Tax News
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BAKER DONELSON
BEARMAN, CALDWELL & BERKOWITZ, PC
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In this issue:

Can You Deduct Losses from Failed Investments?

Nedom A. Haley 404.221.6505
nhaley@bakerdonelson.com Atlanta, GA

In the current economic climate, many investors have suffered losses on investments and from uncollectible debts. The deductibility of such losses depends on the nature of the investment, whether the investment is a capital asset, whether the investment is totally worthless, the nature of the investor (e.g. individual, corporation or other artificial entity).

It is important to keep in mind the distinction between a bad debt and a loss. The deductibility of losses is governed by IRC§165, while the deduct-

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An In-Depth Look at Employee Benefit Plans and Unclaimed Property Laws

Paul R. O'Rourke 901.577.2313 porourke@bakerdonelson.com Memphis, TN

Some benefits will go unclaimed for many of the companies that maintain employee benefit programs. States generally have the ability to take unclaimed property, through statutes enacted for that purpose, and they are becoming increasingly aggressive in that regard.

However, a federal law known as the Employee Retirement Income Security Act of 1974 (ERISA) arguably limits the application of unclaimed property statutes or similar laws. A plan's resistance to state claims normally will be driven by economic considerations and the positions of federal regulatory agencies – primarily the U.S. Treasury Department/Internal Revenue Service (IRS) and the U.S. Department of Labor (DOL). As discussed below, these agencies don't clearly agree about the circumstances under which a state can take plan assets.

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Recent Decision Further Clouds the Muddy Waters of Annual Exclusion Giving

D. Nathan Smith 601.969.4682 dnsmith@bakerdonelson.com Jackson, MS

Present law allows a donor who desires to make a gift the ability to transfer up to $13,000 per donee, per calendar year, free of the gift tax and without the requirement of filing a gift tax return. *See* IRC § 2503(b). In order to qualify for this annual exclusion, however, the gift must be of a "present interest" in property. Obviously an outright gift of cash would qualify for the exclusion, but many times a donor desires to transfer illiquid assets, or desires to place some restrictions on the use of the property transferred due to the age or maturity level of the donee. In these cases, the availability of the annual exclusion becomes less clear.

The initial annual exclusion battleground between taxpayers and IRS was set when taxpayers asserted that gifts in trust could qualify for the annual exclusion. Despite vigorous opposition by IRS, the courts generally approved such gifts in trust for the exclusion when donees were given an immediate (but temporary) right to withdraw in full the gift which was made in trust. *See Crummey v. Comm'r*, 397 F.2d 82 (9th Cir. 1968).

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Can You Deduct Losses from Failed Investments?, *continued*

ibility of bed debts is governed by IRC§166.

The first question to be answered is whether the investment is a "security," which IRC§165(g) defines as including:

1. Shares of stock of a corporation;
2. The right to subscribe for, or receive, shares of stock of a corporation; or
3. A bond, debenture, note or other evidence of indebtedness to pay a fixed and determinable sum of money, which instrument has been issued with interest coupons or in registered form by a domestic or foreign corporation or my any government or political subdivision thereof.

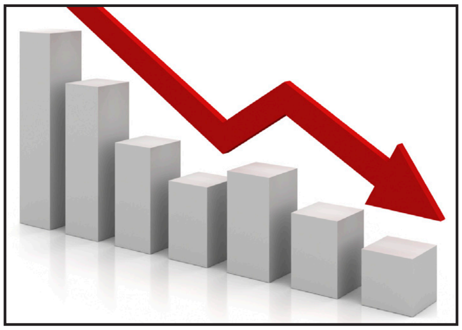
An interest in a partnership or limited liability company is not a security.

The first two elements of this definition should not present any problems in interpretation. With respect to the third, interest coupons have been virtually obsolete since 1982 when Congress imposed severe impediments to issuing bearer bonds. "Registered form" means that ownership can be transferred only on the books of the issuer or on the books of a transfer agent appointed by the issuer. Thus, a negotiable promissory note which may be transferred to a holder in due course without any participation by the obligor is not a "security" in the context of IRC §165(g) even though it may be a security for other purposes of the Internal Revenue Code.

No deduction is permitted for partial worthlessness of a security. The security must be entirely worthless as evidenced by various factors. Such factors may include filing of Chapter 7 bankruptcy, the fact that the liabilities greatly exceed the assets of the corporation and that the corporation has no intrinsic worth.

In addition, the taxpayer must establish that the security had value at the beginning of the taxable year and lost its value during the year.

