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QUINN JOHNSTON
HENDERSON - PRETORIUS - CERULO

Estate and Gift Tax Law Update

Kenny Eathington
309.674.1133
keathington@quinnjohnston.com

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ESTATE & GIFT TAX UPDATE

Adjusted figures for 2017.

Unified Credit. The basic exclusion amount for estate tax, and gift tax and GST tax exemptions are increased to $5,490,000.

Annual gift tax exclusion. The §2503 gift tax annual exclusion remains at $14,000.

Annual exclusion for gifts to a noncitizen spouse. The §2523(i)(2) annual gift tax exclusion for gifts made to a noncitizen spouse is increased to $149,000.

Special use valuation. The maximum value reduction allowable as a result of a §2032A special use valuation election for decedents dying in 2017 is increased to $1,120,000.

§6166 estate tax installment payments. The portion of the taxes being paid in installments that bears interest at the 2% rate is increased to $1,490,000.

Projected for 2018: $5,600,000 for the basic exclusion amount for estate tax, gift tax and GST tax exemptions.

Annual gift tax exclusion projected to increase to $15,000 for 2018.

CCA 201650017 (October 14, 2016)

The Chief Counsel for the IRS stated that if the taxpayer had a gross estate of more than $5 million, then no relief is available to the estate, even if the estate is nontaxable. The estate had an absolute obligation to file and having failed to do so within 9 months of date of death, the election for portability is missed.

Extension of Time to File a Portability Election.
There have been several Private Letter Rulings issued by the Service that grant estates that missed the deadline for filing a portability election additional time to file Form 706 to make a portability election. For example, **Ltr. 2017370004, June 5, 2017 and Ltr. 201737009, June 5, 2017.** These estates' values are less than the applicable exclusion amount in the years of the decedents' dates of deaths, including any taxable gifts made.

On June 26, 2017, the Service issued **Rev. Proc. 2017-34, 2017-1 C.B. 1282** which provides a simplified approach. Rev. Proc. 2017-34 provides an automatic extension until the later of (i) January 2, 2018, or (ii) two years after the decedent's death to file a Form 706 for the purpose of making a portability election. This only applies to estates that were not required for file a Federal Estate Tax Return. The executor needs to write on the top of the Form 706 "filed pursuant to Rev. Proc. 2017-34 to elect portability."

Revenue Procedure 2016-49, 2016-42 IRB 462 (9/27/2016)
In some cases, executors inadvertently make QTIP elections that are not necessary to reduce the estate tax liability to zero, either because the value of the estate is less than the applicable exclusion amount or because the executor makes the election for both the credit shelter trust and the marital trust. Generally, Rev. Proc. 2001-38 provided that the IRS will disregard the QTIP election and treat it as null and void in those cases. As a result, the property for which the QTIP election was made will not be included in the estate of the surviving spouse, the spouse will not be treated as making a gift of the property if the spouse disposes of the income interest with respect to the property, and the spouse will not be treated as the transferor for GST tax purposes with respect to the property.

With the availability of portability, however, an executor of a decedent's estate might wish to make a QTIP election, even if it is unnecessary to reduce the estate tax to zero, to increase the DSUE amount. Rev. Proc. 2001-38 is modified to provide that a QTIP election will not be treated as void when the executor of the estate made, or was considered to have made, the portability election under §2010.

Estate of Sower v. Commissioner, 149 T.C. No. 11 (2017).
Upon first spouse's death, the Return reported a deceased spousal unused exclusion of over $1 million. The IRS issued an Estate Closing Letter to the estate. Upon the surviving spouse's date of death, her estate filed a timely estate tax return claiming the DSUE from the first spouse's return. As a part of the surviving spouse's audit, the IRS redetermined the amount of the DSUE from the first spouse's return and reduced the amount because certain lifetime gifts were not taken into account when determining the DSUE. The surviving spouse's estate challenged the IRS's actions but the Tax Court ruled in the IRS's favor.

Estate of Powell v. Commissioner, 148 T.C. No. 18 (5/18/2017).
Nancy Powell was terminally ill with substantial cash and other marketable securities valued at $10 million. Her son, using a power of attorney granted to him by his mother, caused her living trust to transfer $10 million in assets to a newly formed limited partnership. In return, Nancy's living trust received a 99% limited partner interest. Her sons contributed 2 unsecured promissory notes for their 0.5% limited partner interests and the one son was the general partner.

Using the power of attorney, the son then had the living trust transfer its 99% limited partnership interest to a charitable lead annuity trust (CLAT). The CLAT then payed a fixed dollar amount to Nancy's private foundation for her life. At her death, the total amount of CLAT would pass to the two sons. Nancy passed away 7 days later. The assets were included in her estate. The case is a prime example of aggressive deathbed tax planning.

Both the majority and concurring opinions agreed that §2036(a)(2) applied to the facts such that the partnership assets were part of the taxable estate. The majority opinion reasoned that since (1) the decedent together with all the other partners could dissolve the partnership and (2) that the decedent could control the amount and timing of distributions, the value of the gross estate shall include the value of all of the property.

The majority opinion addresses how §2043 applies in light of §2036 for FLP cases. Many practicing attorneys have been concerned about the possibility of double-inclusion of a decedent's assets where the decedent would have to include the value of the partnership interest under §2033 and the value of the property transferred to the FLP. The majority opinion stated the gross estate includes both the value of the partnership interest ($8.5 million) under §2033 and the amount of the discount ($1.5 million) under §2035, 2036, and §2043. The $1.5 million comes from §2043 partial consideration rule, where the estate reduces the $10 million of contributed assets by the $8.5 million of limited partner interest in the FLP.

The majority opinion's §2043(a) analysis avoids double taxation of the same value if the assets have not appreciated (and because the decedent died only 7 days later, the parties stipulated that the contribution values were also the date of death values). But if the assets have appreciated, footnote 7 of the majority opinion acknowledges that "duplicative transfer tax" would apply because the date of death asset value is included in the gross estate under §2036 offset only by the date of contribution discounted value of the partnership interest. The date of death value of the LP interest would also be included under §2033, so all of the post-contribution appreciation of the assets would be included under §2036 and the discounted post-contribution appreciation would also be included under §2033. More value may be included in the gross estate than if the decedent had never contributed assets to the FLP.

Since neither party in Powell brought up the double-inclusion issue, the concurring opinion didn't understand why the majority formulated a more difficult two-step process anyway. Judge Lauber writing the concurring opinion stated that he believed the existing precedent is easier to enforce.

Estate of Eva Kollsman v. Commissioner, TC Memo 2017-40 (2/22/2017).

This case involved the valuation of two Brueghel paintings. The Decedent died in August 2005. Sotheby wrote to the Decedent's executor proposing terms for the sale of the Brueghel paintings at auction, and providing "preliminary estimates" of the sales price of $600,000 to $800,000 for Maypole and $100,000 to $150,000 for Orpheus. About a month later, Sotheby's sent the executor two documents. The first was a letter stating that the fair market value of Maypole was $500,000 and the fair market value of Orpheus was $100,000.

These values were reported by the executor on the estate tax return. The valuation was based on the appraiser's "firsthand inspection" but did not cite comparables or explain how the value was derived. The estimated sales prices in the Sotheby's consignment agreement were greater: $600,000 to $800,000 for Maypole and $100,000 to $150,000 for Orpheus. At about the same time, the executor consulted with a framing and restoration service to have the paintings reframed and to have surface dirt removed.

The Maypole painting was sold by Sotheby's for $2,100,000. The Orpheus was not sold. The IRS issued a notice of deficiency against the estate, initially valuing the Maypole at $1,750,000 and the Orpheus at $300,000. The IRS later increased its valuations to $2,100,000 and $500,000 in an amended answer to the estate's petition in Tax Court. The estate bore the burden of proving that the values in the notice of deficiency were incorrect. The IRS bore the burden of proof with respect to the increased values and the increased deficiency asserted in its amended answer.

The IRS's expert, Mr. Cardile, identified comparable paintings by Pieter Breughel for Maypole and adjusted the values for their artistic quality, condition, provenance, and size. The court accepted the valuation of $2,100,000, but allowed a 5% discount for the risk of cleaning, for a resulting value of $1,995,000. Cardile also found comparables for the Orpheus painting, and adjusted them for similar factors. The court accepted the valuation of $500, 000, but allowed a 10% discount for the risk of cleaning and slight bowing, for a resulting value of $375,000.

Estate of James Heller v. Commissioner, 147 TC No. 11 (9/26/2016)
James Heller died on January 31, 2008. He owned a 99% interest in James Heller Family, LLC, which held only one asset: an account with Bernard L. Madoff Investment Securities, LLC.

After the Madoff Ponzi scheme became public, the remaining Madoff account became worthless. The estate filed the estate tax return on April 1, 2009, reporting a date of death value for the 99% interest in the LLC at $16,560,990. The estate also claimed a $5,175,990 theft loss deduction relating to the Madoff Ponzi scheme. The loss amount equaled the difference between the $16,560,990 value of the estate's interest in the LLC reported on the estate tax return and the estate's share of the amounts withdrawn from the Madoff account in 2008. The IRS determined that the estate was not entitled to the $5,175,990 theft loss deduction because the estate did not incur a theft loss during its settlement.

The Tax Court first noted that whether an estate is entitled to a §2054 theft loss deduction relating to property held by an LLC was an issue of first impression, and was not addressed by either regulations or legislative history. The court noted that while the LLC lost its sole asset as a result of the Ponzi scheme, the estate, during its settlement, also incurred a loss because the value of its interest in the LLC decreased from $5,175,990 to zero. The nexus between the theft and the value of the estate's LLC interest is direct and indisputable. The loss suffered by the estate relates directly to its LLC interest, the worthlessness of which arose from the theft. The court held that the estate was entitled to a section 2054 deduction relating to its LLC interest.

Estate of Victoria Dieringer v. Commissioner, 146 TC 117 (3/30/2016)
Mrs. Dieringer died in April 2009. At the time of her death, she, together with other family members, owned Dieringer Properties, Inc., a closely held real property management corporation that managed commercial and residential properties in Portland, Oregon.

She owned 425 voting shares (81% of the voting shares) and 7,736.5 nonvoting shares (84% of the nonvoting shares). The voting shares were valued on her estate tax return at $1,824 per share, and the nonvoting shares were valued at $1,733 per share, for a total of $14,182,471. The fair market values included no discount for the voting shares and only a 5% discount for the nonvoting shares. Pursuant to her estate plan, all of the shares would be distributed to a private foundation at her death.

Pursuant to a redemption agreement, all of the estate's voting shares and 5,600.5 nonvoting shares were redeemed in exchange for two promissory notes, at a price to be determined by an independent appraisal. For purposes of the redemption, the voting shares were valued at $916 per share and the nonvoting shares were valued at $870 per share. The appraiser applied discounts of 15% for lack of control and 35% for lack of marketability, plus an additional 5% discount for the nonvoting shares for lack of voting power. The executor testified that the share price was also reduced from the April 2009 value because of a declining real market. The redemption was approved retroactively by the local circuit court, and promissory notes for $5,218,462 were issued by the company. The estate claimed a charitable deduction of $14,182,471 for the Company's shares included in the estate.

The IRS argued that the value of the charitable deduction should reflect the value of the property that actually passed to the foundation ($5.2 million of promissory notes rather than $14.2 million of stock) and take into account the post-death redemption of the shares for a significantly lesser amount. The Tax Court noted that the appraiser who determined the fair market value of the stock for purposes of the redemption was instructed by the Company to value the stock as a minority interest, even though the shares represented over 60% of the equity and 80% of the vote.

The court found that decedent's majority interest was redeemed for a fraction of its value without any independent and outside accountability. As a result, the estate was not entitled to a charitable deduction for the full fair market value of the stock as of the date of death.

PLR 201647001 (11/18/2016)

The Grantors created a grantor trust. The Grantors allocated GST exemption to the transfers to Trust so that the Trust has an inclusion ratio of zero for GST tax purposes. Due to unforeseen and unanticipated circumstances, payment by the Grantors of the income taxes on Trust's income became unduly burdensome. The Independent Trustee sought court approval to modify the Trust, contingent on obtaining a favorable ruling from the IRS.

Under state law, a court may modify the administrative terms of a trust if continuation of the trust on its existing terms would be impracticable or wasteful or impair the trust's administration, or if, because of circumstances not anticipated by the settlor, modification will further the settlor's stated purpose or, if there is no stated purpose, the settlor's probable intention.

The modified Trust provides that Grantors will not be entitled to any right of reimbursement under any applicable law for their tax liability. If in any calendar year, the Trust is treated as a grantor trust as to either Grantor, an Independent Trustee may from time to time, distribute to a Grantor so much of the income or principal of the trust as may be sufficient to satisfy all or part of the Grantor's personal income tax liability attributable to the inclusion of all or part of the trust's income in the Grantor's taxable income in excess of the taxes that would have been imposed if the Trust's income, gains, losses and deductions had not been included in the determination of the Grantor's income tax liability. Assuming there is no understanding between either Grantor and the Independent Trustee regarding the Independent Trustee's exercise of discretion, the Independent Trustee's discretion to satisfy either of the Grantor's obligation would not alone cause the inclusion of the trust in either of the Grantor's gross estate for federal estate tax purposes.

The IRS further ruled that the proposed modifications were administrative in nature and would not be considered to shift a beneficial interest to a lower generation or extend the time for vesting of any beneficial interest in the trust. Therefore, the modifications would not cause the Trust to lose its zero inclusion ratio for GST purposes.

