neutral manager reviewed the personnel file and decided that discharge is appropriate? | | | |
| 15. After reviewing the personnel file, will a reasonable person conclude the employee's action is either part of a pattern or a willful and deliberate act? | | | |
| 16. Was treatment of the employee consistent with company policies? | | | |
| 17. Was treatment consistent with previous similar cases? | | | |
| 18. Can the business demonstrate that neither discrimination, harassment, nor retribution has occurred? | | | |
| 19. Can the business defend against a breach of contract, fraud, or invasion of privacy claim? | | | |
| 20. Has the business complied with all internal procedures for managing the situation? | | | |
| 21. Can the employer state the reasons for its decision in writing? | | | |
| 22. Is the discharge timely in relation to the employee's actions? | | | |
| 23. Should the business proceed with the termination without discussing the case with labor counsel? | | | |

APPENDIX 13: Exit Interview Form (Long Form)

Instructions: Each employee, regardless of reason for termination, should have an exit interview with at least two employer representatives, usually the manager assigned personnel responsibilities and one other manager outside the employee's direct chain of command. The employer should complete Part I of this form, which should then be shown to the employee during the interview. The employee should complete Part II of this form.

Employee Name: _____ SS# _____

Last Job Title: _____ Last Salary: _____

Hire Date: _____ Termination Date: _____

Part I

To Be Completed by the Employer

1. Separation was initiated by: _____ Employee
_____ Employer; Person's Name and Title _____
2. Reason for the separation: _____
3. Amount of final wages due: \$ _____ for period _____ to _____
4. Amount of vacation benefits due: \$ _____ for _____ hours
5. Amount of sick time benefits due: \$ _____ for _____ hours
6. Other benefits due: \$ _____ for _____
\$ _____ for _____
7. If employee elects continued group health coverage:
Employee will pay \$ _____ by the _____ of each month, for self
Employee will pay \$ _____ by the _____ of each month, for dependents
8. Does the employee have an outstanding indebtedness with the
company? _____
If so, what are the repayment arrangements? _____

9. Is the employee in possession of company property? _____
If so, what property? _____
10. List any other separation arrangements. _____

Reprinted with permission from PPC's *Personnel Compliance Guide*, © 1994 by Practitioner's Publishing Company, Fort Worth, Texas.

Part II

To Be Completed by the Employee

- 1. Have you read, and do you understand, Part I of this form? _____
- 2. If you disagree with Part I of this form, please state why: _____

- 3. Please state the reason for the termination or resignation: _____

- 4. Do you have another job? _____
- 5. What information may we *not* tell the inquiring employers? _____
- 6. What did you like best about working for the company? _____

- What did you like least? _____
- 7. Do you intend to reapply for employment with this company? _____
- 8. Please rate the following as excellent, good, average, fair or poor:
 Quality of professional services offered by our firm _____
 Professional competence of staff and partners _____
 Opportunities for advancement _____
 Professional training and development _____
 Compensation and fringe benefits _____
- 9. Do you feel that you were treated fairly? _____
 Explain: _____
- 10. What can we do to help make your transition easier? _____
- 11. What is your current address and telephone number? _____
- 12. What should be done with mail and telephone calls? _____

Signed: Employee: _____ Date: _____

Employer: _____ Date: _____

Witness: _____ Date: _____

APPENDIX 14: Separation Interview Checklist

- Final paycheck.** Prepare final paycheck and give to employee. Include accrued overtime, vacation pay, other fringe benefits, if applicable. Issue separate checks for pension plan and profit-sharing plan distributions.
- W-2 wage statement.** Prepare W-2 and give to employee, if requested.
- Group insurance.** Inform employee of conversion privileges, costs, and time limits involved. Supply necessary forms for conversion.
- COBRA documents.** Provide departing employees with a statement of their rights under COBRA and a form to continue or waive their rights to insurance coverage.
- Forwarding address.** Get a permanent forwarding address. Get new employer's name, address, and telephone number, if possible. Instruct receptionist and mailroom on how to handle calls and mail.
- Firm property.** Ask the employee to return office keys, equipment keys, membership cards, briefcase, calculator and carrying case, computer and software, audit bags, personnel guide, audit guide, accounting and tax manuals, other firm property.
- Timesheet.** Make sure all client work is recorded through the time of termination.
- Passwords.** Change computer passwords to files containing sensitive information if the employee had access to them.
- Telephone credit cards and access codes.** Cancel the employee's telephone company credit card number. If employee had access to a long-distance service, such as MCI or Sprint, change access code number. Cancel access codes to photocopy, fax, or computer network equipment.
- Directories, stationery, agreements.** Remove the employee's name from employee lists, stationery, scheduling records, payroll, building directory, white and yellow pages listings, and from bank accounts and wire transfer agreements.
- Desk.** Have the employee clean out desk and take personal belongings.
- Parking space.** Remove employee's name from reserved parking space and reassign.
- Personnel file.** Update all personnel records to date of termination. Attach copy of written resignation or documentation of steps leading to discharge.
- References.** Employer and employee should agree on topics that may be discussed with references. Was a signed consent obtained for any references?

SECURITIES REGULATION

1. INTRODUCTION

- 1.1 Purpose
- 1.2 Scope

2. DEFINITIONS

3. FEDERAL SECURITIES REGULATION: OVERVIEW

4. THE SECURITIES ACT OF 1933

- 4.1 The Purpose of Registration Under the 1933 Act
- 4.2 The Process of Registration
- 4.3 Contents of the Registration Statement
- 4.4 Contents of the Prospectus
- 4.5 Exemptions From Registration
 - 4.5.1 Accredited investors
 - 4.5.2 Intrastate offerings
 - 4.5.3 Judicially approved exchanges
 - 4.5.4 Private placements
 - 4.5.5 Rule 506
 - 4.5.6 Small issues
 - 4.5.7 Voluntary exchanges
 - 4.5.8 California issuers
 - 4.5.9 Other exemptions
- 4.6 Secondary Transactions and Rule 144
- 4.7 Simplified Registration

5. THE SECURITIES EXCHANGE ACT OF 1934

- 5.1 Overview
- 5.2 Securities and Exchange Commission (SEC)
- 5.3 Registration of Brokers and Exchanges
- 5.4 Registration of Securities: General Issues
- 5.5 Registration of Over-the-Counter Securities: Specifics