Alternatively, if the investor cannot establish to the satisfaction of the Service that an investment is wholly



worthless and cannot sell the security in an arms length transaction, the investor may abandon the security. The regulations require that in order to abandon a security, the investor must permanently surrender and relinquish all rights in the security and receive no consideration in exchange for the security. All facts and circumstances determine whether a transaction is properly characterized as an abandonment or other type of transaction.

An individual may deduct a loss for a worthless security only if the loss is (1) incurred in a trade or business, (2) incurred in a transaction entered into for profit, or (3) incurred as a result of casualty or theft.

Losses from worthless securities are usually a loss from the sale or exchange of a capital asset and allowed to the extent of the rules applicable to capital losses. Losses from the following may be claimed as ordinary losses:

1. Securities held by banks;
2. Stock of an affiliated corporation;
3. Securities held be a regulated Small Business Investment Corporation;
4. Stock of a Small Business Investment Corporation; and
5. Section 1244 Stock.

When IRC §165 does not apply because the investment is not a security, IRC§166, dealing specifically with bad debts, may permit a deduction.

Unlike IRC §165, which does not permit deductions unless the investment is wholly worthless, IRC §166 permits a deduction for partially worthless debts when the Internal Revenue Service is satisfied that a debt is recoverable only in part.

A loss, whether from partial or full worthlessness of a debt acquired in the course of a trade or business, is deductible in computing ordinary income. That is not the case for a nonbusiness bad debt. A nonbusiness bad debt is any debt other than (1) a debt created or acquired in connection with a trade or business of the taxpayer, or (2) a debt the loss from the worthlessness of which is incurred in connection with the taxpayer's trade or business.

Where a nonbusiness bad debt become worthless within the taxable year, the loss is classified as a short term capital loss and the availability of a deduction is determined under the rules for capital losses.

No investor makes an investment intending to lose money, but investors should be prepared to prove to the IRS that every effort was made to recover the money invested.

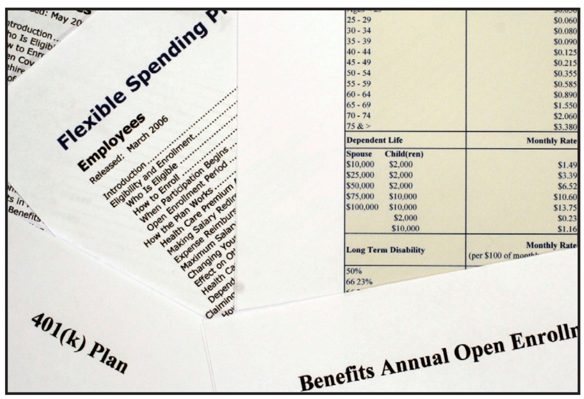
Nedom A. Haley

An In-Depth Look at Employee Benefit Plans and Unclaimed Property Laws, *continued*

Unclaimed Property Statutes and Escheat

At times, a state takes mere possession of unclaimed property. In other cases, a state claims title to the property (historically, this was through a process known as "escheat"). The distinctions between escheat and possession under an unclaimed property statute are becoming increasingly blurred, with the terms being used interchangeably in some circumstances. Each of these processes has its origin in centuries-old feudal times, when a lord or the king could take property under certain circumstances. Modern due process requirements protect the owners of property, and require a more formal process to establish a state claim.

Normally, any transfer of property held by the state to a rightful owner would be without any change in value from the time the custody was previously taken by the state. Although a rightful owner may reclaim the property. because the state has an interest-free loan of the property, it may not be anxious to make a swift transfer.



ERISA provides even further protections against governmental claims to the property of a covered benefit plan.

ERISA Preemption

ERISA sought to establish a uniform national set of rules for specified types of employers and employee benefit plans. In enacting ERISA, Congress wanted to encourage employers to provide benefits to employees, and to create and protect certain participant rights. At the same time, Congress wanted to avoid the burden, expense and inconsistent results which could occur for both employers and employees if different state laws applied from one jurisdiction to the next. ERISA thus prohibits the application of "any and all State laws insofar as they now or hereafter relate to any employee benefit plan…." The term commonly used for this broad prohibition against state involvement in covered employee benefit plans is "ERISA preemption" of state law. There are very narrow exceptions to ERISA preemption of state law, primarily allowing states to enforce insurance, banking and securities laws of general application. Thus, for example, a state may not be able to regulate a benefit plan directly, but within limits it can regulate an insurance company which insures plan benefits. With limited exceptions for multiple employer welfare arrangements (MEWA), ERISA prohibits a benefit plan which an employer self-insures from being treated as an insurance company, thus preventing state regulation of the plan as an insurance company. Principles are slowly evolving to determine when a statute sufficiently "relates to" an employee benefit plan and may thereby be preempted by ERISA.