PLR 201737001, June 14, 2017 and PLR 201737008, June 14, 2017

Grantor created irrevocable trust to benefit the grantor's spouse and descendants. One provision of the Trust was entitled "Special Power of Appointment.' However, the language was such that it created general power of appointment in favor of the spouse. The grantor filed a petition with state court to reform the language such that the power of appointment be construed as a special power of appointment. The state court entered such an order.

After the state court order was entered, the grantor requested the private letter rulings which were granted by the Service. The Service held that after the modification of the power of appointment language, the spouse's power of appointment was not a general power of appointment and the property subject to the power would not be included in the spouse's gross estate and the modification of the trust was not a release of a general power of appointment for gift tax purposes.

Estate of Edward Beyer v. Commissioner, TC Memo 2016-183 (9/29/2016).

Edward Beyer created a family limited partnership in October 2003. One revocable trust was the sole initial general partner, and a second revocable trust was the sole initial limited partner. At the time of formation, Mr. Beyer intended to create an irrevocable trust at a later time, which would eventually purchase the limited partnership interest from the Trust.

The limited partnership agreement contained a laundry list of 28 separate purposes. The partnership was funded in April 2004 with about $41 million of marketable securities. In December 2005, the Trust sold its 99% LP interest to the irrevocable trust in exchange for a $20,866,725 promissory note, bearing interest at 4.4%. At the time of the sale, the irrevocable trust had only $10 of other assets. The note was secured by a security agreement, giving Mr. Beyer a security interest in all "accounts and accounts receivable, . . . and all other tangible personal property" of the irrevocable trust.

After the sale, the Trust was no longer a partner. Nevertheless, the partnership made several distributions to the trust or Mr. Beyer. He received $660,000 in April 2006 for gift tax payments. Interest payments on the promissory note owned by the irrevocable trust were paid directly from the partnership account. After Mr. Beyer's death, checks were drawn on the partnership account to pay administration expenses and over $9.3 million of estate taxes.

Generally, capital accounts and partnership records of the Limited Partnership were not accurately kept. The general partner did not receive its 1% of distributions until a catchup distribution was made in 2009. The IRS asserted that the assets held by the partnership were includible in Mr. Beyer's gross estate under §2036(a). Section 2036(a) has an exception for any transfer of property which is a "bona fide sale for an adequate and full consideration in money or money's worth." The bona fide sale exception is satisfied where there is a "legitimate and significant nontax reason" for creating the family limited partnership.

The estate failed to demonstrate that Mr. Beyer received an adequate and full consideration in money or money's worth for his transfer to the partnership, because the capital accounts were no properly maintained which credited contributions proportionately to the contributing partners, and distributions were made on a non-pro rata basis. In addition, although Mr. Beyer had retained $4 million outside of the partnership when it was formed, he shortly thereafter made a gift of $2,500,000 to his nephews, leaving only $1,500,000. The court found that he had not retained sufficient assets outside the partnership to meet his anticipated financial obligations, including gift and estate taxes. The estate argued that if the partnership assets were includible under §2036(a), the assets held in the RMA should be discounted to account for restrictions under the RMA agreement. The Tax Court disallowed any discount.

Estate of Natale Giustina v. Commissioner, TC Memo 2016-114 (6/13/2016)

At his death, Natale Giustina owned a 41.128% limited partner interest in Giustina Land & Timber Co. The company owned 47,939 acres of actively managed timberland in Oregon. The value of the estate's interest in Giustina Land & Timber was reported as $12,657,500 on the estate tax return.

The IRS challenged the valuation and issued a notice of deficiency based on a value of $35,710,000. The estate and the IRS agreed that the value of the company's timberlands was $143 million. The Tax Court previously had examined in detail the valuation reports produced by both the estate's and the IRS's experts, including the weight given to the discounted cash flow and net asset value valuation approaches.

The Tax Court concluded that the value of the estate's interest was $27,454,000, based on an assumption that there was a 25% likelihood of liquidating the partnership, even though Natale was not a general partner and could not have unilaterally decided to liquidate. The Ninth Circuit disagreed with the Tax Court's assumption and held that it was a clear error to assign a 25% likelihood to the liquidation of the business. The Ninth Circuit remanded the case to the Tax Court to recalculate the value of the estate's interest based solely on the partnership's value as a going concern. On remand, the Tax Court reduced the value of the 41% partnership interest to $13,954,730.

The Ninth Circuit had also held that the Tax Court erred by failing to adequately explain its basis for cutting the company-specific risk premium determined by the estate's expert from 3.5% to 1.75%. The Tax Court explained that it had assumed that a hypothetical buyer would have been able to eliminate some of the partnership-specific risk associated with owning the 41% partnership interest, because the buyer could have been an entity owned by multiple owners, who each could have held a diverse portfolio outside of the timberlands investment. On remand, the Tax Court concluded that the hypothetical buyer must be a permissible transferee of a partnership interest. Transfers were permitted only to another limited partner or to a person approved by the general partners. The Tax Court concluded that it was not likely that a multiple owner investment entity would have been approved as a buyer, and therefore a hypothetical buyer would not have been able to diversify the partnership specific risk as they had originally assumed. As a result, the 3.5% discount was allowed in full.

Notice 2017-15, 2017-6 IRB 783 (1/17/2017)
After the *Windsor* and *Obergefell* cases*,* the IRS issued Regulation §301.7701-18, defining terms related to marriage for federal tax purposes. Notice 2017-15 provides special administrative procedures allowing certain taxpayers and the executors of certain taxpayers' estates to recalculate a taxpayer's remaining applicable exclusion amount and remaining GST exemption to the extent an allocation was made to certain transfers made while the taxpayer was married to a person of the same sex. Same sex spouses will now be assigned to the same generation, and descendants of those spouses will be assigned to a generation based on familial relationships rather than age.

The taxpayer should include a statement at the top of the Form 706 or Form 709 that the return is "FILED PURSUANT TO NOTICE 2017-15". As applicable, the taxpayer must attach a statement supporting the claim for the marital deduction and detailing the recalculation of the taxpayer's remaining applicable exclusion amount, or stating that the allocation of GST exemption in a prior year is void and computing the allocation of GST exemption. If a QTIP or QDOT election is required in order to obtain the marital deduction, 9100 relief must be separately requested.

PLR 201615004 (4/8/16) Termination of GPA Marital Trust.
Decedent's revocable trust created Trust B at his death for the benefit of the decedent's children from a prior marriage and their descendants. The trust also created two marital trusts for his Spouse: a general power of appointment marital trust (Trust C), which granted her a testamentary general power of appointment to decedent's issue or her estate, and a QTIP marital trust (Trust C-1). The estate mistakenly made a QTIP election for both Trust C and C-1.

The Spouse and children entered into a settlement agreement to terminate both of the marital trusts, pay cash and securities to the Spouse, pay any of the Spouse's income tax liability on the distribution, pay any gift tax liability with respect to the termination, and distribute the balance to Trust B. The termination of the Spouse's interest in the GPA marital trust was a release of her testamentary general power of appointment. The value of the Trust C property in excess of the consideration Spouse received was a taxable gift. In addition, Spouse was treated as the transferor of Trust C for GST purposes to the extent that she made a taxable gift.

Estate of Clara Morrissette v. Commissioner, 147 TC 171 (4/13/2016).
Clara Morrissette established three dynasty trusts for her three sons, Arthur, Donald, and Kenneth (Dynasty Trusts). Clara Morrissette's revocable trust (CMM Trust), the three sons, the Dynasty Trusts, and other shareholders of Interstate Group entered into a buy-sell agreement that provided for the purchase of the shares held by each son and his Dynasty Trust upon that son's death.

To fund the buyout, each Dynasty Trust purchased two universal life policies – one on each other brother. To fund the purchase of the policies, each Dynasty Trust and the CMM Trust entered into split-dollar life insurance arrangements. The CMM Trust contributed almost $10 million to each Dynasty Trust. The Dynasty Trusts then used that money to pay a lump-sum premium on each policy to maintain that policy for the insured's projected life expectancy. Under the split-dollar agreements, upon the death of an insured the CMM Trust would receive a portion of the death benefit from the policy insuring that person equal to the greater of (i) the cash surrender value (CSV) of that policy, or (ii) the aggregate premium payments on that policy.

From 2006 to 2009 Mrs. Morrissette reported gifts to the Dynasty Trusts totaling $637,000, using the economic benefit regime to value the gifts. The amount of each gift was the cost of the current life insurance protection as determined using IRS Table 2001 4, less the amount of each premium paid by the Dynasty Trusts.

Mrs. Morrissette died in September 2009. The value of the receivables from the Dynasty Trusts under the split dollar agreements reported on the estate tax return was $7,479,000. The IRS issued a notice of deficiency in the amount of $13,800,179 (plus a penalty of $2,760,036) for gift tax liability for 2006. The IRS determined that Mrs. Morrissette had failed to report total gifts of $29.9 million, the total amount of the policy premiums paid for the six split-dollar life insurance policies in 2006. The final regulations under §61 provide two mutually exclusive regimes for taxing split-dollar life insurance arrangements entered into after September 17, 2003, either the economic benefit regime or the loan regime.

Under this general rule, the Dynasty Trusts would be considered the owners of the policies and the loan regime would apply. An exception to the general rule provides that if the only economic benefit provided under the split-dollar life insurance arrangement to the donee is current life insurance protection, then the donor will be the deemed owner of the life insurance contract, and the economic benefit regime will apply. If the done receives any additional economic benefit, other than current life insurance protection, then the donee will be considered the owner and the loan regime will apply. The issue in this case was whether the lump-sum payment of premiums on the policies made indirectly by the CMM Trust generated any additional economic benefit other than current life insurance protection to the Dynasty Trusts.

The Tax Court found that there was no possibility of the Dynasty Trusts receiving any additional benefit because the CMM Trust would receive the greater of the aggregate premiums paid or the CSV of the policy. The IRS argued that the Dynasty Trusts had an interest in the CSV of the policies because under the terms of the CMM Trust, the receivables owed by the Dynasty Trusts would pass to the Dynasty Trusts on her death. The court determined that the Dynasty Trusts did not have current access to the CSV of the policies or a legally enforceable right to the CSV, because the CMM Trust was revocable by Mrs. Morrissette. Because the Dynasty Trusts received no additional economic benefit beyond that of current life insurance protection, the CMM Trust was the deemed owner of the life insurance contract and the economic benefit regime applied.

Estate of Edward Beyer v. Commissioner, TC Memo 2016-183 (9/29/2016)

In 2001 Edward Beyer created a 529 plan for ten family members and contributed $10,000 to each Section 529 account in December 2001 and $55,000 in January 2002. Mr. Beyer did not file a gift tax return for 2002 to elect to treat the $55,000 gifts in 2002 as having been made over 5 years.

In 2004, he created a 529 plan for eight additional family members, and contributed $11,000 to each in December 2004 and $55,000 in January 2005. Mr. Beyer filed a 2005 gift tax return, but did not report the gifts to the 529 plans. The estate tried to argue that although Mr. Beyer had not reported the gifts in 2002 and 2005 to the 529 plans, he intended to treat the gifts as having been made over 5 years, and as result, he did. The tax court found the argument unpersuasive, and held that the gifts to the 529 plans increased his taxable gifts in 2002 and 2005.

William Cavallaro v. Commissioner, 118 AFTR 2d 2016-6684 (1st Cir. 11/18/2016), affirming in part, reversing in part, and remanding TC Memo 2014-189 (9/17/2014)
In 1979 Mr. and Mrs. Cavallaro started Knight Tool Co., a contract manufacturing company that made specialized, custom tools and machine parts for other companies, primarily in the defense, aerospace and industrial industries. The Cavallaros' three sons also worked in the family business. In 1982 Mr. Cavallaro and his son Ken found an opportunity to create and produce on a mass basis a computerized liquid-dispensing machine for use in the production of computer circuit boards. Mr. Cavallaro and Ken developed the machine with the assistance of Knight employees and called the machine CAM/ALOT. In 1987 the three sons incorporated Camelot Systems, Inc. ("Camelot"), a business dedicated to selling the CAM/ALOT machines, which would be produced by Knight. However, there was no evidence that any intellectual property rights related to the CAM/A LOT machine had been transferred from Knight to Camelot.

A key issue in the case was the relationship between the two-family companies. The Cavallaros' position was that Camelot was the owner of the machine technology and Knight produced the CAM/ALOT machines for Camelot as a contractor as it did with its other third-party customers. The IRS's position was that Knight manufactured the machines and Camelot sold them to third parties. In 1995 Knight and Camelot merged, with Camelot as the surviving company.

Each company was valued by Ernst & Young, using the assumption that the CAM/ALOT technology resided with Camelot, and not Knight. Camelot was sold in 1996 for $57 million, with about $11 million in proceeds going to the parents, and $46 million going to the sons. The IRS initially determined that the pre-merger value of Camelot was $0, so that the parents had made a taxable gift of $46 million upon the merger. By the time of trial, the IRS's expert determined that the combined value of the companies was $64.5 million, Knight's share was 65% or $41.9 million, so that the gift was 46% of the total value, or $29.6 million.

The tax court had noted that the IRS's notice of deficiency was presumed to be correct, and the taxpayers had the burden of proof. Because the taxpayers' appraisals of the companies assumed that the CAM/ALOT technology was owned by Camelot, the tax court concluded that their appraisals had to be disregarded completely and they had not met their burden of proof. As a result, the tax court adopted the IRS's value of the companies, although noting that it was also flawed.