6. OTHER FEDERAL SECURITIES-RELATED ACTS

- 6.1 Foreign Corrupt Practices Act of 1977
- 6.2 Investment Advisers Act of 1940
 - 6.2.1 Consequences of registering
 - 6.2.2 Examples of situations involving public accountants
- 6.3 Investment Company Act of 1940
- 6.4 Trust Indenture Act of 1939

- 6.5 Public Utility Holding Company Act of 1935
- 6.6 Racketeer Influenced and Corrupt Organizations Act (RICO)
 - 6.6.1 State RICO statutes
- 6.7 Securities Investor Protection Act of 1970
- 6.8 Small Business Incentive Act of 1980

7. STATE SECURITIES REGULATION

- 7.1 Uniform Securities Act
- 7.2 States With Exemptions Equivalent to Federal Rules Under Regulation D

8. ACCOUNTANTS' LIABILITY UNDER THE FEDERAL SECURITIES ACTS

- 8.1 Securities Act of 1933
- 8.2 Securities Exchange Act of 1934 and SEC Rule 10b-5

9. GOING PUBLIC

- 9.1 Registration Statement
- 9.2 Alternative Registration for Small Issues
- 9.3 Selling Securities Without Registration
- 9.4 State Securities Laws
- 9.5 Advantages and Disadvantages of Going Public
 - 9.5.1 Advantages
 - 9.5.2 Disadvantages
- 9.6 Costs of Going Public
- 9.7 Deciding to Go Public
- 9.8 Planning and Assistance
 - 9.8.1 Underwriters and Investment Bankers
 - 9.8.2 Law Firms
 - 9.8.3 Financial Public Relations Firms
 - 9.8.4 Certified Public Accountants
- 9.9 Pricing the Securities
- 9.10 Public Trading

REFERENCES

APPENDIX 1: Common 1933 Act Forms for Registration of Securities

APPENDIX 2: Commonly-Used 1934 Act Forms for Registration of Securities

APPENDIX 3: SEC Accounting and Reporting Requirements

APPENDIX 4: SEC Industry Guides

APPENDIX 5: State Securities Regulators

APPENDIX 6: SEC Regulation S-X (Excerpts on Accountants' Reports and General Instructions Regarding Financial Statements)

APPENDIX 7: Solicitation of Proxies

4.4 Contents of the Prospectus

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

- Audited balance sheets for two years and statements of income and changes in cash flow for three years.
- Description of the business, its markets, sources of supply, and its competitive conditions.
- A plan of operations.
- A statement of whether it will be necessary to raise additional funds within six months.
- Use of the proceeds of the present offering.
- Plan of distribution, including names of selling security-holders and information about the underwriters.
- Revenue, operating income or loss, and identifiable assets attributable to different industry segments.
- Nature of dependence on a few customers.
- Amounts spent on research and development.
- Segment information by geographic area.
- Descriptions of properties.
- Legal proceedings.
- History of market prices and dividends for most recent two years.
- Number of holders of each class of equity securities.
- Description of securities to be registered.
- Selected financial data for the last five fiscal years.
- Selected quarterly financial data.
- Management's discussion and analysis of financial condition and results of operations.
- Disagreements with and changes in independent accountants.

- Identification of directors, executive officers, significant employees and their business experience, and involvement in bankruptcy and certain other legal proceedings.
- Executive compensation, stock options, and bonuses.
- Ownership by any group of more than 5 percent of any securities.
- Transactions with or indebtedness exceeding \$60,000 with directors, executive officers, and other related or selected persons.

4.5 Exemptions From Registration

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

Regulation D consolidates several *limited offering exemptions* and encompasses Rules 501 through 506. The first two of these define common terms and set out general conditions. Rule 503 describes the Form D filing that is required. The final three Rules describe the exemptions. The following are general conditions that govern circumstances for all Regulation D exemptions:

- Attempted compliance with a rule does not create an exclusive election, and other exemptions may be asserted.
- Compliance with a rule creates no exemption from other federal securities provisions, such as antifraud and civil liabilities, or from blue sky laws.
- The exemptions apply only to transactions by the issuer of the securities, not to the securities themselves or to resales, except that resales may be made for Rule 504 securities registered under blue sky laws.

Practitioners should be alert to advise their clients that exempt transactions and issues of exempt securities are still subject to state antifraud

and blue sky laws as well as to the antifraud portions of federal securities law whenever the telephone, mail, or other instrumentalities of interstate commerce are used to offer, sell, or buy securities. The relevant portions of federal regulation are Section 10b of the 1934 act and SEC Rule 10b-5, which discuss the most commonly encountered exemptions.

4.5.1 Accredited investors

Various provisions of securities regulation confer special status and treatment for potential purchasers of securities who are designated “accredited investors.” For example, accredited investors do not have to be counted when determining the thirty-five-purchaser limitation referred to in Rules 505 and 506. Certain institutional investors and certain large investors are called accredited investors for purposes of the exemptions under Rules 505 and 506 and Section 4(6). These institutional investors are

- Banks (including those acting as fiduciaries).
- Investment companies.
- Insurance companies.
- Small business investment companies.
- Practically all employee-benefit plans subject to Title I of ERISA.
- Tax-exempt organizations having assets exceeding \$5 million.
- Savings and loan associations supervised by a state or federal authority.
- Broker-dealers registered with the SEC under the 1934 act.
- Corporations, partnerships, or business trusts with total assets exceeding \$5 million, provided the entity has not been formed solely for the purchase.
- Trusts, other than business trusts, with assets that exceed \$5 million and that are directed by a “sophisticated” person.
- Governmental employee benefit plans having assets exceeding \$5 million.

These are also considered accredited investors:

- Directors, general partners, or executive officers of the issuer
- Natural (not corporate) persons whose net worth, individually or jointly with a spouse, exceeds \$1 million or whose annual income exceeds \$200,000 (individually) or \$300,000 (jointly)

The Small Business Investment Incentive Act of 1980 added Section 4(6) to the 1933 act to provide exemption from registration for transactions involving offers or sales solely to accredited investors if the offering price does not exceed \$5 million and there is no advertising or public solicitation. A single offer or sale to a nonaccredited investor will invalidate this exemption. Form D must be filed. This exemption appears to be equivalent to SEC Rule 506.