For What Types of Benefits Might ERISA Preemption Apply

ERISA preemption of state law can exist only when ERISA applies and a plan is involved. Not all types of employee benefits are covered by ERISA, nor are all benefit arrangements a "plan." Employer-sponsored retirement plans (both tax-qualified and non-qualified), severance benefits, medical coverage (including dental, vision, drug, health reimbursement accounts, medical flexible spending accounts, and employee assistance plans which provide counseling), life insurance, and long term disability programs are generally (but not always) subject to ERISA. A few less common other types of benefits may be subject to ERISA in some cases. Thus, in any circumstance involving benefit plan assets, it must be determined whether the state is seeking the assets of a type of plan which is subject to ERISA. There must also be a "plan" involved. As a broad simplification, to have an ERISA plan there must be some administrative discretion which will need to be exercised (e.g., regarding eligibility) and some level of ongoing administration. Thus, for example, a one-time lump sum severance pay agreement between an employer and an employee may be an ERISA-type benefit but not a plan, in which case ERISA preemption could not apply. On the other hand, a general severance pay program may constitute an ERISA plan.

ERISA Does Not Apply to Certain Employers

Just as ERISA does not apply to all types of benefits, neither does it apply to all types of employers. The key exclusions from the application of ERISA are for governmental instrumentalities and "non-electing" church plans. Church plans may elect to be subject to ERISA, a rare and generally irrevocable election which should be considered carefully. ERISA preemption of state law thus could not apply unless the employer is subject to ERISA, so that determination is necessary.

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An In-Depth Look at Employee Benefit Plans and Unclaimed Property Laws, *continued*

The View of The Federal Courts Regarding ERISA Preemption

If both the employer and the type of benefit are subject to ERISA, and if a plan exists, only then may a state's claim to plan assets be preempted by ERISA, but only if the statute sufficiently "relates to" the ERISA plan and only if no exception applies.

The federal courts have been unwilling to permit states to require the application of unclaimed property or escheat laws to apply to ERISA plan assets. In an often-cited court opinion involving an Illinois claim to assets which clearly belonged to an ERISA plan, the court stated that under the Illinois unclaimed property statute "The state does not acquire title to the property. It is merely a custodian….In effect, the property is an interest-free loan to the state – in perpetuity if the owner never shows up to claim it… The state becomes the plan administrator with respect to those assets…in violation of ERISA's provisions regarding plan administration… it depletes those assets, by taking the interest that accrues on them…[and thus]…the state would actually be reducing [participants'] ERISA benefits…. ERISA's preemption clause, and the case law interpreting it, make clear that a state cannot take over the operation of an ERISA plan, no matter how forcefully it argues that it can do a better job than the plan's trustees and administrators."

By contrast, an earlier decision by a different federal appeals court held that the state could claim amounts held in an insurance company's (Aetna) reserve account. The reserve account held money to cover checks written by Aetna for ERISA plan benefits which it had insured. Some of those checks were not cashed for years, at which time the state claimed Aetna's assets which backed the checks. Neither the employer which sponsored the insured group medical plan, nor the plan itself, had any claim to any amounts in the insurance company's reserve account, whether or not the benefit checks were ever cashed. Thus, the plan never had possession of those particular funds, and never would under any circumstances. However, all claim-related amounts paid by Aetna, including amounts paid to the state from Aetna's reserve account under the unclaimed property statute, would be taken into account by Aetna in the claims experience rating of the plan, and thus could increase the plan's future premium costs. The court noted that the statute did not require any significant additional "primary" administration by the plan itself as a result of the state claim, nor did it change the plan benefits. The court then concluded that ERISA preemption did not apply, even though there might be some effect on the plan, because any effect would be too indirect and remote. The court went on to note that this was a traditional exercise of state power and, in the court's view, did not pose a significant threat of inconsistent treatment from state to state. Thus, the state could claim Aetna's assets, at least where the effect on the plan itself was indirect and remote, didn't change plan benefits, and did not add significantly to plan administration.

The U.S. Treasury Department and IRS View

The Treasury Department and the IRS regulate and enforce federal tax laws, including the tax laws which apply to some employee benefit plans. Whether or not ERISA applies to a plan is generally irrelevant for tax law purposes, which have a different purpose and focus than does ERISA. However, there are some tax law rules which merit at least consideration when escheat or unclaimed property statutes might apply.