On appeal, the First Circuit agreed that the value shown in the IRS's deficiency noticed was presumed to be correct and that the Cavallaros' had the burden of proof to show by the preponderance of the evidence that the value was incorrect. However, the Tax Court was incorrect in its conclusion that the Cavallaros also had the burden of proof to show the proper amount of their tax liability. The Tax Court had refused to allow the taxpayers to challenge the valuation methodology used by the IRS's appraiser after concluding that the taxpayer's experts' appraisals were fatally flawed. However, they should have had the opportunity to rebut the report of the IRS's appraiser. If the taxpayer was successful, the Tax Court should have determined for itself the proper value rather than simply relying on the IRS's position.

CCA 201643020 (10/21/2016)

Taxpayer filed a gift tax return that reported the gifts made in the current tax year, but did not report taxable gifts from prior years. This resulted in an under assessment of the gift tax due, because the tax was calculated at a lower rate. Because the gift made in the current year was properly reported, the statute of limitations for assessing gift tax on that gift was not extended by the failure to report prior taxable gifts. The rules under Section 6501(c)(9) for extending the statute of limitations for assessing gift tax did not apply to the current years' gift, because that gift was reported and it was adequately disclosed.

Section 2704 Proposed Regulations IRS issues proposed regulations under Sections 2701 and 2704.

On August 2, 2016, Treasury issued proposed regulations under §§2701 and 2704. The regulations provide new rules for the valuation of equity interests in family-controlled entities for all transfer tax purposes. The effect would be to increase the value of family-controlled entity interests for gift, estate, and GST tax purposes, by valuing interests based on the net asset value or liquidation of the entire entity, rather than the actual fair market value of the interests. The proposed regulations would create an additional category of restrictions ("disregarded restrictions") that would be ignored in valuing an interest in a family-controlled entity transferred to a member of the family if, after the transfer, the restriction will lapse or may be removed by the transferor and/or the transferor's family.

Many of the new rules are controversial, and there is now little expectation that the rules will be finalized in the near future.

PLR 201633023 (8/12/2016)

Prior to September 25, 1985, Grandfather created an irrevocable trust for the benefit of his grandchildren. A separate share was created for each grandchild. The trustees have the power to distribute income and principal to a grandchild from their share as they may determine. A grandchild may withdraw half of their share at age 25, and the share will terminate and be distributed to the grandchild when they reach age 35. If the grandchild dies before reaching age 35, their share will be distributed among Grandfather's issue (other than the grandchild) or spouses of issue as the grandchild appoints, otherwise to the grandchild's issue, or if none, to the issue of the child who is the grandchild's parent, or if none, to Grandfather's issue, or if none, to Charity.

One grandchild has cognitive deficits and other disabilities, and does not have the capacity to exercise the power of appointment over his share. The trustees wish to modify the trust terms as they apply to the disabled grandchild. State law permits a court may modify the administrative or dispositive terms of a trust or terminate the trust if, because of circumstances not anticipated by the settlor, modification or termination will further the purposes of the trust. In addition, state law permits a court to modify the administrative terms of a trust if continuation of the trust on its existing terms would be impracticable or wasteful or impair the trust's administration. The IRS ruled that the trust would remain exempt from the application of GST tax after the modifications took effect.

PLR 201641020 (10/7/16)
Prior to September 25, 1985, Settlors created an irrevocable GST exempt trust for the primary benefit of their daughters, Daughter 1 and Daughter 2. The trustee may, in his absolute discretion, pay income or principal of the trust to Daughters. The trust will continue for the life of the Daughters and upon the death of the last to die, the trustee will distribute all the remaining trust property to the then surviving children of Daughters. Daughters are currently the co-trustees of the trust. At the death of one of the Daughters, the surviving daughter will become the sole trustee and sole current beneficiary of the trust. Daughters were concerned that the surviving daughter may be deemed to have a general power of appointment.

Daughters propose to jointly resign as trustees and petition a state court to name two independent successor co-trustees who are not related or subordinate to either Daughter (X and Y) and to approve an amendment to the successor trustee provisions. The proposed amendments to the successor trustee provisions would provide that if X ceases to act as a trustee, Daughter 1 shall appoint a successor trustee who is not related or subordinate to her. Similarly, if Y ceases to act as a trustee, Daughter 2 shall appoint a successor trustee who is not related or subordinate to her.

The IRS ruled that the joint resignation of Daughters as co-trustees, the appointment of X and Y as successor trustees, and the court approval of the proposed amendment to the successor trustee provisions (1) will not cause either Daughter to be treated as having possessed, exercised or released a general power of appointment, (2) will not cause a Daughter's interest in the trust to be includible in her gross estate; and (3) will not cause the trust to lose its grandfathered GST tax exempt status.

PLR 201626016 (2/5/2016)
Prior to September 25, 1985, Grantor created an Irrevocable Trust, under which separate trusts were created for the Grantor's six children. Upon the death of a child, the child has a testamentary power of appointment to the child's spouse and the Grantor's descendants. Any unappointed property is to be allocated per stirpes among the child's descendants. Child 1 died without a surviving spouse or living descendants. Child 1's estate plan provides for all of her own assets to be used for animal welfare, and does not make any gifts to individuals or trusts for individuals. Child 1 did not exercise her testamentary power of appointment. The Irrevocable Trust is silent as to the disposition of the trust property in a child's trust if she dies without having exercised the power of appointment or leaving a spouse or descendants. Family members negotiated for two years and finally entered into a settlement agreement on the disposition of Child 1's trust, subject to state court approval and a favorable IRS ruling.

A settlement that results in a compromise between the positions of the litigating parties and reflects the parties' assessments of the relative strengths of their positions is a settlement that is within the range of reasonable outcomes. In this case, the parties were represented by separate counsel, and the agreement was the product of arm's length negotiations. The fact that the Irrevocable Trust did not contain a distribution provision in the event Child 1 died with no surviving spouse or descendants created a bona fide issue regarding the construction of the Irrevocable Trust. The IRS concluded that the terms of the settlement agreement represented a compromise between the positions of the litigating parties and reflected their assessments of the relative strengths of their positions, and therefore was within the range of reasonable outcomes. As a result, the termination of Child 1's trust and distribution of the trust assets pursuant to the terms of the settlement agreement would not result in GST tax.

PLR 201626016 (6/24/2016)
Trust was created prior to September 25, 1985. Trust currently has 18 beneficiaries, including 13 adults and 5 minors. The number of living beneficiaries and potential beneficiaries makes the administration of Trust unwieldy, and it is very difficult for the trustees to determine and weigh the relative needs of the beneficiaries and potential beneficiaries for the purpose of making all distributions. As a result, the time and cost expended in the administration of Trust has become disproportionate to the value of Trust and made it difficult to maintain the intended purposes of Trust. State law permits the termination of a trust by a court-approved nonjudicial settlement agreement, if the court concludes that the continuance of the trust is not necessary to achieve any clear material purpose of the trust. The court may order the trust property to be distributed as agreed by the parties or otherwise as the court determines to be equitable, consistent with the purpose of the trust.

The 13 adult beneficiaries of Trust entered into a nonjudicial settlement agreement, under which the entire trust property will be distributed in equal shares to 12 of the current adult beneficiaries, each of whom is either a grandchild or great-grandchild of the grantor. The remaining adult beneficiary and the five minor beneficiaries, each of whom is a great-great grandchild, will not receive a distribution.

The IRS ruled that the termination and distribution of the trust pursuant to the nonjudicial settlement agreement was a permissible modification because it did not shift any beneficial interest in the trust to a lower generation beneficiary of the trust.

PLRs 201634016 and 201634017 (8/19/2016)
Prior to September 25, 1985, Settlor created an irrevocable trust for the benefit of Beneficiary and Beneficiary's descendants. The trust is grandfathered from GST tax. The IRS ruled that the proposed modifications would not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation than the person who held the beneficial interest prior to the modification. In addition, the modification did not extend the time for vesting of any beneficial interest in the trust beyond the original perpetuities period. Accordingly, the modification would not cause the trust to lose its GST exempt status.

Notice 2017-12, 2017-5 IRB 742 (1/6/2017)
The IRS changed its policy of issuing a closing letter for every estate tax return filed (other than returns filed solely to elect portability) as of June 1, 2015, and announced that it will no longer issue estate tax closing letters unless they are requested. Executors are directed to wait at least four months before making the request, to allow time for processing the return. The estate tax closing letter confirms that the estate tax return has either been accepted by the IRS as filed, or has been accepted after an adjustment by the IRS to which the estate has agreed. Thus, the receipt of an estate tax closing letter generally has indicated that the IRS examination of the estate tax return is closed, although it does not prevent the IRS from reopening or reexamining the estate tax return.

In lieu of an estate tax closing letter, the executor may obtain an account transcript, which reflects current account data, including the acceptance of the Form 706 and the date on which the examination was closed. An account transcript presents this account data by including transaction codes together with the descriptions of those codes. An account transcript that includes transaction
code “421” and the explanation “Closed examination of tax return” indicates that the IRS’s examination of the estate tax return has been completed and that the IRS examination is closed. Thus, an account transcript showing a transaction code of “421” can serve as the functional equivalent of an estate tax closing letter.

New IRS Requirements for Release of Estate Tax Lien on Real Estate IRS
Section 6324(a) imposes an estate tax lien on a decedent’s property, which attaches automatically at the decedent’s death. If real estate included in the estate is sold, the purchaser may insist on that the estate obtain a Release of Lien from the IRS. Before June 2016, the executor could obtain a Release of Lien by filing a Form 4422 with the IRS and providing information about the estate and the real estate to be sold, including the sales contract and a proposed closing statement. An IRS agent reviewed the Form 4422 and generally issued the Release of Lien within a relatively short period. The IRS now appears to be insisting on additional requirements beyond those listed in the Form 4422. The IRS is now requesting an appraisal of the property to be sold. In addition, the IRS is now requiring that, for taxable estates, that the net sale proceeds be paid to Treasury or held in escrow with an escrow agent until an estate tax closing letter is issued.

Specht v. U.S., 118 AFTR 2d 2016-5906 (6th Cir. 9/22/2016), affirming 115 AFTR 2d 2015-357 (S.D. Ohio 1/6/2015)
Janice Specht was appointed as the executor of the estate of her cousin Virginia Escher, who died in December 2008 with an estate of approximately $12.5 million. Specht was 73 years old, had only a high school education, and had no experience serving as an executor. Specht hired Mary Backsman to help her administer the estate, since she was Escher’s estate planning attorney. Unknown to Specht, Backsman was suffering from brain cancer.

Although the estate tax return was due in September 2009, it was not filed until January 2011, after Specht had retained new counsel. Backsman had informed Specht that an estate tax return would be due in September 2009, but Specht did not follow up with her on filing the return or an extension. Specht began to receive indications that the estate was not being handled properly by Backsman. She received multiple notices from the probate court, beginning before September 2009, that the estate had missed several deadlines. She received notice from the Ohio Department of Revenue in 2010 that the state tax return had not been filed. Friends of Virginia Escher who had engaged Backsman for other matters called Specht to inform her that Backsman was incompetent.

Specht finally hired a new attorney in November 2010, who prepared and filed the estate tax return. In this case, the estate unsuccessfully requested an abatement of the penalties assessed by the IRS for late filing of the return and late payment of the estate tax. Penalties can be waived under §6651(a) if the failure is “due to reasonable cause and not due to willful neglect.” Reliance on the attorney to file an extension or file the return is not reasonable cause, even in a case like this where the executor appeared to be very unsophisticated in business and tax matters, the attorney on which she relied had a serious medical condition, and the executor “was the victim of staggeringly inadequate legal counsel.”

On appeal to the Sixth Circuit, the estate argued that Specht's continued reliance on Backsman did not constitute willful neglect of her duty to file the estate tax return and pay the estate tax due. However, Specht had multiple warnings that should have put her on notice that Backsman was unable to fulfill her responsibilities as attorney for the estate. In addition, Specht's reliance on Backsman was not a substitute for meeting her non-delegable duty to ensure that the estate tax return was filed by the deadline.

Estate of Hake v. U.S., 119 AFTR 2d 2017-727 (DC Pa. 2/10/2017)
Esther Hake died on October 2, 2011. Two of her sons Ricky and Randy Hake were appointed as executors. The executors relied on long-time family attorneys, Douglas France and Jennifer Galloway, who had previously advised the family on business affairs. At her death, Mrs. Hake's five children were in the midst of an intrafamily dispute over her care and the value of her assets. Because of the need to resolve these issues during estate administration, France recommended extending the period for filing the estate tax return and paying the estate tax for as long as possible.

Galloway prepared the Form 4768, seeking a six-month extension to file the return and a one year extension to pay the tax. The IRS approved the requests, but Galloway then mistakenly informed France, who then informed the executors, that the time for both filing the return and paying the tax were extended for one year. The executors paid the tax on February 12, 2013 (five months before it was due), and filed the return on July 2, 2013, when they had been told it was due. The IRS assessed a late filing penalty of about $200,000.