4.5.2 Intrastate offerings

For this exemption to apply, the issuer and all offerees (and purchasers) of the exempted securities must be residents of the same state. In the case of a corporate issuer, both its principal place of business and its incorporation must be in the state. For offerees who are noncorporate business entities, only their principal place of business need be located in the state; for individuals, their principal residence. SEC Rule 147 requires that 80 percent of the proceeds be used in the state. The exemption is lost if a resale to a nonresident takes place within nine months after the last sale made in the same state.

4.5.3 Judicially approved exchanges

A relatively narrow exemption from registration is available under the 1933 act, Section 3(a)(10), when a judicial or federal or state administrative authority approves, as for example in a reorganization. This exemption has been used for court-approved settlements of private litigation.

4.5.4 Private placements

Section 4(2) of the 1933 act exempts transactions when there is no public offering (that is, no general solicitation). Offerings relying on this exemption will be made to sophisticated institutional and private investors who have access to the kind of information that would otherwise have to be provided in the registration documents. Since the statute itself does not identify what would constitute a nonpublic offering, the benefits of this section are of less certain operation than exemption under Rule 506, which is somewhat similar in its intent. For example, resale within a short period of time of the securities that were the subject of a private placement may cause the seller to be deemed an underwriter and may relate back and destroy the private placement exemption. The SEC's Rule 144 operates to provide protection against these unintended consequences. (See section 4.6, below.)

4.5.5 Rule 506

Characteristics of the securities offerings under Rule 506 include these:

- No limit on size of offering
- No limit on sales to accredited investors
- Sales to no more than thirty-five “sophisticated” investors
- Prohibition against solicitation to the general public
- Requirement of certain disclosures, unless all sales are made to the accredited investors
- Form D filing with the SEC

The “sophisticated” investors must be of sufficient business and investment acumen to be capable of evaluating the rewards and risks of the investments. In this task they may utilize the assistance of a personal financial adviser or a purchaser representative. According to Rule 506(b), each purchaser who is not an accredited investor either alone or with his purchaser representative(s) has such knowledge and experience in financial and business matters that he is capable of evaluating the merits and risks of the prospective investment, or the issuer reasonably believes immediately before making any sale that such purchaser comes within this description.

Prior to sale of the securities, a disclosure document must be delivered to the prospective purchaser. Rule 506 provides a safe harbor for offerings that satisfy its requirements. Despite failure to qualify under some provision of Rule 506, an exemption under a similar provision, for example, Section 4(2) concerning private placements, may still be available. Securities issued under Rule 506 are restricted as to resale by purchasers.

4.5.6 Small issues

To facilitate access to the capital markets by small businesses, several avenues are available to the small issuer or to the issuer of small amounts of securities. In addition to the rules discussed below, see the sections in this chapter that cover accredited investors, intrastate offerings, private placements, and simplified registration.

Rule 504. The exemption under Rule 504 carries these conditions:

- Form D must be filed with the SEC.
- Issuer cannot be an investment company or any company otherwise required to report to the SEC.
- Issue is limited to \$1 million offering and sale within a twelve-month period.

- General solicitation is permitted if made in states that require registration and delivery of a disclosure document.
- Disclosure document need not be distributed if no general solicitation is made, unless required by state law.
- Resale of these securities by the purchaser is not restricted.

Rule 505. The conditions for a Rule 505 exemption are

- Limitation to \$5 million in a twelve-month period.
- No restrictions on number of offerees to which offering can be made so long as there is no general solicitation or advertising.
- Purchasers limited to thirty-five except for accredited investors.
- No limit to the number of purchasers who are accredited investors.
- If any sale is made to a nonaccredited investor, disclosure documents must be provided to all purchasers.
- Not available to issuers who are investment companies or to those guilty of postal or securities fraud.
- Form D must be filed with the SEC.
- Securities are restricted in subsequent resale.

Since the thirty-five nonaccredited investors have to meet no particular standards for sophistication or suitability, this exemption is popular for limited partnerships. Unless formed for the specific purpose of acquiring the offered securities, an entity such as a corporation or partnership counts as one purchaser.

4.5.7 Voluntary exchanges

When an issuer exchanges a new issue of securities exclusively with its existing security-holders, an exemption from registration is provided. Cash paid or received to effect an equivalency of value does not invalidate the exemption. This exemption is not available where

- Remuneration is paid for solicitation, promotion, or underwriting.
- The securities are exchanged in the course of a Bankruptcy Act proceeding.

Technically, such exchanges are exempt transactions (rather than exempt securities). Subsequent resales of these securities by a holder will thus require registration unless shielded by another exemption.

4.5.8 California issuers

Regulation CE provides a registration exemption for offers and sales of securities that comply with the conditions of Section 25102(n) of

the California corporation code. The limit is \$5 million for each offering. This exemption is available to California issuers and non-California issuers having more than half of their property, payroll, and sales in that state. Securities sold under this exemption are restricted securities.

4.5.9 Other exemptions

Exemptions are also available under Section 3(a) of the 1933 act for securities of the following:

- Federal, state, and local governmental bodies and organizations (including certain industrial development bonds)
- Federal Reserve banks
- Certain insurance companies
- Qualified pension, profit, and stock plans and certain Keogh partnership plans
- Notes, drafts, and bankers' acceptances with an original maturity of not more than nine months
- Building and loan associations
- Farmers cooperatives
- Bankruptcy Act certificates
- Many insurance and annuity contracts

These are not blanket exemptions, however, and the securities acts, SEC rules, and court cases may bear on a particular offering. In some cases only an experienced securities attorney can be relied upon for confirmation of the exemption. The Keogh exemption, for example, is available only to firms offering services in the investment banking, pension consulting, investment advising, legal, and accounting fields. In these fields an employer can be expected to have the requisite knowledge and experience to guard his or her own as well as employees' interests. Independent investment advice must nevertheless be secured in setting up the plan.