The federal tax laws regarding employee benefit plans are not *required* to be followed, but the tax effects on the employer and/or the employee are worse if they are not followed. The tax laws do not require the vesting of plan benefits over time, other than for tax-qualified retirement plans. Once vested, tax-qualified retirement plan benefits may not be forfeited or taken from the participant under the plan itself, except under very narrow circumstances. Tax-qualified retirement plan assets are required to be held in a "spendthrift" trust, under which the benefits are free from the claims of creditors or others outside of the plan, again except under very limited circumstances. Among the exceptions allowing at least the conditional loss of a vested benefit is where there is an "inability to find the participant or beneficiary to whom payment is due." In that case, under Treasury Department regulations a plan is permitted to conditionally forfeit even a vested retirement benefit, "provided that the plan provides for reinstatement of the benefit if a claim is made by the participant or beneficiary for the forfeited benefit. In addition, a benefit which is lost by reason of escheat under applicable state law is not treated as [an impermissible] forfeiture." Thus, the Treasury regulations allow a conditional forfeiture inside of the plan (in which case there may be nothing for the state to claim), and also allow a plan to provide for escheat under state law. Although there is no express requirement in the Treasury Regulation that any escheat to the state must be voluntarily, a plan is not required to include such a provision, so the voluntary nature of any escheat appears effectively to be required. It should be noted that there is no similar express provision in the Treasury Regulation permitting a surrender of a retirement plan benefit to a state under an unclaimed property statute, though again those distinctions have blurred.

U. S. Department of Labor

In Advisory Opinion Letter 94-14A, the DOL noted that a Texas unclaimed property statute would directly affect core

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An In-Depth Look at Employee Benefit Plans and Unclaimed Property Laws, *continued*

plan functions and reduce trust assets, and concluded that because the statute did not fall within the exception allowing states to regulate insurance, banking or securities, it could not be applied to take custody of plan assets. Similar conclusions were reached by the DOL in Advisory Opinions 78-32A (Illinois statute), and 79-30A (California statute).

By contrast, in 1983 Advisory Opinion 83-39A, the DOL concluded that the New York Abandoned Property Law was not preempted by ERISA, in circumstances similar to that involved in the Aetna court decision discussed above, where the assets really belonged to an insurance company and the effect of the plan was negligible.

In 1995, the DOL issued a letter to the National Conference of Commissioners on Uniform State Laws, expressing concern that the states were trying to apply the Aetna decision too broadly in developing a model law for unclaimed property. The DOL noted that the proposed law would "significantly interfere with the administration" of ERISA plans if applied directly to a plan, requiring additional records, notices to missing persons and to the states, interest payments, and potentially large penalties and fines. In addition, the DOL noted that turning over custody of plan assets to the state would result in the state holding those assets outside a trust and administered contrary to ERISA. Furthermore, the DOL argued that there was "serious doubt" about the earlier Aetna court decision, because the U. S. Supreme Court had since indicated that any state law is preempted if it relates to an ERISA plan, even if "the effect is only indirect."

The DOL has made it clear that ERISA preemption can apply to any type of ERISA plan. The same principles should apply to both pension and welfare plans, though state involvement in third-party-insured welfare plans should allow more state involvement, both because the assets may be insurance company assets and because a state is generally allowed to enforce insurance statutes of broad application.

If the positions in both Advisory Opinion 83-39A and the 1995 letter to the National Conference of Commissioners on Uniform State Laws remain valid in the view of the DOL, then the Department's general view would be that ERISA preempts all state laws which "relate to" any ERISA plan. However, preemption of state law won't occur where the assets sought by the state are not actually plan assets, provided the statute does not significantly affect the plan, its benefits, its assets or its administration. The DOL has "serious doubt" that even indirect effects on a plan are permitted.

Circumstances Matter

The DOL initially made it clear in Advisory Opinion 94-41A that it did not necessarily agree with the Treasury Department position that escheat of pension plan assets should be permitted. Of course, the focus of these agencies is dramatically different. Where they apply, the tax laws are focused on plan coverage and reasonably equivalent benefits. The DOL is concerned with fiduciary responsibility and the protection of plan assets. As a result, even between federal regulatory agencies there has not always been clear agreement on what is permitted.