The court found that the executors' reliance on the attorneys' advice on the due date for the return constituted reasonable cause, based on the court's view of the difficulty in determining the correct due date in what it described as "a specific, unusual, and narrowly defined set of facts." The court found that "with respect to payment and filing deadlines, the legal terrain requires a subtle multifaceted analysis. First, one must determine the initial filing and payment deadlines. Next one must negotiate a series of deadline extension rules. Some of these extensions are automatic; others are discretionary. Further, one must be alert to the fact that the application of these differing rules can lead to different deadlines for payment and filing. Finally, one must remain mindful of the fact that the filing rules themselves change depending upon the residency status of the executors."

The court found that executors' reliance on the advice of the attorneys with respect to the due date for the return was "objectively reasonable" due to the difficulty in determining the extended due date. In addition, the executors were careful to ensure that the estate tax was paid timely, and even paid the tax several months before it was due. The court held that the executors had exercised "ordinary business care and prudence" in relying upon their attorney's erroneous advice, and that the late filing penalty should be waived.

U.S. v. Estate of Espinor, 118 AFTR 2d 2016-5479 (D. CA 8/11/2016)
Cipriano Espinor died in 2004. On his death, Michael Espinor and Toni Espinor Hicks were appointed as co-executors. His will contained a pour-over clause directing that residuary assets were to be transferred into a Family Trust. Michael Espinor and Toni Hicks also were the successor co-trustees after Espinor's death. The total estate tax liability was $1,586,551. The executors elected to defer $622,563 for five years, and pay the remaining tax liability in ten installments. In 2012, the estate was in default under the installment agreement, and the IRS sent a notice and demand for payment for $621,850, which was the remaining amount due.

As executors and trustees, Michael Espinor and Toni Hicks made multiple distributions to themselves and other beneficiaries from the estate and trust assets, at a time when the estate did not have sufficient assets to pay its outstanding liabilities, including estate taxes. The Federal priority statute provides that when the estate of a deceased debtor, in the custody of the executor or administrator, is not enough to pay all debts of the debtor, a claim of the U.S. government must be paid first. An executor who pays any part of a debt of the person or estate or distributes property to a beneficiary of the estate before paying a claim of the government is liable to the extent of the payment for unpaid claims of the government. Under §6901, the executor is personally liable for the unpaid claims of the United States to the extent of a distribution from the estate when (1) the executor distributed assets of the estate; (2) the estate was insolvent at the time of the distribution or the distribution rendered the estate insolvent; and (3) the executor had notice of the government's claim.

Michael Espinor and Toni Hicks, as co-executors and cotrustees, had distributed property of the estate prior to fully paying the federal estate tax liabilities, and were not discharged from personal responsibility under 26 U.S.C. §2204. Therefore, they were jointly and severally liable for the full amount of unpaid federal estate taxes. They were also each jointly liable as individual transferee for the value of the vehicles and cash distributed to them. Richard Espinor, John Espinor, Pauline DiBattista, and S&P Sheet Metal were each jointly liable as an individual transferee, for the value of assets distributed to each of them respectively as a beneficiary.

U.S. v. Johnson, 118 AFTR 2d 2016-6781 (D. Utah 12/1/2016)
Anna Smith died on September 2, 1991. Two of her four children Mary Carol Johnson and James Smith were named as the personal representatives of her estate and the trustees of her revocable trust. The trustees filed the estate tax return on June 1, 1992, showing $6,631,000 of federal estate tax due.

The estate elected to defer payment under §6166 of a portion of the estate tax attributable to closely held shares in the State Line Hotel, which represented about 70% of the value of the estate. In December 1992, the trustees distributed all of the remaining trust assets to the four children and entered into a distribution agreement under which each child agreed to pay his or her share of any increase in the estate tax due if the return were to be audited. The distribution was necessary because the hotel held a gaming license, and Nevada gambling law limited the ability of a trust to own stock in a casino.

In August 1997, the executors provided the IRS with an executed Agreement to Special Lien Under Section 6324A signed by all four children and additional information about the State Line Hotel stock requested by the IRS. The agreement restricted the sale of the State Line Hotel stock while the lien on the stock was in effect. Based on the 1996 Tax Court settlement, the offered shares of stock had a total value of $6,092,578. Because the unpaid balance of the tax assessment was then $1,899,970 and the amount of security needed was $2,192,365, the IRS agent Colleen Girard believed a special lien against the stock would adequately secure the liability for the remainder of the §6166 election.

However, the agent notified the executors that IRS District Counsel had advised that closely held stock should not be accepted as collateral by the IRS. The executors' counsel responded that "if an election is made under §6324A and the identified property can be expected to survive the period of deferral, the requirements of the statute have been met and the application of the special lien is mandatory." The IRS agent and the executors agreed to revisit the issue again in two years, but nothing was done.

In January 2002, the hotel filed for bankruptcy, and the bankruptcy court approved the sale of all the hotel's assets to a third party. The children received no value for their hotel shares received from the estate. In 2003, the estate defaulted on its federal estate tax liability, after having paid $5,000,000 of the total $6,872,000 due. In 2005, the IRS sent a notice and demand for payment of the tax liability to the estate and the personal representatives. First, the court reconsidered whether the Mary Carol Johnson and James Smith, as trustees of Anna Smith's revocable trust, were liable for the estate tax as a transferee pursuant to §6324(a)(2).

Section 6324(a)(2) imputes personal liability for federal estate taxes to certain individuals who receive property from an estate at the time of a decedent's death. The court concluded that the assets of the revocable trust were includible in the gross estate under §2033 because the decedent had beneficial ownership in the trust property at her death. Therefore, the trustees were not "transferees" for purposes of §6324.

Second, the court held that the executors and trustees had furnished a valid §6324A special lien. Section 6324A is a taxpayer election, and the government is not authorized to reject the election if its requirements are satisfied. In this case the executors had met the requirements that (1) the executors make an election by applying to the IRS, (2) an agreement for special lien be signed by all parties with an interest in the property stating the amount of the lien and the fair market value of the property, and (3) the lien property can be expected to survive the §6166 deferral period. The IRS could not reject the collateral offered for the special lien simply because it would prefer more marketable collateral. As a result, the executors had discharged their personal liability and were not personally liable.

U.S. v. Spoor, 118 AFTR 2d 2016-6018 (11th Cir. 10/4/2016)
Louise Gallagher died on July 5, 2004, owning 39,700 units in Paxton Media Group, LLC, a privately held and family-owned newspaper publishing company. The estate made a §6166 election to defer and pay its estate tax liability in ten equal installments. The estate made tax payments of about $8.4 million through 2008.

In August 2010, the estate agreed to the creation of a special deferred estate tax lien on the Paxton Media Group units pursuant to §6324A. By 2012 the value of the Paxton Media Group units had become less than the unpaid portion of the deferred tax and interest. The IRS demanded additional collateral from the estate, which the estate was unable to provide. The IRS then accelerated the remaining deferred tax obligations. As of September 2013, the remaining estate tax, penalties, and interest were about $10.4 million, and the value of the Paxton Media Group units owned by the estate had fallen to approximately $2 million.

The executor had claimed a $1,086,265 deduction on the estate tax return for his executor's fee, and about $486,000 of his fee was still unpaid. The executor maintained that his claim, as an administration expense, took priority over the government's tax liens. The Eleventh Circuit held that rules are different for the lien under §6324 that attaches to all assets in the gross estate and a special lien under §6324A.

The property subject to the special lien, which has been identified by the executor and is limited in value to the amount of the deferred estate tax plus interest, is not subject to claims for administration expenses before the estate tax is paid.

Estate of Backemeyer v. Commissioner, 147 Tax Court 17 (12/8/2016).
Farmer in Nebraska prepaid crop inputs in 2010. He deducted the cost of the crop inputs on his 2010 income tax return. He died in March 2011 and his property was left to his surviving spouse.

Surviving spouse continued the farming operation and used the crop inputs for the 2011 crop. She deducted the value of the crop inputs on her 2011 income tax return. The Service objected claiming that there was an impermissible double deduction.

The Tax Court rejected the Service's position and found no issue with the fact that both the decedent and surviving spouse were able to deduct the cost of the crop inputs. The Tax Court relied upon Section 1014(a) which provides for a step up in basis for such assets.
4821-5002-0433, v. 2

Key Issues for Buy-Sell Agreements for Closely Held Businesses

Michael A. Kraft
309.674.1133
mkraft@quinnjohnston.com

Buy-Sell Agreements – The Basics

"The future's hard to predict. It hasn't happened yet." Yogi Berra

- A buy-sell agreement may be one of the most important documents signed by the owners of any small business, to help ensure succession and continuity.
- A buy-sell agreement is often triggered during circumstances which are most stressful to the operation of the business and the cohesion of its owners.
- A well drafted buy-sell agreement should help steer a business through and clear of major or business-ending disputes and deadlocks.

Buy-Sell Agreements – The Basics

- A big benefit of a buy-sell agreement is that it forces the owners of the closely held business to think and plan ahead, for good times and bad.
- A buy-sell agreement is likely an important component of the owners' estate plans.
- One size does not fit all – significant effort and thought should be put into the buy-sell agreement upon its creation, avoiding the simple use of a "boilerplate" agreement form without any due diligence or planning.

Buy-Sell Agreements – The Basics

- The buy-sell agreement should be re-visited periodically.
- Once a triggering event occurs, the owners' interests very often diverge, sometimes immediately, which makes the pre-planned terms of the buy-sell agreement that much more important.
- Ignoring the importance of future planning because it may be difficult is a very bad choice.

"You've got to be very careful if you don't know where you're going, because you might end up there." Yogi Berra

Buy-Sell Agreements – The Basics

A well drafted buy-sell agreement can protect against:

- Risk of a divorcing owner's spouse gaining interest in the business
- Risk of other owners combining their interests to the detriment of minority owners
- Risk of another owner with greater resources buying additional control
- Risk arising from the bankruptcy of an owner

Buy-Sell Agreements – The Basics

- Disagreement among owners as to whether to accept a purchase offer from a third party
- Termination of an employee-owner's employment
- Failure to make distributions
- Application of minority or lack of marketability discounts to any redemption or cross-purchase of interests

Key Issues in Creating a Buy-Sell Agreement

"When you come to a fork in the road … take it." Yogi Berra

Buyout Triggers

What are the triggers?

- Retirement
- Disability
- Death
- Divorce
- Involuntary withdrawal: Termination of employment; breach of separate shareholder or employee obligations to the business entity

Key Issues in Creating a Buy-Sell Agreement

Buyout Triggers

- Voluntary withdrawal
- Sale to a third party
- Bankruptcy or insolvency of an owner

Does the type of business require the ownership interest to continue to be held and controlled by the current ownership group? (e.g. business that owns an apartment complex versus a computer programing services business)

Key Issues in Creating a Buy-Sell Agreement

Buyout Triggers

What do the triggers actually trigger?

- Remaining owners' or business entity's option to cross-purchase or redeem the selling owner's interest
- Selling owner's option to force the business entity and/or remaining owners to buy out his/her interest
- Mutual obligation for the selling owner to sell to the business entity or remaining owners

Key Issues in Creating a Buy-Sell Agreement

Buyout Triggers

What do the triggers actually trigger? (cont.)

- Proper trigger events should appease both the potential selling owner, by ensuring that his/her interest will be purchased upon any of the agreed upon trigger events, and the buying owners, by ensuring that they are not forced to buy a selling owner's interest which they cannot afford or do not want.

"We're lost, but we're making good time." Yogi Berra

Key Issues in Creating a Buy-Sell Agreement

Identify the Proper Buyer

- The proper buyer must be one who will fit in with the ownership group and can continue to successfully operate the business.
- A selling owner's interests are often paid for in future installments, funded principally from the continuing operations of the business, therefore, making the decision as to the proper buyer (future operator of the business) being that more important.

Key Issues in Creating a Buy-Sell Agreement

Identify the Proper Buyer

- Does a family member work in the business?
- Is a family member interested in becoming a part of the business?
- Does the size and value of the business require that the ownership interest be spread amongst numerous siblings/family members? Some of whom may not be involved in the business?

Key Issues in Creating a Buy-Sell Agreement

Identify the Proper Buyer

- Is it appropriate to consider providing both non-voting interests and voting interests to such siblings/family members?

- Is there any risk of a majority of the owners combining their interests after a triggered sale to oppress or bully a minority owner or owners?

- Should each of the remaining owners have an equal right to increase their ownership interest? Is there a risk that one of the remaining owners may have disproportionately greater resources than the other remaining owner(s)?

Key Issues in Creating a Buy-Sell Agreement

"A nickel ain't worth a dime anymore." Yogi Berra

Choose the Proper Mechanism to Set the Purchase Price

- Owners mutually agree on the purchase price each year
  - Strengths: Can more accurately reflect the value of the business year-to-year.
  - Weaknesses: Owners may forget to set the mutually agreed price; circumstances may change to the point that the owners' interests diverge substantially, with some part of ownership pushing for a significantly higher purchase price and the other remaining interest holders pushing for a significantly lower purchase price.

Key Issues in Creating a Buy-Sell Agreement

Choose the Proper Mechanism to Set the Purchase Price

- Appraised value
  - Strengths: More accurately reflects the value of the business year-to-year; does not require the owners to agree on the actual price year-to-year; the purchase price should be determined by an appraiser who is knowledgeable in the valuation process.
  - Weaknesses: Can lead to litigation if guidance provided to the appraiser in making the valuation is not detailed enough; will still require the owners to either agree upon a single appraiser or go through a more cumbersome and expensive process of choosing multiple appraisers; fertile ground for litigation if the issues of minority interest discounts and lack of marketability discounts are not properly addressed.