4.6 Secondary Transactions and Rule 144

Section 4(1) of the 1933 act exempts from registration transactions by "any person other than an issuer, underwriter, or dealer." The term *issuer* includes any person who directly or indirectly controls or is controlled by the issuer. An *underwriter* is any person who purchases from an issuer "with a view to, or offers or sells for an issuer in connection

with, the distribution of any security.” Thus nonissuers and nonunderwriters can distribute securities in transactions deemed exempt under this section.

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

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

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

Rule 144A provides a safe harbor from registration requirements for the resale of unregistered securities to a *qualified institutional investor*

acting for its own account. A qualified institutional investor is one that has \$100 million in securities under its discretionary management or, subject to certain conditions, is a registered securities dealer, investment company, or bank.

Considerable litigation has resulted regarding Rule 144, and at least one book of substantial length has been devoted entirely to it. Because of varying judicial interpretation, clients must be advised not to place their reliance for an exemption entirely upon the two-year holding period, particularly if they are controlling persons within the context of the SEC rules. If the exemption of a resale transaction is challenged by the SEC, it is a question of fact to be decided by the courts whether a seller of securities originally purchased them with the intent to distribute them. Despite these possible pitfalls, however, most registered broker-dealers will have worked out procedures for safely handling Rule 144 securities and clients may be counseled to rely on these procedures.

4.7 Simplified Registration

Regulation S-B provides two forms for a simplified registration. Financial statements must conform to generally accepted accounting principles but need not comply with the SEC's more stringent requirements stated in Regulation S-X.

Form SB-1 is available for most small business issuers (SBI) that have not previously registered with the SEC. The limit is \$10 million of securities issued for cash in any continuous twelve-month period. SB-2 can be used for an unlimited cash issuance by an SBI. A small business issuer is a U. S. or Canadian company, other than an investment company, that has revenue of less than \$25 million and a public float of securities less than \$25 million.

Regulation A provides another type of simplified registration—in effect, a miniregistration. Its features are these:

- It allows aggregate offerings, within a twelve-month period, to \$5 million by the issuer, its affiliates that became such within the last two years, and its predecessors. Additionally, included in the \$5 million limitation are certain secondary distributions by affiliates and other exempt securities sold under Section 3(b) of the 1933 act (Rule 504 or 505).
- It provides for lower limits for securities offered on behalf of nonaffiliated persons other than the issuer. These are
 - \$100,000 on behalf of any person; \$300,000 for all such persons.
 - \$500,000 limit if offering person is an estate.

- Solicitation of investor interest allowed prior to filing of an offering statement containing the offering circular used to sell the securities.
- Filings are made with and reviewed by regional SEC offices.
- State registration will ordinarily be required.
- Financial statements need not be certified but must conform to generally accepted accounting principles.
- Financial statements must include a balance sheet prepared within ninety days of the filing and profit and loss statements for the two preceding fiscal years.
- Financial statement specifications can be found in SEC Form 1-A.
- An offering circular must be provided to prospective purchasers.

Many attorneys believe the costs of filing and the necessity for approval by the SEC, when compared to the small size of the allowed offering, argue against the use of Regulation A registration in cases where an exemption can be found within Regulation D.

5. THE SECURITIES EXCHANGE ACT OF 1934

5.1 Overview

The Securities Exchange Act of 1934, cited hereafter as the 1934 act, prescribes registration and reporting requirements for issuers of certain securities by securities dealers, securities exchanges, and self-regulatory organizations (the only one to date being the National Association of Securities Dealers). The act in addition concerns itself with proxy solicitation, tender offers, insider profits, and manipulative and fraudulent practices. The 1934 act established the SEC.

from -50 to +400 percent on a representative group of IPOs in a recent six-month period.

After notifying the SEC and conforming with strict guidelines, the underwriter is allowed to stabilize the price of the newly issued stock by entering buy orders just below the offering price. Resales of stock obtained by the underwriter through stabilization must be made below the stabilization price.

9.10 Public Trading

The following are the New York Stock Exchange minimum listing requirements:

- At least 1 million shares publicly held
- At least 2,000 shareholders
- Total market value of shares, \$16 million
- Net assets, at least \$18 million
- Pretax net income, \$2.5 million

The following are the American Stock Exchange minimum listing requirements:

- At least 300,000 shares publicly held
- At least 900 shareholders
- Total market value of shares, \$2.5 million
- Net assets, at least \$4 million
- Pretax net income, \$750,000

The following are the National Association of Securities Dealers Automated Quotation System (NASDAQ) requirements:

- At least 100,000 shares publicly held
- At least 300 shareholders
- \$1 million corporate net worth
- \$2 million assets
- Two or more market makers

There are no formal requirements for listing in the pink sheets—a daily service offered by the National Quotation Bureau. Quotes in the sheets are gathered from market makers on each of about 15,000 unlisted stocks.

REFERENCES

- Afterman, Allan B. *SEC Regulation of Public Companies*. New York: Prentice Hall, 1994.
- AICPA. *SEC Reporting*. CPE Course Manual. New York: American Institute of Certified Public Accountants, 1994.
- Bloomenthal, Harold S. *Going Public Handbook, 1993*. New York: Clark Boardman Callaghan, 1993.
- . *Securities and Federal Corporate Law*. 4 vols. Revision. New York: Clark Boardman Callaghan. Looseleaf service.
- Blue Sky Law*. 2 vols. New York: Clark Boardman Callaghan. Looseleaf service.
- Capital Changes Reporter*. Chicago: Commerce Clearing House. Looseleaf service.
- Causey, Denzil Y., Jr. *Duties and Liabilities of Public Accountants*, 5th ed. State College, Miss.: Accountant's Press, 1995.
- Federal Securities Law Reporter*. Chicago: Commerce Clearing House. Looseleaf service.
- Fippinger, Robert A. *The Securities Law of Public Finance*. New York: Practising Law Institute, 1993.
- Gadsby, Edward N. *Federal Securities Exchange Act of 1934*. 10 vols. New York: Matthew Bender. Looseleaf service.
- Haft, Robert J. *Analyses of Key SEC—No Action Letters: 1992–93 Ed.* (Securities Law Services). New York: Clark Boardman Callaghan, 1992.
- Hazen, Thomas Lee. *Law of Securities Regulation*, 3d ed. St. Paul, Minn.: West Publishing Company, 1996.
- Janvey, Ralph S. *Securities Law Digest*. Boston: Warren, Gorham & Lamont, 1994.
- Jennings, Richard W. *Federal Securities Laws, Selected Statutes, Rules and Forms, 1991*. Westbury, N.Y.: Foundation Press, Inc., 1996.
- . *Securities, Regulation, Cases and Materials, 1993 Supplement* (Continuing Selected Cases, Releases, and Other Materials Under the Federal Securities Laws), 7th ed. Westbury, N.Y.: Foundation Press, 1996.
- Prifti, William A. *Securities: Public and Private Offerings*, 2d ed. New York: Clark Boardman Callaghan, 1995. Looseleaf service.
- Ratner, David L. *Securities Regulation, 1996 Supplement*, 4th ed. St. Paul, Minn.: West Publishing Company, 1996.