However, even the DOL recognizes that sometimes, under some circumstances, someone else has to take control of plan assets. What happens when a plan terminates, benefits need to be distributed to close down the plan and its associated trust, and some participants are missing or nonresponsive? What if the employer will no longer exist, or there will not be any remaining trust to hold the assets separate from the company assets? For tax-qualified account balance plans (like 401(k) plans), if the employer or an affiliated entity has another similar tax-qualified retirement plan, then for tax law purposes if the participant does not consent to a distribution the plan benefit generally must be transferred directly to that other plan of the employer or its affiliate. Such a transfer would keep the assets in a tax-qualified plan and, coincidentally for purposes of this article, in another ERISA-covered plan. ERISA preemption would then continue to apply to those assets in the successor plan.

If there is no other plan of the employer or of some affiliate, then for terminating defined benefit pension plans, there are procedures under which trust assets can be transferred to the Pension Benefit Guaranty Corporation (PBGC), a wholly-owned subsidiary of the United States government and existing by virtue of ERISA. The PBGC then assumes the ultimate liability for payment. There is no known instance where a state sought unclaimed benefits from the PBGC, but if it arose the PBGC

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An In-Depth Look at Employee Benefit Plans and Unclaimed Property Laws, *continued*

would presumably deny the claim, based either on ERISA preemption or sovereign immunity.

For defined contribution plans like 401(k) or profit sharing plans, the PBGC has no statutory authority, so a transfer of assets to the PBGC is not a possibility under current law. At the same time, because the DOL knows that there may still be "missing participants" after adequate efforts to find them, it has indicated that the assets should be sent to an IRA established in the participant's name, when possible. If that isn't possible, the employer "may consider establishing an interest-bearing federally insured bank account in the name of the missing participant *or transferring missing participants' account balance to state unclaimed property funds*….[W]e do not believe that the principles set forth in Advisory Opinion 94-14A, which dealt with a plan fiduciary's duty to preserve assets held in trust for an *ongoing plan*, prevent a plan fiduciary from *voluntarily* deciding to escheat missing participants' account balances under a state's *unclaimed property statute* in order to complete the plan termination process." Thus, after decades of ERISA's application, the DOL has indicated that at least where there is no other option the plan fiduciaries may "voluntarily" send plan assets to the state if establishment of an IRA or bank account in the participant's name is not possible. For years after passage of the Patriot Act, it was difficult to establish accounts in the name of a participant without the participant's signature. However, with the passage of time and additional guidance from the federal government, this is now a fairly easy process. Of course, if assets are transferred to a bank account or IRA the benefits would no longer be plan assets and the state could clearly claim the bank account or IRA eventually as unclaimed property.

Plan Design Matters

As discussed above, sometimes the permissible application of an escheat or unclaimed property statute depends upon whether the assets are to be transferred to the state voluntarily. Under ERISA, for a plan to make a voluntary transfer of assets to a state by escheat, the plan document would have to provide for such a transfer. As permitted under Treasury Regulations, plans are allowed to provide for an escheat of benefits payable to missing participants (though the DOL may disagree under some circumstances). More commonly, a plan would provide instead for a forfeiture within the plan, which would not appear to be an issue for either the DOL or IRS.

If a forfeiture occurs within the plan and the participant or beneficiary later appears, the benefit is required to be reinstated within the plan. It is not clear what would happen if the plan later terminated without a successor plan to assume the normal obligation to re-establish the benefit if the participant appeared. Although a successor plan would assume the contingent obligation to restore the benefit, it does not appear that the employer would have any obligation to restore the account balance based on the termination of the plan, in order to allow a transfer to an IRA or a bank account. If there is no continuing obligation of some plan to restore the benefit, and no transfer to an IRA or bank account, then the participant could actually be in a worse position than if the state had taken the assets.

It is common today for plans to force retirement plan distributions of small account balances after a participant leaves employment. Balances of $1,000 or less can be sent to the participant, and balances of up to $5,000 can be transferred to an IRA. While there may be some dispute as to whether a state can claim assets underlying an insurance company check for insured welfare plan benefits, pension plan assets should be free from state claims if checks remain uncashed. However, where an IRA is established to receive pension plan funds, the assets cease to be ERISA plan assets and state law can apply to those assets, including unclaimed property laws.

So, Where Are We?

We believe that states will be increasingly aggressive in seeking unclaimed property. When plan assets are involved, there appears to be an uneasy truce under which the states view the question of ERISA preemption as unsettled, posing the possibility of expensive litigation. In some cases, a state may request the assets, but drop the issue upon resistance from a plan representative. Given the position of the DOL and the IRS, if the assets being sought are either trust assets under a tax-qualified plan or true assets of any ERISA plan, the plan fiduciary who turns over assets to the state is exposed to personal liability for any loss to the plan for having done so.