Key Issues in Creating a Buy-Sell Agreement

Choose the Proper Mechanism to Set the Purchase Price

- Accountant's calculation of the purchase price based upon an agreed upon calculation
  - Strengths: Calculation formula can be narrowly tailored for the uniqueness of each business entity and to more accurately reflect FMV year to year; typically a cheaper and quicker option, especially if the accountant is agreed upon in the buy-sell agreement
  - Weaknesses: Corporate accountant may be considered as more favorable to one ownership group over another; corporate accountant may be unwilling to make such calculation due to relationships with each owner

Key Issues in Creating a Buy-Sell Agreement

Choose the Proper Mechanism to Set the Purchase Price

- Fixed price
  - Since these types of agreements are not always updated, they can be ticking time bombs.

The purchase price calculations are most often tailored as to "favored" (e.g. retirement, death and disability) and "disfavored" sales (e.g. voluntary withdrawals, bankruptcy, sales to third parties, and breaches of other agreements with the business entity).

Key Issues in Creating a Buy-Sell Agreement

Terms Determining Value

- Fair market value
- Fair value
- Formula pricing
- Book value

Key Issues in Creating a Buy-Sell Agreement

Include Appropriate Purchase Terms

- Notice periods for the parties' exercise of their various rights under the buy-sell agreement
- Time period between exercise of option to purchase and closing
- Amounts due at and after closing – down payment, installments, interest, etc.
- Security/collateral for any installment payments/personal guaranties
- Terms of promissory note/loan

Key Issues in Creating a Buy-Sell Agreement

Include Appropriate Purchase Terms

- Acceleration of payments due upon events such as the sale or merger of the business
- Voting rights/dividends/capital calls during installment payment
- Clarification of the equity ownership position of the buyers and sellers during any installment payment period
- Events of default on buyer's non-payment and remedies therefor

Key Issues in Creating a Buy-Sell Agreement

Funding the Purchase

- Life insurance
- Installment sale
- Borrowing/loans
- Personal resources

Key Issues in Creating a Buy-Sell Agreement

Miscellaneous Terms

- Covenant not to compete
- Non solicitation provisions
- Terms regarding permitted and/or prohibited transfers of interests to third parties
- Non-selling owners' right of first refusal to purchase
- Guaranteed employment terms
- Election of Directors and Officers

Factual Issues Which Affect the Drafting of Buy-Sell Agreements

"It's like déjà vu all over again." Yogi Berra

- Number of owners today and as expected in the future
- Family-owned?
- Type of business involved – Does it require special terms (e.g. professional licensing issues)?
- Age, status and insurability of each owner
- Relative percentages owned by each owner

Factual Issues Which Affect the Drafting of Buy-Sell Agreements

- What level of restrictions do the owners want to put on the transfer of interests? First right or refusal?
- Which trigger events are “penalized” for not being favored?
- Are there separate agreements or organizational documents with which the buy-sell agreement must be aligned?
- Do the parties prefer dispute resolution by litigation, mediation or arbitration?

Potential Tax Pitfalls

- IRC Section 302: If less than 100% of a shareholder’s interest is sold by redemption, and the complete termination or substantially disproportionate requirements are not met, the distribution to the selling shareholder will be deemed a dividend.
- If purchase price is greater or less than FMV, the selling owner or purchasing owner(s), respectively, may be deemed to have received a gift or compensation.
- Insurance proceeds could trigger business entity’s AMT

Conclusion

A Buy-Sell Agreement is an excellent tool to help business owners plan for today and tomorrow, and to help avoid costly and time-consuming disputes which can cripple and devastate an on-going business.

"Love is the most important thing in the world, but baseball is pretty good, too." Yogi Berra

"It ain't over till it's over." Yogi Berra

"I really didn't say everything I said." Yogi Berra

Employment Law Update 2017

Stephen M. Buck
309.674.1133
sbuck@quinnjohnston.com

Employment Law Update - 2017

The latest efforts at improving our lives through governmental regulation

Status of DOL Overtime Rule

- "New" OT Rule was set to take effect on Dec. 1, 2016
  - DOL said new rule was to simplify and make easier the identification of overtime protected employees under FLSA
  - Proposed significant changes to the minimum salary requirements of the "White Collar Exemptions"
    - **Executive**
    - **Administrative**
    - **Professional**
    - **Highly Compensated Employees (HCE)**
- No proposed changes to the "Primary Duties" tests

Status of DOL Overtime Rule

"New" Minimum Salary levels for Exempt Employees

(1) Must pay employee $913/week or $47,476 annually [currently is $455/week or $23,660 annually];

(2) For HCE employees, increases required annual salary to $134,000 [currently is $100,000 per year];

(3) Proposed OT Rule does allow for Non-Discretionary bonuses to satisfy up to 10% of salary;

(4) New OT Rule builds in automatic updating of salary levels every three years [estimated to increase to $51,168 by 2020].

Status of DOL Overtime Rule
So what happened to the Rule?

- Nationwide Preliminary Injunction Issued on November 22, 2016 [by federal judge in Texas]
  - 21 states filed suit challenging Rule
  - Enjoined the DOL from implementing and enforcing Rule
- Court found that language of FLSA did not support new OT Rule, as “White Collar Exemptions” depend on duties of employee not the employee’s salary
  - Rule created “de facto salary-only test” making 4.2 million workers non-exempt without any change in their duties
- Also found DOL lacked authority to provide for automatic updates

Status of DOL Overtime Rule
So what happened to the Rule?

- DOL filed a notice of appeal on December 1, 2016
  - Briefs were due to be filed by March 1, 2017
  - But Trump DOL asked for 60 day extension until May 1st
  - On April 14, 2017, asked for extension until June 30, 2017
  - DOL then filed its Brief on Appeal – asking 5th Circuit Court of Appeals to address only the question of the DOL's authority to set a salary level
    - Stating affirmatively that the DOL had decided not to advocate for the $913 per week salary level in the original proposed rule
- On July 25, 2017, DOL began a new "rulemaking" process by issuing an RFI

Status of DOL Overtime Rule
So what happened to the Rule?

- While appeal pending, on August 31, 2017, Texas District Court Judge entered final judgment in case – invalidating the proposed OT Rule
  - Determined the proposed rule was based on impermissible construction of the FLSA [basing exemptions on salary only]
  - But recognized authority of DOL to implement salary level test
- DOL filed unopposed motion to dismiss the pending appeal on September 5, 2017
- 5th Circuit Court of Appeals dismissed on Sept. 6th
- Obama proposed OT Rule effectively dead

Status of DOL Overtime Rule

So what happened to the Rule?

- For now, prior salary level test applies [$455/week]
- Comment period on DOL RFI closed on Sept. 25, 2017
- What can we expect:
  - During Senate confirmation hearings, Sec. Acosta stated OT Rule salary threshold should be updated to match inflation [at about $33,000]
  - Said impact on economy needs to be considered, as well as impact on non-profits [stated Obama administration went too far]
  - Would not commit to a DOL position, but said the DOL would review and possibly revise the proposed OT Rule

Status of EEOC Proposed Rule to Revise EEO-1 to collect Pay Data

- Why?
  - In an effort to advance equal pay, EEOC in conjunction with DOL announced in January of 2016 its intent to seek revisions to EEO-1 to collect pay data
- Who is required to file an EEO-1?
  - Employers with more than 100 employees, federal contractors with more than 50 employees
- What is an EEO-1?
  - A compliance survey that requires employees to categorize employment data by race/ethnicity, gender, and job category

EEOC Proposed Revisions to EEO-1

- What Pay Data will be required under new Rule?
  - Would require reporting earnings and hours worked by race and gender and job category
  - Proposes grouping in twelve pay bands, ranging from about $20,000 to above $200,000
    - For instance, the employer would report that it employs 6 White males and 8 African-American women Professionals in the eighth pay band of $80,080 to $101,900
- When would rule go into effect?
  - The proposed changes were set to take effect in 2017 with first and new reporting deadline of 3/31/18

EEOC Proposed Revisions to EEO-1

- Potential Impact on Employers:
  - Millions of hours and dollars spent compiling and reporting data
  - Intended use of data by EEOC to "discern potential pay discrimination" is actually complicated by questionable reliability of manner in which data reported
    - Use of W-2 data in Box 1 could produce misleading results
    - Use of "proxy hours" for exempt employees also misleading
    - Failure of data to take into account other variables like education, seniority, and level of responsibility
- Businesses and Employers voiced strong concerns and criticisms over proposed costs and unreliability of data [Obama Administration ignored criticisms/concerns and pushed rule forward]

Proposed EEO-1 Revisions Stayed

- On August 29, 2017, EEOC Acting Chair announced that the OMB was initiating an ***immediate stay*** and review of the new EEO-1 pay reporting requirements
- OMB announced stay was result of:
  – Data file specifications issued by EEOC after rule was proposed, which were not part of rule-making process for public comment
  – Fact that EEOC's burden/cost analysis did not account for these data file specifications
  – OMB believes the collection of the information violates the Paperwork Reduction Act, lacks practical utility, is unnecessarily burdensome, and does not address privacy/confidentiality issues

New Illinois Statutes

Employee Sick Leave Act

- Effective January 1, 2017 (amended January 13, 2017)
- **DOES NOT REQUIRE EMPLOYERS TO PROVIDE SICK LEAVE**
- **DOES REQUIRE**: Employers to allow Employees to use personal sick leave benefits already provided by the Employer to cover absences due to an illness, injury, or medical appointment of the employee's family member [on the same terms upon which the employee is able to use sick leave benefits for his/her own illness or injury].
  - "**Family member**" includes the "employee's child, stepchild, spouse, domestic partner, sibling, parent, mother-in-law, father-in-law, grandchild, grandparent, or stepparent."

New Illinois Statutes

Employee Sick Leave Act

- **Personal sick leave benefits** means "any paid or unpaid time available to an employee as provided through an employment benefit plan or paid time off policy to be used as a result of absence from work due to personal illness, injury, or medical appointment."
  - An employment benefit plan or paid time off policy does not include long term disability, short term disability, an insurance policy, or other comparable benefit plan or policy.

New Illinois Statutes

Employee Sick Leave Act

- **Limitations on Application**
  - Does not apply to employers subject to Title II of the Railway Labor Act, employers/employees under federal Railroad Unemployment Insurance Act, or Sections 51 through 60 of the Federal Employer's Liability Act
    - Essentially means that the Act applies to employers not in railroad or airline business
  - Does not invalidate, diminish, or interfere with any CBA or any party's power to collectively bargain for such an agreement
  - Department of Labor may adopt rules that could further limit application or create exemptions

New Illinois Statutes

Employee Sick Leave Act

- Limitations on Application
  - Employers may limit the use of personal sick leave benefits for absences due to an illness of family member to an amount not less than the leave that would be earned or accrued during 6 months at the employee's then current rate of entitlement.
  - Employers who base personal sick leave benefits on years of service may limit amount of sick leave to be used to half of the employee's maximum annual grant.
  - Act does not extend the maximum period of leave to which an employee is entitled under FMLA

New Illinois Statutes

Employee Sick Leave Act

Retaliation Prohibited: An employer may not deny an employee the right to use sick leave in accordance with the Act, and may not retaliate against an employee for using personal sick leave benefits, attempting to exercise his/her rights under the Act, filing a complaint with the DOL, or cooperating in an investigation associated with a violation of the Act, or opposing any policy or practice prohibited by the Act.

- HOWEVER – the Act expressly states that it does <u>not prohibit</u> an employer from applying/enforcing the terms and conditions set forth in the employment benefit plan or paid time off policy applicable to personal sick leave benefits.

New Illinois Statutes
Child Bereavement Leave

- Passed and Effective on July 29, 2016
- Allows employees up to 2 weeks (10 work days) of <u>unpaid</u> leave to attend the funeral (or alternative) of a child, to make arrangements necessitated by the death of a child, or to grieve the death of a child.
  - Up to six weeks in the event of the death of more than one child
- **Child** means an employee's "son or daughter who is a biological, adopted, or foster child, a stepchild, a legal ward, or a child of a person standing in loco parentis."

New Illinois Statutes

Child Bereavement Leave

- Employer and Employer are defined in accordance with the Family and Medical Leave Act (FMLA).
  - Only applies to employers with 50 or more employees.
  - Employees must have worked 1,250 hours in prior 12 months to be eligible for leave under Act.
- Leave must be completed within 60 days of notice of the death.
- Employee must provide the employer with at least 48 hours' advance notice, unless it is not reasonable and practicable.
- Employer may require reasonable documentation [death certificate, published obituary, written verification from funeral home, religious institution or governmental entity].

New Illinois Statutes

Child Bereavement Leave

- Act expressly prohibits an Employer from retaliating against an employee exercising, or attempting to exercise, his or her rights under the Act
- Employee who believes his/her rights under Act have been violated may file complaint with IL DOL w/in 60 days of violation
- Penalties
  - Civil penalty not to exceed $500 for first offense (for each employee affected)
  - Civil penalty not to exceed $1,000 for subsequent offenses (for each employee affected)
  - Civil action seeking injunction and other equitable relief

New Illinois Statutes

IL Right to Privacy in the Workplace Act

- Previously the Act prohibited Employers from requesting an employee's passwords to social networking websites;
- Effective January 1, 2017 the scope of the Act was expanded to include "Personal Online Accounts (POAs)" defined as "an online accounts that is used by a person primarily for personal purposes."
  - POAs do not include an account created, maintained or used by a person for a business purpose of the person's employer

New Illinois Statutes

IL Right to Privacy in the Workplace Act

- Amended Act now prohibits an employer from:
  - Requesting, requiring or coercing any employee or prospective employee to authenticate or access an online account in the presence of the employer;
  - Requiring or coercing an employee to invite an employer to join a group affiliated with the POA;
  - Requiring or coercing the employee to join an online account established by the employer or add the employer to the employee's list of contacts in the employee's POA.
- Act also now includes Retaliation provisions, prohibiting an employer from disciplining or discharging employee who refuses access to a POA or refuses to participate in any prohibited activity under the Act.