- . *Securities Regulation in a Nutshell*, 4th ed. St. Paul, Minn.: West Publishing Company, 1992.
- Rice, Denis T. *Securities Regulation Forms*. New York: Clark Boardman Callaghan, 1988. Looseleaf with forms on disk.
- Richter, Robert. *SEC Accounting and Reporting Manual*. New York: Warren, Gorham & Lamont. Looseleaf service.
- SEC Accounting Rules*. Chicago: Commerce Clearing House. Looseleaf service.
- SEC Compliance—Financial Planning and Forms*. Warren, Gorham & Lamont. Looseleaf service.
- SEC Today*. Washington, D.C.: Washington Service Bureau, Inc. Looseleaf service.
- Securities Regulations*. New York: Warren, Gorham & Lamont. Looseleaf service.
- Securities Regulation Reporter*. 5 vols. New York: Matthew Bender. Looseleaf service.
- Securities Regulation and Law Report*. Washington, D.C.: Bureau of National Affairs. Looseleaf service.
- Soderquist, Larry D. *Securities Regulation*, 1996 Supplement (Containing Statutes, Rules and Forms, and Selected New Material), 2d ed. Westbury, N.Y.: Foundation Press, 1996.
- . *Understanding the Securities Laws*, 3d ed. New York: Practising Law Institute, 1993.
- Sowards, Hugh L., and Matthew Bender's Editorial Staff. *Blue Sky Regulation*. 4 vols. New York: Matthew Bender. Looseleaf service.
- . *Federal Securities Acts—Treatise and Primary Source Manual*. 6 vols. New York: Matthew Bender. Looseleaf service.
- Steinberg, Marc I., and Ralph C. Ferrara. *Securities Practice—Federal and State Enforcement*. New York: Clark Boardman Callaghan, 1990. Looseleaf service.
- Steinberg, Marc I. *Securities Regulation*, 2d ed. New York: Matthew Bender, 1993.

DK-1
4/1/99

ACCOUNTANT'S BUSINESS MANUAL
Supplement 22, November 1998
Volume 1

FILING INSTRUCTIONS

This is the twenty-second supplement for the Accountant's Business Manual. Check the filing instructions tab in your book for the Filing Instructions for Supplement 21. If you did not receive and file Supplement 21, do not try to file the pages of Supplement 22.

Remove Old Pages

~~Half-title page
iii-iv (Title and Copyright pages)
v (Preface to Supplement 21)
xiii to xxv (Table of Contents)~~

Insert New Pages

Half-title page
iii-iv (Title and Copyright pages)
v (Preface to Supplement 22)
xiii to xxv (Table of Contents)
Dear Subscriber
Moving?

Obtaining Financing

~~27 to 28
35 to 37~~

27 to 28
35 to 37

Business Valuation

~~53 to 55
61 to 64~~

53 to 55
61 to 64

Investment Vehicles

~~15 to 20.2
27 to 28
46.1 to 48
55 to 57~~

15 to 20.2
27 to 28
47 to 48.2
55 to 57

**Employee Retirement & Deferred
Compensation Plans**

~~1 to 4
7 to 12
15 to 28
35 to 44
47 to 48
57 to 58
61 to 62
65 to 70.1
77 to 78
81 to 90
97 to 100~~

1 to 4
7 to 12
15 to 28.1
35 to 44
47 to 48
57 to 58
61 to 62
65 to 70.1
77 to 78
81 to 90
97 to 100

Remove Old Pages

Insert New Pages

Employment Regulations

~~9 to 10
27 to 42~~

9 to 10
27 to 42

Workers' Compensation

~~11 to 37~~

11 to 37

Unemployment Insurance

~~9 to 10
13 to 18
21 to 25~~

9 to 10
13 to 18
21 to 25

Trusts

~~23 to 24
29 to 32~~

23 to 24
29 to 32

Estate Planning

~~23 to 24~~

23 to 24.1

**Social Security And Other Issues
Facing Elderly or Disabled Clients**

~~1 to 50~~

1 to 41

This completes Supplement filing for Volume 1. Please see the Filing Instructions for the Volume 2 pages included with this package and begin filing the Volume 2 portion of Supplement 22.

Upon completion, insert these pages behind the Filing Instructions tab card in Volume 1.

ACCOUNTANT'S BUSINESS MANUAL
Supplement 21, May 1998
Volume 1

FILING INSTRUCTIONS

This is the twenty-first supplement for the Accountant's Business Manual. Check the filing instructions tab in your book for the Filing Instructions for Supplement 20. If you did not receive and file Supplement 20, do not try to file the pages of Supplement 21.