Where the assets being sought are third-party insurance company assets, with the plan having no right to the assets whether or not a benefit claim is made, the state can in some circumstances collect those assets from the insurance company, with little or no involvement by the company or the plan (though insurance rates may increase). Where the assets being sought are benefits under a self-insured employer-sponsored ERISA benefit plan, whether as a result of an uncashed check or otherwise, ERISA preemption should prevent any successful state claim.

For a non-ERISA benefit arrangement, ERISA preemption of state law is not an issue, and a state can assert a claim after the required waiting period.

Paul R. O'Rourke

Recent Decision Further Clouds the Muddy Waters of Annual Exclusion Giving, *continued*

More recently, however, IRS has argued that gifts of interests in an entity, such as limited liability companies or limited partnerships, do not qualify for the annual exclusion. In *Hackl v. Comm'r*, 118 T.C. 279 (2002), the United States Tax Court agreed with IRS and held that transfers of interests in an LLC which operated a tree farm did not qualify for the annual exclusion.[1] The Tax Court found that the donee recipients of the interests did not enjoy a "substantial present economic benefit" from the interests because they had no right to withdraw their capital accounts without the approval of the manager of the LLC, and because they further had no right to sell their interests without the approval of the manager. Thus, the court concluded that the donees did not have a present interest in the property received.

It is important to note that the court's decision in *Hackl* did not completely foreclose the possibility that gifts of interests in an LLC could qualify for the annual exclusion. Rather, the court held that gifts of LLC interests would not qualify for the annual exclusion if the provisions of the operating agreement governing a member's ability to alienate or liquidate his or her interest were too restrictive.

The recent decision of the U.S. District Court for the Southern District of Indiana in *Fisher v. U.S.*, 105 AFTR 2010-1347, expands the decision of *Hackl* and creates uncertainty in the area of annual exclusion giving. The facts of *Fisher* are similar to *Hackl* in that a donor transferred real estate to an LLC and then made gifts of interests in the LLC to his children, intending that the gifts qualify for the annual exclusion. Like the court in *Hackl*, the court in *Fisher* sided with IRS in finding that the gifts were not gifts of a present interest. Several reasons were recited, all of which related to the perceived over-restrictiveness of the operating agreement of the LLC.

First, the court found that the operating agreement allowed the donees to withdraw their capital accounts only with the approval of the manager of the LLC (which approval could be withheld in the manager's sole discretion). This holding was similar to the *Hackl* court's holding.

Second, the court dismissed Fisher's arguments that the right to enjoy the real estate (it consisted of beachfront property) meant that the donees had a present interest in the transferred interests. The court found that the test for present interest was that a "substantial present *economic* benefit" be conferred on the donees. Non-pecuniary benefits attendant to the ownership of an LLC interest were thus regarded as irrelevant in determining whether the exclusion under IRC § 2503 applied.

Finally, and perhaps most importantly, the court held that the donees had an insufficient ability to alienate their interests in the LLC. The operating agreement in *Fisher*, unlike in *Hackl*, provided that a member could transfer his or her interest to a third party and management approval was not required. However, the LLC would have a right of first refusal to purchase the interest for the price offered by the intended third party purchaser. The purchase price could be paid by means of a promissory note payable over a period of 15 years. Also, the right of first refusal would be waived if the interest was sold to a family member. The court found that this right of first refusal made it "impossible for the Fisher Children to presently realize a substantial economic benefit" from the gifts of LLC interests they received. The court therefore found that the gifts of LLC interests did not qualify for the annual exclusion.

The *Fisher* decision creates uncertainty in many current tax planning methods because most operating agreements for family-owned LLCs include a right of first refusal. The reason the right exists is to keep ownership of the LLC within the family to the extent possible, a goal which is beneficial to the family members of the LLC for obvious reasons. Unfortunately, the *Fisher* court did not explain in any particular detail why the right of first refusal at issue was considered excessive. Perhaps the payment terms (i.e., the 15 year deferred payment by promissory note) were considered to be too lengthy to equate with a "present interest." Or perhaps any right of first refusal at all would be considered too restrictive by the court in the context of family entities, and planners will need to incorporate a right of withdrawal similar to the right approved in the *Crummey* case into operating agreements going forward.

In any case, the decision in *Fisher* is the opinion only of a federal district court and thus is not binding in other circuits, although it may be utilized as persuasive authority in future challenges by IRS. It remains to be seen how the case law will develop in this area of tax planning.