New Illinois Statutes

IL Right to Privacy in the Workplace Act

- Act also states that nothing in statute shall prohibit an Employer from:
  - Complying with State and federal laws, rules, and regulations and the rules of self-regulatory organizations created pursuant to federal or State law
  - Requesting or requiring employees or prospective employees to share ***specific content*** that has been reported in order to:

    (1) ensure compliance with applicable laws or regulatory requirements;

    (2) to investigate an allegation, based on receipt of specific information, of the unauthorized transfer of an employer's proprietary or confidential information or financial data to an employee or applicant's personal account;

    (3) to investigate an allegation, based on receipt of specific information, of a violation of applicable laws, regulatory requirements, or prohibitions against work-related employee misconduct;

    (4) to prohibit an employee from using a personal online account for business purposes; or

    (5) to prohibit an employee or applicant from accessing or operating a personal online account during business hours, while on business property, while using an electronic communication device supplied by, or paid for by, the employer, or while using the employer's network or resources, to the extent permissible under applicable laws.

<u>**NOTE**</u>: Even when engaged in above activity, an employer may not require a password or other means of authentication that provides access to the employee or applicant's personal online account.

New Illinois Statutes

IL Right to Privacy in the Workplace Act

- Amended Act also provides that an employer that "inadvertently receives" the password or other info which would allow it to gain access to a POA is **not** liable unless:
  - uses that information, or enables a third party to use that information, to access the employee or potential employee's personal online account; or
  - after the employer becomes aware that such information was received, does not delete the information as soon as is reasonably practicable, unless that information is being retained by the employer in connection with an ongoing investigation of an actual or suspected breach of computer, network, or data security. Where an employer knows or, through reasonable efforts, should be aware that its network monitoring technology is likely to inadvertently to receive such information, the employer shall make reasonable efforts to secure that information.

New Illinois Statutes

Illinois Freedom to Work Act

- Effective January 1, 2017
- **Background:** IL Attorney General sues Jimmy Johns in June of 2016 over covenants not to compete required of its delivery drivers and shop workers
  - For 2 years after leaving Jimmy Johns, the employee may not work at another business within 2 miles of a Jimmy Johns that gets 10% of its revenue from selling sandwiches;
  - State of New York piled on – brought its own action
- Concerned about impact of covenants on limiting mobility of low-wage workers, Illinois legislature acted "*freaky fast*" and passed law on August 19, 2016

New Illinois Statutes

Illinois Freedom to Work Act

- Prohibits and declares void any covenant not to compete between an Employer and low-wage Employee.
  - **Low-wage employee**: an employee who earns the greater of (1) the hourly rate equal to the minimum wage or (2) $13.00 per hour.
  - **Covenant not to compete**: any agreement that restricts the employee from performing (A) any work for another employer for a specified period of time, (B) any work in a specified geographical area, or (C) work for another employer that is similar to the work that the employee is performing for the employer.

New Illinois Statutes

Victims' Economic Security and Safety Act

- Amended Effective January 1, 2017 to increase the number of Employers subject to the Act;
- Expands definition of Employer (Section 10) to include any person that employs at least one employee [previously required Employer to employ 15 employees to be covered].
- Section 20 of the Act amended to add additional category of required leave, now providing that an employee working for an employer that employs at least one but not more than 14 employees shall be entitled to a total of 4 workweeks of leave during any 12-month period.
  - Law also provides 12 weeks of leave if the Employer has 50 or more employees, and 8 weeks of leave if the Employer has 15 to 49 employees

New Illinois Statutes

Domestic Workers Bill of Rights Act

- Effective January 1, 2017
  - Domestic Workers historically excluded from protections of State Law
- Amends the Illinois Human Rights Act, Minimum Wage Law, Wages of Women and Minors Act, and One Day Rest in Seven Act to include Domestic Workers.
- Domestic Worker defined as a person performing any of the following: (1) housekeeping; (2) house cleaning; (3) home management; (4) nanny services; (5) caregiving, personal care or home health services for elderly persons or persons with an illness, injury, or disability who require assistance in caring for themselves; (6) laundering; (7) cooking; (8) companion services; (9) chauffeuring; or (10) other household services for members of households or their guests in or about a private home or residence or any other location where the domestic work is performed.

New Illinois Statutes

Domestic Workers Bill of Rights Act

Excluded from coverage under the Act:

- Persons performing domestic work for immediate family members;
- Child and day care home providers participating in the child care assistance program under the IL Public Aid Code
- Persons employed by one or more employers and who perform domestic work for less than 8 hours per week in the aggregate on a regular basis, exclusive of individuals whose primary work duties are caregiving, companion services, personal care or home health services for elderly persons or persons with an illness, injury, or disability who require assistance in caring for themselves
- Persons who are (a) free from control and direction over the performance of his/her work; (b) are engaged in an independently established trade, occupation, profession or business; (c) or who are deemed a legitimate sole proprietor or partnership.

New Illinois Statutes

Illinois Wage Assignment Act

- Effective January 1, 2017 the Act was amended as follows:
  - Eliminated the 84-day expiration period for wage assignments, and now provides that a wage assignment demand will apply to wages due at the time of service of the demand and upon subsequent wages until the total amount due under the assignment is paid;
  - Act also now allows an employee to revoke a wage assignment by written notice, if the wage assignment is revocable under federal law.
- Changes were also made to language set out in the Act to be used as "form" demands and notices to reflect the above changes.

Legislation Pending in Illinois: *How may the government help you?*

SB 2147: Healthy Workplace Act – If enacted into law, it would require employers to provide paid sick days to employees:

- Would allow employees to earn and use up to 7 paid sick days during a 12-moth period;
- Would apply to full-time and part-time employees;
- Could be used for events such as illnesses, injuries, or health conditions of the employee or his or her family member; medical appointments or seeking medical diagnosis for the employee or his or her family member; closures related to a public health emergency; and being or having a family member who is a victim of domestic violence.

• Family member is defined in the bill as a child, spouse, parent, or the child or parent of an employee's spouse.

Legislation Pending in Illinois:
How may the government help you?

HB 3297: Employee Paid Health Care Time Act – if enacted it would require employers to provide accrued paid health care time to employees:

- For employers with 50 or more employees, paid health care time would be provided at a rate of not less than 1 hour for every 22 hours worked;
- For employers with less than 50 employees, paid health care time would be provided at a rate of not less than 1 hour of paid health care time for every 40 hours worked.

- Employees could use paid health care time for illnesses, injuries, and medical appointments, or for caring for family members.
  - Family member: child, stepchild, foster child, parent, parent-in-law, grandparent, spouse, or domestic partner, or a ward of the employee who lives with the employee.
- Accrued but unused time is not compensable on termination/ separation unless otherwise agreed upon.

Legislation Pending in Illinois: *How may the government help you?*

SB 981 and HB 2462: Amendments to Equal Pay Act of 2003 – if enacted would prohibit an Employer from:

1) Screening job applicants based on their wage or salary history;
2) Requiring that an applicant's prior wages satisfy minimum or maximum criteria, and
3) Requesting or requiring as a condition of being interviewed or as a condition of continuing to be considered for an offer of employment that an applicant disclose prior wages or salary.

Also prohibits an employer from seeking the salary, including benefits or other compensation or salary history, of a job applicant from any current or former employer.

Legislation Pending in Illinois:
How may the government help you?

SB 981 and HB 2462: Amendments to Equal Pay Act of 2003

Proposed Amendments provide for enhanced civil penalties if the Act is violated, including:

- Compensatory damages where an employee shows that the employer acted with malice or reckless indifference;
- Punitive damages and injunctive relief as may be appropriate in cases involving an employee who is paid less than the wage to which he or she is entitled.
- Director of DOL may seek injunctive relief for unpaid wages.
- **VETOED BY GOV. RAUNER ON AUGUST 25, 2017**

Legislation Pending in Illinois:
How may the government help you?

SB 81 Minimum Wage Increase – if enacted would increase minimum wage in Illinois:

- To $9 per hour from Jan. 1, 2018 to Dec. 31, 2018;
- To $10 per hour from Jan. 1, 2019 to Dec. 31, 2019;
- To $11.25 per hour from Jan. 1, 2020 to Dec. 31, 2020;
- To $13 per hour from Jan. 1, 2021 to Dec. 31, 2021;
- And to $15 per hour after Jan. 1, 2022.

VETOED BY GOV. RAUNER ON AUGUST 25, 2017

Cybercrime, Digital Evidence and the Impact on an Intellectual Property Practice

Mitch M. Gilfillan
309.674.1133
Mgilfilln@quinnjohnston.com

What is Cybercrime?

- Cybercrime is defined as a crime in which a computer is the object of the crime (hacking, phishing, spamming) or is used as a tool to commit an offense.
- Cybercriminals may use computer technology to access personal information, business trade secrets or use the internet for exploitive or malicious purposes.
- Criminals can also use computers for communication and document or data storage. Criminals who perform these illegal activities are often referred to as hackers.

Cybercrime, Black's Law Dictionary (10th ed. 2014).

What are different types of Cybercrime?

- Online banking;
- Identity Theft;
- Online Predatory Crimes;
- Virus attacks and spam; and
- Unauthorized computer access, to name a few.

Places Where Cybercrime most-often committed?

- Workplace computers;
- Networks and other online databases;
- Information technology (IT) resources; and
- Homes.

-USA Today


THREAT Toons™
by: Alex Savchuk
ALL OF OUR CYBERSECURITY ISSUES HAVE BEEN SOLVED WITH ZERO EFFORT AND MINIMAL BUDGET... APRIL FOOLS'!!!
Is your CSO playing April Fools' jokes?

Cybercriminals in the Workplace: What to do?

- Failure to take appropriate precautions exposes the enterprise to otherwise avoidable or manageable risks and fallout.
- Evidence of criminal activity may be a potential violation of federal or state obstruction of justice statutes.
- Duty to report? Evidence of child-related issues.
- Although such offenses require proof of criminal intent associated with the destruction of evidence, the government may not share your view when it comes to the existence of that intent.
- Destroying, purging and emptying ("trash bin") evidence
  - Be careful - 720 ILCS 5/11-20.1(b)(5)

Execution of a Search Warrant, Subpoena or Request to Search

Steps when law enforcement suspects criminal activity:

- What to do?
- Contact attorney for advice
- Probable cause for a search warrant?
- Privacy issues?
- Notice issues?
- Do you have a response plan in place?
- Who has responsibility for managing the situation?

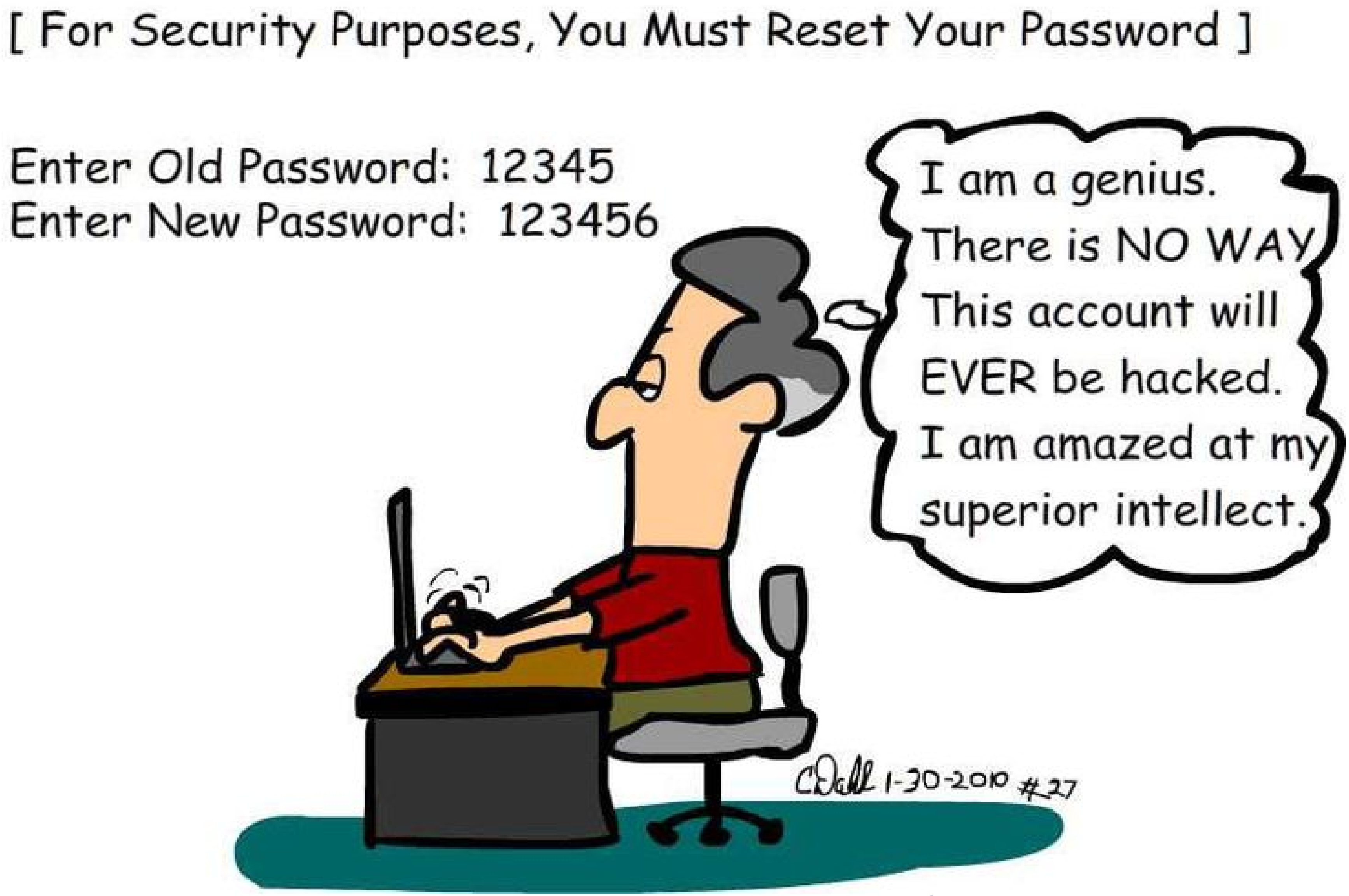
What to do if you suspect an employee of criminal activity?