Remove Old Pages

Half-title page
iii-iv (Title and Copyright pages)
v (Preface to Supplement 20)
xiii to xxv (Table of Contents)

Insert New Pages

Half-title page ✓
iii-iv (Title and Copyright pages) ✓
v (Preface to Supplement 21) ✓
xiii to xxv (Table of Contents) ✓
Dear Subscriber
Moving? ✓

Sole Proprietorships

3 to 14
19 to 32
37 to 38.1

3 to 14.1 ✓
19 to 32.1 ✓
37 to 38.1 ✓

Partnerships

3 to 8
19 to 24
27 to 36
47 to 52

3 to 8.1 ✓
19 to 24.1 ✓
27 to 36.4 ✓
47 to 52 ✓

Corporations

1 to 28

1 to 28.3 ✓

S Corporations

1 to 42

1 to 41 ✓

Business Valuation

1 to 2
27 to 28
31 to 32
41 to 44
53 to 56

1 to 2 ✓
27 to 28 ✓
31 to 32.1 ✓
41 to 44 ✓
53 to 55 ✓

OK
5/19/98

Remove Old Pages

Insert New Pages

**Employee Retirement & Deferred
Compensation Plans**

| | | |
|----------|----------|---|
| 49 to 50 | 49 to 50 | ✓ |
| 71 to 72 | 71 to 72 | ✓ |
| 103 | 103 | ✓ |

Employment Regulations

| | | |
|----------|----------|---|
| 33 to 34 | 33 to 34 | ✓ |
|----------|----------|---|

Hiring Foreign Nationals

| | | |
|----------|------------|---|
| 1 to 3 | 1 to 3 | ✓ |
| 9 to 38 | 9 to 37 | ✓ |
| 45 to 52 | 45 to 52.1 | ✓ |
| _____ | 59 to 60 | ✓ |

Insurance

| | | |
|--------------|--------------|---|
| 11 to 12 | 11 to 12 | ✓ |
| 15 to 16 | 15 to 16 | ✓ |
| 20.1 to 20.2 | 20.1 to 20.2 | ✓ |
| 35 to 38 | 35 to 38 | ✓ |

Trusts

| | | |
|----------|----------|---|
| 23 to 24 | 23 to 24 | ✓ |
|----------|----------|---|

Estate Planning

| | | |
|----------|----------|---|
| 31 to 34 | 31 to 34 | ✓ |
|----------|----------|---|

Social Security

| | | |
|----------|------------|---|
| 13 to 18 | 13 to 18.1 | ✓ |
| 35 to 36 | 35 to 36 | ✓ |
| 45 to 46 | 45 to 46 | ✓ |

Securities Regulation

| | | |
|----------|----------|---|
| 19 to 20 | 19 to 20 | ✓ |
|----------|----------|---|

This completes Supplement filing for Volume 1. Please see the Filing Instructions for the Volume 2 pages included with this package and begin filing the Volume 2 portion of Supplement 21.

Upon completion, insert these pages behind the Filing Instructions tab card in Volume 1.

ACCOUNTANT'S BUSINESS MANUAL
Supplement 20, November 1997
Volume 1

FILING INSTRUCTIONS

This is the twentieth supplement for the Accountant's Business Manual. Check the filing instructions tab in your book for the Filing Instructions for Supplement 19. If you did not receive and file Supplement 19, do not try to file the pages of Supplement 20.

Remove Old Pages

Half-title page
iii-iv (Title and Copyright pages)
v (Preface to Supplement 19)
xiii-xxv (Table of Contents)

Insert New Pages

~~Half-title page
iii-iv (Title and Copyright pages)
v (Preface to Supplement 20)
xiii-xxv (Table of Contents)
Dear Subscriber
Moving?~~

Sole Proprietorships

9 to 10
17 to 18

~~9 to 10
17 to 18~~

Partnerships

35 to 36
47 to 50

~~35 to 36
47 to 50~~

Corporations

1 to 2
5 to 8.3
29 to 30

~~1 to 2
5 to 8.3
29 to 30~~

S Corporations

5 to 14.2

~~5 to 14.2~~

Investment Vehicles

1 to 2
17 to 20
32.1 to 32.2
46.1

~~1 to 2
17 to 20.2
32.1 to 32.2
46.1~~

Remove Old Pages

Insert New Pages

**Employee Retirement & Deferred
Compensation Plans**

3 to 4
13 to 14
35 to 38
47 to 52
57 to 64
69 to 70.1
75 to 76

~~3 to 4~~
~~13 to 14~~
~~35 to 38~~
~~47 to 52.1~~
~~57 to 62~~
~~69 to 70.1~~
~~75 to 76~~

Employment Regulations

9 to 14.1
20.1 to 20.2
27 to 43

~~9 to 14.1~~
~~20.1 to 20.2~~
~~27 to 42~~

Workers' Compensation

11 to 36

~~11 to 37~~

Unemployment Insurance

7 to 10
15 to 16
21 to 25

~~7 to 10.1~~
~~15 to 16~~
~~21 to 25~~

Trusts

11 to 12
21 to 24

~~11 to 12.1~~
~~21 to 24.1~~

Estate Planning

1 to 3
17 to 18
23 to 36
40.5 to 40.6

~~1 to 3~~
~~17 to 18.1~~
~~23 to 36.2~~
~~40.5 to 40.6~~

Social Security

1 to 6
11 to 16
19 to 20
29 to 32
35 to 36
39 to 40
47 to 50

~~1 to 6~~
~~11 to 16~~
~~19 to 20~~
~~29 to 32~~
~~35 to 36.1~~
~~39 to 40~~
~~47 to 50~~

Remove Old Pages

Insert New Pages

Human Resources

1 to 2
7 to 8
19 to 22
27 to 30

~~1 to 2~~
~~7 to 8~~
~~19 to 22~~
~~27 to 30~~

Index

Please delete and discard the Index pages and Index tab card in Volume 1. The Index will now reside only in Volume 2.

This completes Supplement filing for Volume 1. Please see the Filing Instructions for the Volume 2 pages included with this package and begin filing the Volume 2 portion of Supplement 20.

Upon completion, insert these pages behind the Filing Instructions tab card in Volume 1.

CAD
12/10/97

ACCOUNTANT'S BUSINESS MANUAL
Supplement 19, May 1997
Volume 1

FILING INSTRUCTIONS

This is the nineteenth supplement for the Accountant's Business Manual. Check the filing instructions tab in your book for the Filing Instructions for Supplement 18. If you did not receive and file Supplement 18, do not try to file the pages of Supplement 19.

Remove Old Pages

Half-title page
iii-iv (Title and Copyright pages)
v (Preface to Supplement 18)
xiii-xxv (Table of Contents)

Insert New Pages

Half-title page
iii-iv (Title and Copyright pages)
v (Preface to Supplement 19)
xiii-xxv (Table of Contents)
Dear Subscriber
Moving?