D. Nathan Smith

1. This decision was affirmed by the Seventh Circuit. *Hackl v. Comm'r,* 335 F.3d 664 (7th Cir. 2003).

BAKER DONELSON
BEARMAN, CALDWELL & BERKOWITZ, PC

Protecting Your Nest Egg: Use of the Asset Protection Trust in Tennessee

Angelia Morie Nystrom 865.971.5170 anystrom@bakerdonelson.com Knoxville, TN

Historically, trusts have been among the most regularly used and accepted asset protection tools when an individual sought to make assets available to beneficiaries but wished to protect those assets from creditors. Until the late 1990s, attention in this area was focused on the use of offshore trusts to protect assets, which were generally governed by more liberal laws and which often put assets out of reach of judgment creditors since many foreign jurisdictions do not recognize U.S. judgments. In 1997, however, both Alaska and Delaware enacted legislation permitting domestic asset protection trusts. Several other states quickly followed suit. In May 2007, Tennessee joined a handful of states in enacting its own legislation permitting the creation of self-settled asset protection trusts, with the enactment of the Tennessee Investment Services Act of 2007.

Prior to the enactment of the May 2007 legislation, if an individual created a trust under which he was the beneficiary, the assets of the trust were subject to the claims of creditors. As a result, an individual who built up a large nest egg could not retain control of those assets and ensure availability for future use while simultaneously shielding them from claims of creditors or judgment claims in the event of an accident, lawsuit or divorce. This changed with the enactment of the Tennessee Investment Services Act of 2007 (the Act).

Signed into law on May 10, 2007, the Act became effective July 1 of that same year. The Act was supported by the Tennessee Bankers Association and attempted to provide protection from creditors by allowing the creation of self-settled, asset protection trusts referred to as "Investment Services Trusts." The Act has been beneficial to Tennessee banks and trust companies in that it allows Tennessee residents to keep assets in Tennessee rather than transferring them to other jurisdictions with more favorable trust laws. It also has allowed Tennessee financial institutions to administer trusts for residents located in neighboring states.

Briefly, the Act provides protection from creditors by allowing the creation of a self-settled, asset protection trust (or "IST"). An IST is a trust that appoints a qualified trustee to hold and administer property that is the subject of a qualified disposition. The IST must expressly incorporate the laws of the State of Tennessee to govern the construction, validity and administration of the trust; must be irrevocable; and must provide that the interest of the transferor or beneficiary of the trust property or income may not be transferred, assigned, pledged or mortgaged, whether voluntarily or involuntarily, before distribution by the trustee.

With an IST, the individual creating the trust may retain the right to direct the investment of trust assets, to receive trust income, to request up to 5% of the trust principal annually, to receive additional distributions based upon the discretion of the trustee, to live in a home owned by the trust, to direct disposition of trust assets on death, and to remove the trustee and appoint a successor trustee who is not related to the individual creating the trust.

A "qualified disposition" is a transfer into the trust, with or without consideration for the transfer. In making a disposition, the transferor must sign a "qualified affidavit" which states that the transferor:

1. Has full right, title and authority to transfer the assets to the trust;
2. Will not be rendered insolvent by the transfer;
3. Does not intend to defraud a creditor by transferring the assets to the trust;
4. Does not have any pending or threatened court actions against him or her, except for those identified in an attachment to the qualified affidavit;
5. Is not involved in any administrative proceedings, except for those identified in an attachment to the qualified affidavit;
6. Does not contemplate the filing for relief under the federal bankruptcy code; and
7. Did not obtain the assets being transferred through unlawful activities.

In most instances, a qualified disposition cannot be attached by creditors unless the creditor makes a claim under the Uniform Fraudulent Conveyance Act. Creditors cannot make claims against a trustee or any person involved in the counseling, drafting, preparation, execution and funding of the IST.

The trustee of an IST must be either a Tennessee resident or an individual

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Protecting Your Nest Egg: Use of the Asset Protection Trust in Tennessee, *continued*

or entity authorized by Tennessee law to be a trustee and whose activities are subject to the control and supervision of the Tennessee Department of Financial Institutions, the FDIC, the Comptroller, or the Office of Thrift Supervision. The trustee must maintain and arrange for custody and control of property held under the IST, maintain the IST records, file the IST tax returns, or otherwise participate in the administration of the IST.

While the IST is useful in shielding a nest egg from claims of creditors, it is not without limitation. The IST does not provide asset protection for assets transferred to it until four years after the transfer. Additionally, federal bankruptcy law has a ten year period to set aside transfers which could apply to an IST under certain circumstances. Also, mandatory distributions and discretionary distributions, once made, may be attached by creditors. Finally, the law is unsettled as to whether a court in another state is required to recognize the creditor protection offered by an IST under the Full Faith and Credit clause of the U.S. Constitution.