At some point, everyone will face some level of criminal activity in the workplace:

- Should the employee be confronted?
- Should additional investigative work be undertaken?
- Should law enforcement be called?
- Is there a duty to report this activity to law enforcement?
- Can steps be taken to control the impact?
- How to/who will handle public relations?

Steps to Prevent Cybercrime in the Workplace

1. Firewalls
2. Antivirus software
3. Encryption/cryptography
4. Access restriction and passwords – CHANGE OUR PASSWORDS!
5. Cameras
6. Locks/access devices
7. Controlled use of removable and portable devices (e.g., thumb drives, cell cameras) – policy in place?


[For Security Purposes, You Must Reset Your Password]
Enter Old Password: 12345
Enter New Password: 123456
I am a genius. There is NO WAY This account will EVER be hacked. I am amazed at my superior intellect.
CDall 1-30-2010 #27

Illinois Computer Crime Laws

Illinois computer crime laws differentiate between misdemeanor computer crimes (sending spam, for instance) and felony computer crimes (such as financial fraud).

Illinois Computer Crime Prevention Law (1987)

One way the state battles computer crimes is through the Illinois "Computer Crime Prevention Law" (ICCPL), which makes unauthorized computer use a criminal offense. The law is broken down into three (3) major categories:

1) Computer Tampering: This includes gaining access to a computer, a program, or data, without permission from the owner and creating or distributing computer viruses.
2) Aggravated Computer Tampering: This crime pertains to the government specifically. You can be in violation of the law if you tamper with a computer and you have the intended effect of: (a) disruption of or interference with vital services or operations of State or local government or a public utility, or (b) creating a strong probability of death or great bodily harm to other individuals.
3) Computer Fraud: This crime pertains specifically to using a computer for fraudulent activities.

720 1LCS 5/16D-1, 720 1LCS 5/17-50 et seq.

Cyber Liability Insurance

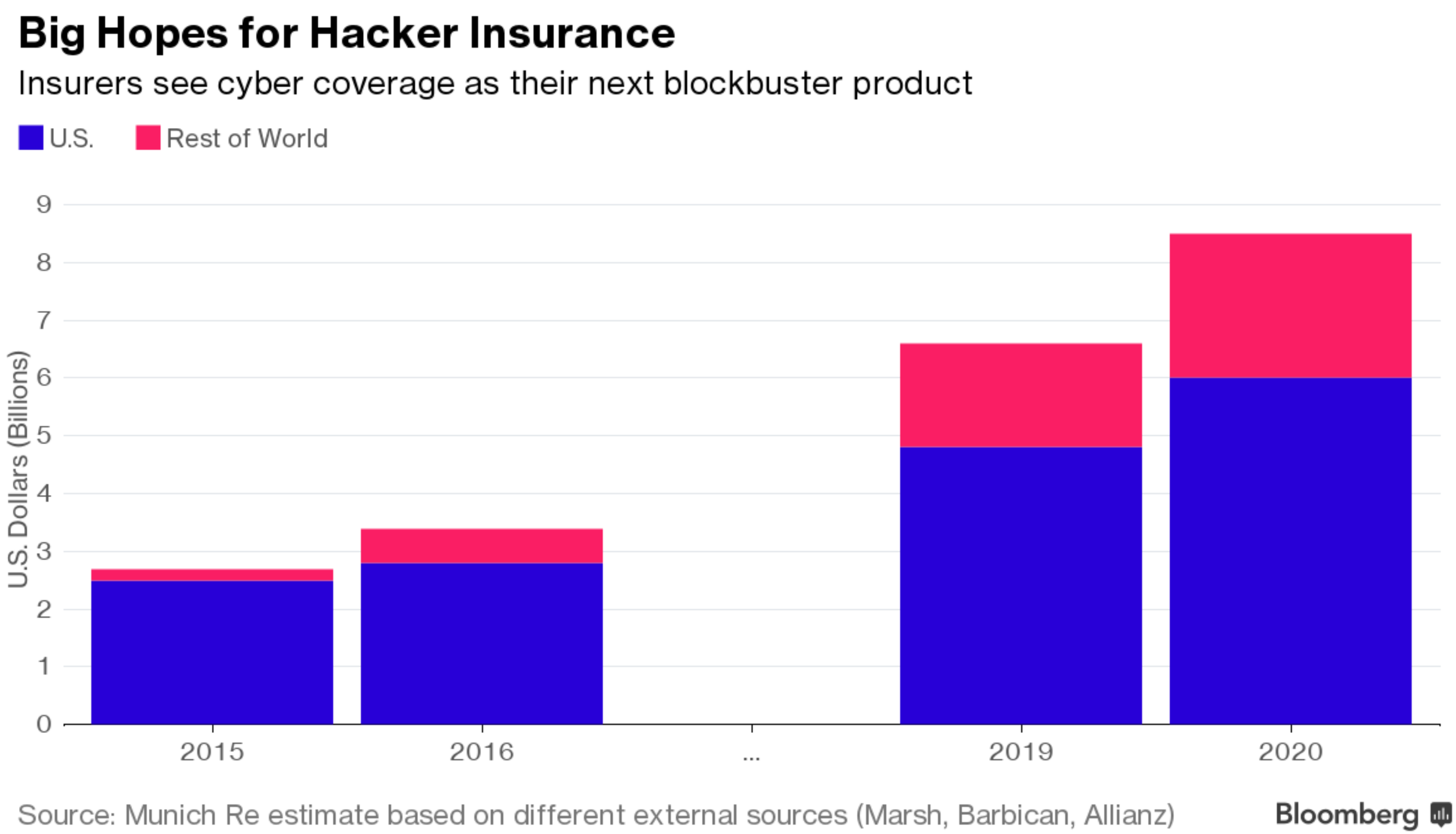
- Just about any organization that uses technology to do business faces cyber risk.
- And as technology becomes more complex and sophisticated, so do the threats we face – which is why every business and organization should be prepared or at least discuss cyber liability insurance and an effective cyber security plan to manage and mitigate cyber risk.

4 Ways Cyber Insurance Helps Protect a Business

- Lost Data – covers breach of data
- Lost Devices – prevents unauthorized use
- Notification Requirements - Notifying customers or clients of a breach and other post-breach responses, which is mandated by law, can be costly
- Forensics – Private client information compromised?

Ponemon Institute 2016 Cost of Data Breach Study

Insurers see Cyber Coverage as Blockbuster Product



What is Digital Evidence?

Digital evidence is any information or data of value to an investigation that is stored on, received by, or transmitted by an electronic device. Text messages, emails, pictures and videos, and internet searches are some of the most common types of digital evidence.

The Digital Trail

Most criminals now leave a digital footprint; a suspect's IP address, posting on a Social Media platform or using their mobile device for everyday use in place of a traditional computer and camera. This is information could reveal:

1) Intent,
2) Location and time of crime,
3) Relationship with victim(s), and
4) Relationship with other suspect(s)

More on Digital Evidence:

- It is latent (hidden), like fingerprints or DNA evidence;
- Crosses jurisdictional borders quickly and easily;
- Can be altered, damaged or destroyed with little effort; and
- Can be time sensitive.

How Digital Evidence and Intellectual Property Issues Intertwine:

What is Intellectual Property?

- Intellectual property (IP) refers to creations of the mind, such as inventions; literary and artistic works; designs; and symbols, names and images used in commerce.
- IP is protected in law by patent, copyright and trademarks, which enable people to earn recognition or financial benefit from what they invent or create. By striking the right balance between the interests of innovators and the wider public interest, the IP system aims to foster an environment in which creativity and innovation can flourish.

What is Intellectual Property?

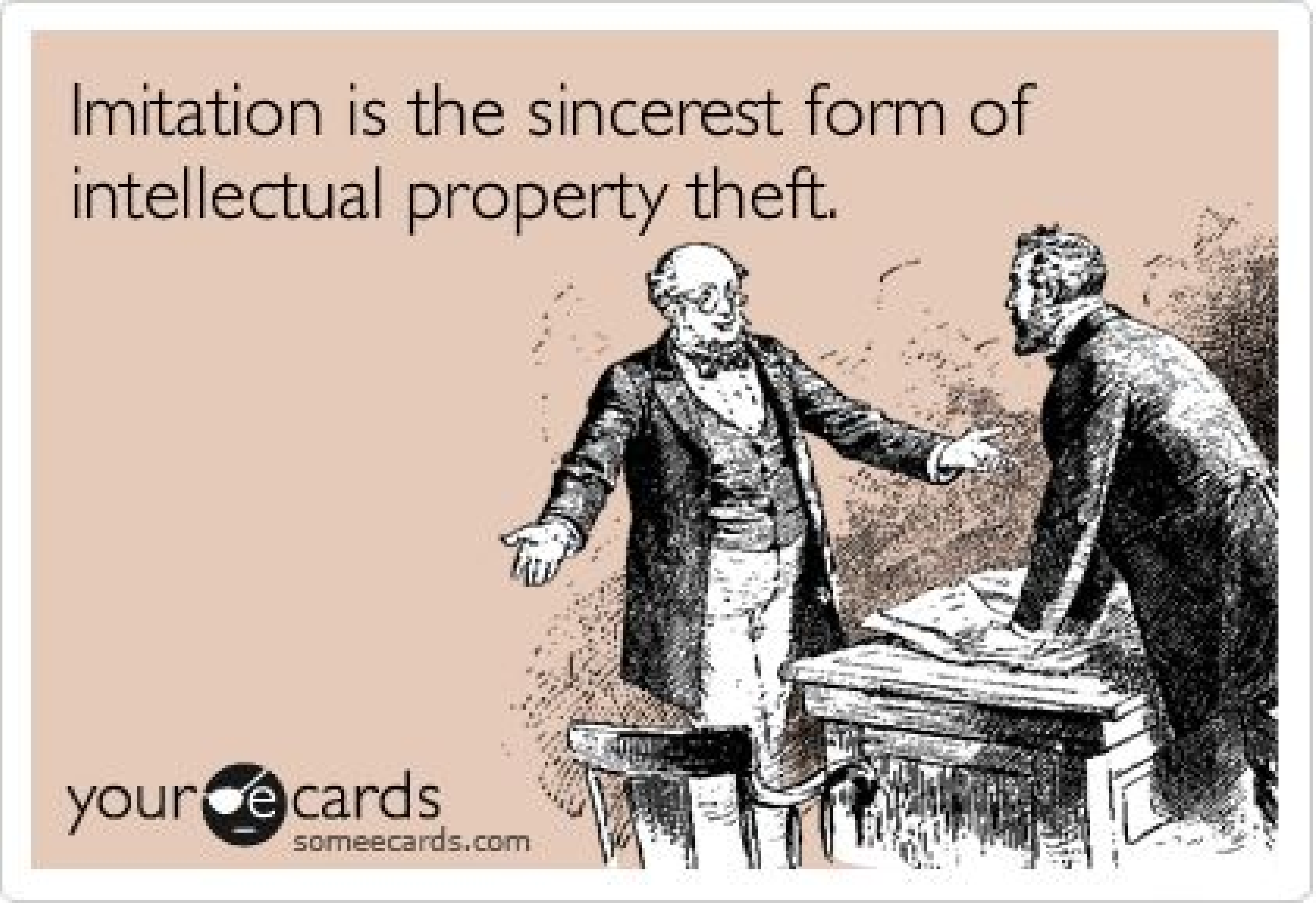
Some states, including Illinois, have their own trademark procedures for protecting names for goods or services used within the state. All these facets of the intellectual property law cooperate to provide the maximum protection for an idea, an invention, a work of art, a book or other item of intellectual property.

Digital Evidence in a IP Case

- Intellectual property litigation will rise and fall with the digital evidence. Consider the facts:
- Over 99 percent of corporate documents are created electronically.
- Fewer than one third of e-documents are ever printed.
- As many as 420 billion e-mails were sent each day in 2016.
- An estimated 60 percent of a business' critical e-mail information is contained within corporate e-mail systems.