Sole Proprietorships

| | |
|----------|------------|
| 7 to 8 | 7 to 8.1 |
| 15 to 16 | 15 to 16.1 |
| 19 to 20 | 19 to 20 |
| 31 to 34 | 31 to 34 |

Partnerships

| | |
|----------|------------|
| 5 to 6 | 5 to 6 |
| 29 to 30 | 29 to 30.1 |
| 39 to 42 | 39 to 42 |

Corporations

| | |
|----------|----------|
| 1 to 2 | 1 to 2 |
| 5 to 6 | 5 to 6 |
| 21 to 24 | 21 to 24 |
| 27 to 28 | 27 to 28 |

Limited Liability Companies

| | |
|---------|---------|
| 1 to 26 | 1 to 20 |
|---------|---------|

Obtaining Financing

| | |
|----------|------------|
| 1 to 2 | 1 to 2.1 |
| 7 to 8 | 7 to 8.1 |
| 19 to 22 | 19 to 22.1 |
| 25 to 26 | 25 to 26.1 |
| 35 to 37 | 35 to 37 |

Remove Old Pages

Insert New Pages

Investment Vehicles

1 to 4
23 to 32
39 to 46
53 to 58

1 to 4
23 to 32.2
39 to 46.1
53 to 57

Employee Retirement & Deferred Compensation Plans

1 to 34
39 to 44
51 to 56
59 to 66
85 to 90
97 to 100
103

1 to 33
39 to 44
51 to 56
59 to 66
85 to 90
97 to 100
103

Trusts

1 to 28

1 to 32

Estate Planning

1 to 40.7

1 to 40.12

Human Resources

1 to 26.5
41 to 42

1 to 26.10
41 to 42

Securities Regulation

1 to 2
21 to 26.2
53 to 56

1 to 2
21 to 26.2
53 to 55

Index

1 to 36

1 to 36

File in 5-20-97

This completes Supplement filing for Volume 1. Please see the Filing Instructions for the Volume 2 pages included with this package and begin filing the Volume 2 portion of Supplement 19.

Upon completion, insert these pages behind the Filing Instructions tab card in Volume 1.

ACCOUNTANT'S BUSINESS MANUAL
Supplement 18, November 1996
Volume 1

FILING INSTRUCTIONS

This is the eighteenth supplement for the Accountant's Business Manual. Check the filing instructions tab in your book for the Filing Instructions for Supplement 17. If you did not receive and file Supplement 17, do not try to file the pages of Supplement 18.

Remove Old Pages

~~Half-title page~~
~~iii-iv (Title and Copyright pages)~~
~~v (Preface to Supplement 17)~~
~~xiii-xxv (Table of Contents)~~

Insert New Pages

Half-title page
iii-iv (Title and Copyright pages)
v (Preface to Supplement 18)
xiii-xxv (Table of Contents)
~~Dear Subscriber~~
Moving?

Sole Proprietorships

| | |
|--------------------|---------|
| 9 to 10 | 9 to 10 |
| 38.1 | 38.1 |

Partnerships

| | |
|---------------------|----------|
| 35 to 36 | 35 to 36 |
| 47 to 50 | 47 to 50 |

S Corporations

| | |
|----------------------|------------|
| 1 to 14.1 | 1 to 14.2 |
| 17 to 20 | 17 to 20.1 |
| 23 to 24 | 23 to 24 |
| 31 to 41 | 31 to 42 |

Limited Liability Companies

| | |
|---------------------|-----------|
| 3 to 4 | 3 to 4 |
| 9 to 10 | 9 to 10.1 |
| 19 to 20 | 19 to 20 |
| 25 to 26 | 25 to 26 |

Obtaining Financing

| | |
|---------------------|----------|
| 27 to 28 | 27 to 28 |
|---------------------|----------|

Remove Old Pages

Insert New Pages

Bankruptcy/Insolvency

~~63~~ to 64

63 to 64

Employee Retirement & Deferred Compensation Plans

~~23~~ to 24

23 to 24

~~69~~ to 70

69 to 70.1

~~77~~ to 78

77 to 78

~~85~~ to 86

85 to 86

I unfiled these, because each one has 2 sections ↓

Employment Regulations

~~7~~ to 14

7 to 14.1

~~19~~ to 20.2

19 to 20.2

~~25~~ to 43

25 to 43

Workers' Compensation

~~11~~ to 36

11 to 36

Unemployment Insurance

~~1~~ to 25

1 to 25

Insurance

~~15~~ to 20.1

15 to 20.3

Trusts

~~11~~ to 14

11 to 14

Two sections

Social Security

~~5~~ to 6

5 to 6

~~11~~ to 22

11 to 22.2

~~29~~ to 32

29 to 32

~~35~~ to 40

35 to 40.1

~~45~~ to 46

45 to 46

Remove Old Pages

Insert New Pages

Index

~~1~~ to 35

1 to 36

Blum 2-7-97

This completes Supplement filing for Volume 1. Please see the Filing Instructions for the Volume 2 pages included with this package and begin filing the Volume 2 portion of Supplement 18.

Upon completion, insert these pages behind the Filing Instructions tab card in Volume 1.

2 leaf
5/29/96

ACCOUNTANT'S BUSINESS MANUAL
Supplement 17, May 1996
Volume 1

FILING INSTRUCTIONS

This is the seventeenth supplement for the Accountant's Business Manual. Check the filing instructions tab in your book for the Filing Instructions for Supplement 16. If you did not receive and file Supplement 16, do not try to file the pages of Supplement 17.

Before filing these pages please do the following:

- 1. Remove the tab card and entire chapter for Financial Mathematics in Volume 1. Insert the tab card and entire chapter immediately following the IRS Practice and Procedure chapter in Volume 2.**
- 2. Remove the tab card and entire chapter for Securities Regulation in Volume 1. Turn the tab card upside down so that the tab is at the bottom. Insert the tab card and entire chapter immediately following the Human Resources chapter in Volume 1.**
- 3. Insert the new tab card for Limited Liability Companies immediately following the S Corporations chapter in Volume 1.**

Complete filing of Supplement 17 as indicated below.