In summary, Tennessee now offers enhanced asset protection through the use of the IST. Individuals concerned about creditor claims and lawsuits may now protect their nest eggs by using an IST, which can be accomplished without the complexity and uncertainty that accompany the offshore trust. While the IST is a useful asset protection tool, it is not without limitation. Individuals interested in the asset protection offered by an IST should proceed with caution and only with the direction of a qualified attorney. However, if properly drafted and funded, an IST offers a solution for protecting a nest egg while still retaining the ability to control the assets held under the trust.

Angelia Morie Nystrom

Congress Clarifies The Economic Substance Doctrine

Adam C. Flock 901.577.8167 aflock@bakerdonelson.com Memphis, TN

On March 30, 2010, President Obama signed the Health Care and Education Reconciliation Act of 2010 (the Act). Among the provisions of the Act is the codification of the common law "economic substance doctrine," which is one of several anti-abuse doctrines[1] that the courts may invoke to disallow the tax benefits of a transaction that it determines has little or no economic effect other than a reduction in federal income tax. By codifying the economic substance doctrine, the Act provides much needed clarity to the doctrine and resolves a split among the courts as to how to test a transaction for economic substance. The Act applies to transactions entered into after March 30, 2010.

The three tests that the courts developed were: (1) the conjunctive test, (2) the disjunctive test and (3) the unitary analysis.

Economic Substance Doctrine Prior to The Act

Prior to codification of the economic substance doctrine, the courts considered two factors in determining whether a transaction had economic substance. Those factors were (1) whether the transaction changed in a meaningful way the taxpayer's economic position, other than federal income tax effects (the Objective Factor), and (2) whether the taxpayer had a substantial purpose for entering the transaction, other than federal income tax effects (the Subjective Factor). The courts, however, were divided as to how the two factors were to be applied and three very distinct tests were developed by the various courts for determining whether a transaction lacked economic substance.

The three tests that the courts developed were (1) the conjunctive test, (2) the disjunctive test and (3) the unitary analysis. In jurisdictions that applied the conjunctive test, a transaction was treated as having economic substance only if both the Objective Factor and Subjective Factor were satisfied. Conversely, in jurisdictions that applied the disjunctive test only one of the two factors had to be satisfied in order for the transaction to be respected. Lastly, in jurisdictions that applied the unitary analysis a totality of the circumstances test was used and both

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Congress Clarifies The Economic Substance Doctrine, *continued*

factors were considered but neither was dispositive.

The lack of uniformity among the courts resulted in similar transactions being respected in some jurisdictions and disallowed in others. In response to the discord among the courts, proposals to clarify the economic substance doctrine through codification began as early as 1999. The various drafts and proposals for codification, however, never took root, and Congress was unsuccessful in codifying the economic substance doctrine prior to passage of the Act.

Economic Substance Doctrine After The Act

As stated above, the Act codifies the economic substance doctrine by amending Section 7701 of the Internal Revenue Code. Specifically, the Act adopts the conjunctive test which requires that both the Objective Factor and Subjective Factor be satisfied. Further, the Act clarifies that an economic profit is not a requirement for economic substance and that financial accounting benefits may qualify as a "substantial purpose" for engaging in a transaction if the reason for the benefit is not the reduction of federal income taxes.

In addition to clarifying the common law economic substance doctrine, the Act also imposes a new penalty for transactions that lack economic substance. The new penalty is a 20% accuracy related penalty for any transaction that lacks economic substance. This new penalty is a strict liability penalty and there are no exceptions, such as reasonable cause or good faith, to its application. It is increased to 40% if the transaction is not disclosed on the taxpayer's federal tax return.

Summary

The codification of the economic substance doctrine resolves the split among the coursts and provides much needed clarity in analyzing whether or not a transaction has economic substance. Specifically, the Act (1) adopts the conjunctive test, (2) clarifies that an economic profit is not a requirement for economic substance, and (3) allows certain financial accounting benefits to qualify as a "substantial purpose" for engaging in a transaction. Despite this clarity, there are still many unanswered questions regarding the economic substance doctrine and a thorough analysis of any proposed transaction must be made. Additionally, the new penalty, which imposes strict liability, underscores the need for competent advice whenever a transaction is contemplated.

Adam C. Flock

1. Other judicially created anti-abuse doctrines include: (1) substance over form doctrine, (2) sham transaction doctrine, (3) step transaction doctrine, and (4) business purpose doctrine.