Remove Old Pages

Insert New Pages

Half-title page
iii-iv (Title and Copyright pages)
v (Preface to Supplement 16)
xiii-xxv (Table of Contents)

~~Half-title page~~
~~iii-iv (Title and Copyright pages)~~
~~v (Preface to Supplement 17)~~
~~xiii-xxv (Table of Contents)~~
~~Dear Subscriber~~
~~Moving?~~

Partnerships
7 to 12.1

~~7 to 12~~

Corporations
5 to 6

~~5 to 6~~

Remove Old Pages

Insert New Pages

S Corporations

1 to 14
21 to 41

~~1~~ to 14.1
~~21~~ to 41

Limited Liability Companies

~~Insert new tab card and chapter pages 1-26 immediately after the S Corporations chapter.~~

Investment Vehicles

3 to 4
9 to 10
15 to 18
23 to 24
47 to 57

~~3~~ to 4
~~9~~ to 10
~~15~~ to 18.1
~~23~~ to 24
~~47~~ to 58

Bankruptcy/Insolvency

3 to 4
21 to 22
33 to 34
45 to 48
53 to 54
61 to 62
67 to 69

~~3~~ to 4
~~21~~ to 22
~~33~~ to 34
~~45~~ to 48
~~53~~ to 54
~~61~~ to 62
~~67~~ to 69

Employee Retirement & Deferred Compensation Plans

5 to 6
9 to 14
23 to 26
33 to 34
37 to 44
47 to 54
57 to 62
65 to 66
69 to 70
79 to 80
85 to 90
97 to 104

~~5~~ to 6
~~9~~ to 14
~~23~~ to 26
~~33~~ to 34
~~37~~ to 44
~~47~~ to 54
~~57~~ to 62
~~65~~ to 66
~~69~~ to 70
~~79~~ to 80
~~85~~ to 90
~~97~~ to 103

Remove Old Pages

Insert New Pages

Insurance

1 to 3
9 to 10
17 to 20
27 to 30
35 to 36
39 to 41

~~1~~ to 3
~~8~~ to 10
~~17~~ to 20.1
~~27~~ to 30.1
~~35~~ to 36
~~39~~ to 41

Trusts

1 to 8.1
14.1 to 14.3
17 to 22.1

~~1~~ to 8.1
~~14.1~~ to 14.3
~~17~~ to 22.2

Estate Planning

1 to 3
11 to 26
30.1 to 30.3
35 to 40.6
57 to 58

~~1~~ to 3
~~12~~ to 26.2
~~30.1~~ to 30.4
~~35~~ to 40.7
~~57~~ to 58

Social Security

11 to 12

~~11~~ to 12

Human Resources

1 to 2
25 to 26
—

~~1~~ to 2.1
~~25~~ to 26.5
~~55~~ to 60

Index

1 to 34

~~1~~ to 35

This completes Supplement filing for Volume 1. Please see the Filing Instructions for the Volume 2 pages included with this package and begin filing the Volume 2 portion of Supplement 17.

Upon completion, insert these pages behind the Filing Instructions tab card in Volume 1.

Z Roy?
1/11/96

ACCOUNTANT'S BUSINESS MANUAL
Supplement 16, November 1995
Volume 1

FILING INSTRUCTIONS

This is the sixteenth supplement for the Accountant's Business Manual. Check the filing instructions tab in your book for the Filing Instructions for Supplement 15. If you did not receive and file Supplement 15, do not try to file the pages of Supplement 16.

Complete filing instructions as below.

Remove Old Pages

- ~~Half-title page~~
- ~~iii-iv (Title and Copyright pages)~~
- ~~v (Preface to Supplement 15)~~
- ~~xvii-xxv (Table of Contents)~~

Insert New Pages

- Half-title page
- iii-iv (Title and Copyright pages)
- v (Preface to Supplement 16)
- xvii-xxv (Table of Contents)
- Dear Subscriber
- Moving?

Sole Proprietorships

- ~~9 to 14~~
- ~~18.1~~
- ~~29 to 34~~
- ~~37 to 38~~

- 9 to 14
- 18.1
- 29 to 34
- 37 to 38

Partnerships

- ~~7 to 8~~
- ~~11 to 12~~
- ~~23 to 24~~
- ~~29 to 30~~
- ~~33 to 36~~
- ~~39 to 42.1~~
- ~~49 to 50~~

- 7 to 8
- 11 to 12
- 23 to 24
- 29 to 30
- 33 to 36
- 39 to 42
- 49 to 50

S Corporations

- ~~7 to 10.1~~
- ~~25 to 26~~
- ~~29 to 32~~
- ~~39 to 41~~

- 7 to 10.1
- 25 to 26
- 29 to 32.1
- 39 to 41

Remove Old Pages

Insert New Pages

Business Valuation

| | |
|---------------------|----------|
| 11 to 12 | 11 to 12 |
| 25 to 26 | 25 to 26 |
| 31 to 32 | 31 to 32 |

Employment Regulations

| | |
|----------------------|-----------|
| 1 to 2 | 1 to 2 |
| 7 to 20.1 | 7 to 20.2 |
| 28 to 42 | 23 to 43 |

Workers' Compensation

| | |
|---------------------|----------|
| 11 to 35 | 11 to 36 |
|---------------------|----------|

Unemployment Insurance

| | |
|---------------------|----------|
| 9 to 12 | 9 to 12 |
| 15 to 18 | 15 to 18 |
| 21 to 25 | 21 to 25 |

Trusts

| | |
|---------------------|----------|
| 5 to 8 | 5 to 6 |
| 9 to 10 | 9 to 10 |
| 19 to 20 | 19 to 20 |
| 25 to 28 | 25 to 28 |

Social Security

| | |
|---------------------|----------|
| 5 to 6 | 5 to 6 |
| 11 to 16 | 11 to 16 |
| 19 to 20 | 19 to 20 |
| 29 to 32 | 29 to 32 |
| 35 to 36 | 35 to 36 |
| 39 to 40 | 39 to 40 |
| 45 to 50 | 45 to 50 |

Index

| | |
|--------------------|---------|
| 1 to 33 | 1 to 34 |
|--------------------|---------|

This completes Supplement filing for Volume 1. Please see the Filing Instructions for the Volume 2 pages included with this package and begin filing the Volume 2 portion of Supplement 16.

Upon completion, insert these pages behind the Filing Instructions tab card in Volume 1.