Potential sources of evidence created outside of the day-to-day operations of corporations:

- Webmail providers;
- Internet service providers (ISPs);
- web-based or cloud application;
- Storage providers;
- Cellphone providers; and
- Government closed-circuit surveillance cameras;
- Highway toll systems


Imitation is the sincerest form of intellectual property theft.
your ecards
someecards.com

Seized Devices in an Investigation:

- Smartphones and other mobile devices;
- Laptops and Computer Desktops;
- CDs, DVDs, digital camera, surveillance systems, GPS devices, thumb drives

Data Breach Fact:

Yahoo

- Date: 2013-14
- Impact: 3 billion user accounts
  Details: In September 2016, the once dominant Internet giant, while in negotiations to sell itself to Verizon, announced it had been the victim of the biggest data breach in history, likely by “a state-sponsored actor,” in 2014. The attack compromised the real names, email addresses, dates of birth and telephone numbers of 500 million users. The company said the "vast majority" of the passwords involved had been hashed using the robust bcrypt algorithm.
- Besides names, dates of birth, email addresses and passwords that were not as well protected as those involved in 2014, security questions and answers were also compromised.
- In October of 2017, Yahoo revised that estimate, saying that all 3 billion user accounts had been compromised.

Funding the Revocable Trust and Asset Ownership Considerations for Estate Planning

Kenny Eathington
309.674.1133
keathington@quinnjohnston.com

Funding the Revocable Trust and Asset Ownership Considerations for Estate Planning

Kenny Eathington
309.674.1133
keathington@quinnjohnston.com

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I. Funding the Revocable Trust

The following is a summary of the steps necessary to transfer assets into your Revocable Trust. As you know, funding your Revocable Trust is an important step in the estate planning process if you are to obtain the maximum probate avoidance from your Trust.

Joint Tenancy Property.

Assets which you hold in joint tenancy with right of survivorship (and not as tenants in common) will avoid probate on the first death, but will not avoid probate on the survivor's death (unless the survivor transfers them into the survivor's Trust or makes other provisions). Too many joint assets can undermine the tax planning in your Trust because joint tenancy property passes to the surviving joint tenant(s) upon the death of one joint tenant, regardless of the provisions in your Revocable Trust Agreement. Consequently, joint tenancy should be used very carefully, and only a few (if any) of your assets should be held jointly in this manner.

Tax Identification Number.

During your lifetime and while you are acting as Trustee of your own revocable trust, the tax I.D. number for the Trust will be your social security number. All income, deductions and credits attributable to your Trust assets will be reported by you on your individual income tax return. If in the future, you are no longer acting as Trustee of your own Revocable Trust, the successor Trustee must furnish your name, social security number, and the address of the trust to all payors. The successor Trustee additionally must provide you with tax information regarding all items of income, deduction, and credit for the trust, as well as other related information so that you are able to complete your individual income tax return. The successor Trustee may also apply for a separate tax identification number for the trust and follow the appropriate reporting requirements.

On-Going Process.

Trust funding is an ongoing process. As you acquire additional assets or deal with your existing assets, you should consider whether the assets should be owned by your Trust. We also suggest that you maintain a schedule that lists your assets (including the value of each asset, the current ownership and the beneficiary designation, if any). This schedule will help your successor Trustee readily determine which assets are held in your Trust and will also provide a means by which your Trust can be reviewed on an ongoing basis.

Methods to Transfer Specific Types of Assets.

The general rule to follow is that when an asset is transferred to your Trust, the asset should be titled as follows:

> John A. Smith and Jill A. Smith, Co-Trustees of the John A. Smith Revocable Trust U/A dated November 6, 2014; or
>
> Jill A. Smith and John A. Smith, Co-Trustees of the Jill A. Smith Revocable Trust U/A dated November 6, 2014.
>
> For assets which will be payable to your Trust upon your death (such as a life insurance beneficiary designation), the beneficiary should be listed as follows:

Trustee of the John A. Smith Trust U/A dated November 6, 2014; or

Trustee of the Jill A. Smith Trust U/A dated November 6, 2014.

The reason for this slight difference is that because the benefits will not be payable to your Trust until your death, there is no certainty as to who will be serving as Successor Trustee at that time. This will also allow you to amend your Trust and change Successor Trustees without having to change beneficiary designations.

Discussion of Specific Asset Transfers.
The information below discusses how to transfer assets into your Trust and is organized by category of assets.

1. **Bank Accounts**. All cash held in a Revocable Trust should be in a separate account titled in the name of the Trust. After an asset is transferred into a trust, the Trustee should deal with the asset in his or her capacity as Trustee.

   For convenience, you may wish to maintain a checking account which is not owned by your Trust. You might want this account to be payable upon your death into your Trust. Accounts which are payable to a named beneficiary such as your Trust upon the death of the account owner(s) are called payable on death ("POD") accounts, and your banker should be able to assist you in retitling or establishing an account in this form.

2. **Publicly Traded Stocks**. The change of title to publicly traded stocks can be done through a stock broker or directly through the transfer agent for the company. Although the requirements will sometimes differ depending upon the company with which you are dealing, usually all that will be required is a signed stock power (which will need to have a medallion signature guaranteed from a bank officer or a registered stock broker) and a letter of instruction to the transfer agent or broker. You will also have to surrender the stock certificate. If you mail these documents to the transfer agent, they should be sent by registered mail.

   If you will be transferring more than one stock certificate of the same company to your Trust, you may want to request that a series of new certificates be issued; each corresponding to your old certificates, rather than one certificate consolidating all of your shares. This way, you will be able to trace your income tax basis in any shares that might later be sold.

3. **Bonds**.

   (a) Registered Bonds. Bonds are transferred in a manner similar to stocks, but instead of a stock power, an assignment of bond is executed.

   (b) Unregistered Bonds/Bearer Bonds. Unregistered or bearer bonds should be assigned to your trust by separate written assignment, or specifically receipted for in writing by the Trustee.

   (c) Savings Bonds. Your bank can assist you with the procedure of changing the ownership of any United States Savings Bonds (Series E, EE, H or HH) to your Trust.

4. **Brokerage Accounts**. When stocks, bonds and similar assets are held in street name in a brokerage account, all that is generally required is a letter of instruction to the broker requesting a change in the ownership of the account and completion of forms that will be furnished by the broker. Some brokerage firms issue a new account number when ownership is transferred.

5. **Mutual Funds**. The transfer of shares in a mutual fund is similar to transfer of publicly traded stocks when the evidence of ownership is in certificate form. When the shares are held in bookkeeping entries, rather than certificates, contact the fund's agent to obtain forms and instructions.

6. **Closely Held Stock**. Stock in a closely held company is transferred by endorsing the existing certificates or signing stock powers, then surrendering the certificates to the person holding the stock book so that existing certificates can be cancelled and new certificates can be issued. The new certificates will be issued in the name of the Trust. You should check any applicable buy/sell or other shareholder's agreements to make sure that transfer restrictions do not prohibit the transfer to a revocable trust. We can assist you in preparing stock powers to transfer any closely held stock.

7. **Partnership and Limited Liability Company Interests**. A partnership or limited liability company interest is transferred by an Assignment of Interest. The Assignment is delivered to the managing general partner or managing member who will record the change of ownership in the partnership or company records. The Partnership Agreement or Operating Agreement may contain certain restrictions on the transfer of partnership/membership interests. The restriction may require the other partners' or members' consent to the transfer, or the transfer may be prohibited, in which case an amendment to the agreement would be necessary.

8. **Real Property**.

   (a) Transfer by Special Warranty Deed/Quit Claim Deed. Any interests in real property are transferred to the Trust by special warranty deed or quit claim deed filed with the Recorder of Deeds in the County where the property is located. The deed contains a legal description of the real property. If there is a loan secured by the real property, permission of the lender may be needed (we suggest that you always obtain the lender's written consent) before the property can be transferred in order not to trigger any "due on transfer" or other acceleration type clauses.

   (b) Contract for Deed. If you are purchasing real estate under a "contract for deed" or land installment contract, your interest in the contract and any escrow agreement should be assigned to your Trust and a deed conveying the subject property to the Trust given to the escrow agent, so that upon completion of the contract, not only the deed conveying the subject property to you, but also the deed conveying the property to the Trust may be filed of record. This should also protect you should you die prior to full performance under the contract.

(c) Mineral Interests. Mineral interests (including those under which you are receiving production payments) should be assigned to your Trust by Mineral Deed. Mineral Deeds should be recorded in the counties where the interests are located. After the Mineral Deeds are recorded, transfer orders should be obtained from the purchasing oil and gas companies so that oil and gas production proceeds will be paid directly to the Trust.

d) Property and Casualty Insurance. When insured property such as real estate or an automobile is transferred to a trust, we also suggest that you contact the insurance carrier and advise them that the Trust should be added as an additional named insured party on the policy. Most insurance companies do not charge a fee for adding the Trust as an additional party.

9. Oil and Gas Interests. Oil and Gas Leasehold interests should be assigned to the Trust by Assignments and the Assignments should thereafter be recorded in the counties where the interests are located. After the Assignments are recorded, transfer orders should be obtained from the purchasing oil and gas companies so that oil and gas production proceeds will be paid directly to the Trust.

10. Life Insurance Policies. Proceeds of life insurance policies are made payable to the Trust by change of beneficiary forms which are provided by the life insurance company (and can be obtained through your life insurance agent). Ownership of individual policies and some group policies can also be transferred to the Trust (so the Trustee can exercise policy rights on your behalf). Again, obtain these forms through your life insurance agent. Your agent should also be able to assist you in having change of ownership and beneficiary forms properly submitted to your insurance carrier.

Remember that, (i) who you name as beneficiaries of life insurance policies, (ii) the extent to which you retain ownership rights in life insurance policies, and (iii) how and when you transfer policies can have significant estate tax, income tax, and generation skipping transfer tax consequences. We suggest that you discuss your particular planning situation with us to coordinate your existing policies with your estate plan. We also suggest that you talk with us before you purchase additional insurance, transfer insurance, or change beneficiary designations.

11. IRAs and Qualified Retirement Plans (401(k)s, Pension, Profit-Sharing, Keoghs, ESOPS, etc.). Although it is not possible to change the ownership of IRAs and retirement plans, you may want to name your Trust as beneficiary. This can be done through beneficiary designation forms provided by the administrator of the IRA or retirement plan.

Failing to designate the proper beneficiary on your retirement plans can result in unintended estate, inheritance and other death tax consequences, but it can also cause premature income taxation. This is particularly true when estate planning is accomplished through a Revocable Trust. Due to the proper beneficiary designation being situation sensitive and subject to exceptions and subsequent changes in the law, no beneficiary designation or change in beneficiary designation should be implemented on qualified retirement plans or IRAs without consulting an attorney or your tax advisor.

12. **Tax Deferred Annuities.** The ownership of a tax deferred annuity may be changed to your Trust. In some circumstances, it may be desirable from an estate tax point of view or for asset management, to name the owner's Trust as primary beneficiary. Thus, you should consult an attorney prior to making any such designations.

13. **Promissory Notes**. Promissory Notes are transferred by executing an Assignment of Promissory Note. This is then forwarded to the maker of the Note with instructions to make subsequent payments to the Trustee. Alternatively, the original promissory note may be endorsed on the reverse side of the note as follows:

    "Pay to the order of John A. Smith and Jill A. Smith, Co-Trustees of the John A. Smith Revocable Trust dated November 6, 2014;" or

    "Pay to the order of Jill A. Smith and John A. Smith, Co-Trustees of the Jill A. Smith Revocable Trust dated November 6, 2014."

14. **Safe Deposit Boxes**. You should retitle your safe deposit box(es) so that your Trust is listed as the owner. In this manner, all unregistered assets (such as bearer bonds, cash, jewelry, etc.) held in the safe deposit box will be in your Trust.

15. **Tangible Personal Property**. You interest in furniture, fixtures, artwork, jewelry, personal belonging and effects may be transferred to your Trust by a general assignment document called an Instrument of Transfer which we can prepare for you.

16. **Automobiles (and Boats, Planes, or other titled assets)**. Many individuals choose not to transfer automobiles they already own into a Trust. Instead, they wait until they purchase a new automobile and then purchase it in the name of a Trust. The risk of waiting to retitle existing automobiles is that the automobile may be subject to the probate process (if the total value of personal property individually owned is greater than $100,000). Many people determine that this risk is outweighed by the difficulty of working with the Department of Motor Vehicles to have a title reissued for an existing automobile.

    In addition, if either of you collect automobiles, or have boats, planes, or other titled assets which you anticipate keeping, you may choose to have some or all of these assets retitled in the name of your Trust. If any automobiles or other titled assets are transferred to a trust, we suggest that you have your property and casualty insurer add the Trust as an additional named insured (see the discussion of property and casualty insurance above).

Documentation.
When you are transferring assets into your Trust, financial institutions or other transfer agents may request a copy of your Trust. You should furnish only the first page, signature pages, and the Trustees Powers and Trustee Succession sections of your Trust Agreement. The dispositive provisions of your Trust are personal and the financial institution or transfer agent does not need to see them. Many financial institutions only require the first page and signature pages.

Please remember that we are available to assist with transfers or to answer any questions. Please call me if you have any questions regarding this information or if we can assist you in transferring assets into your Trust.

II. Ownership of Assets

Certainly, the value of an individual's assets will affect potential estate tax liability. The form of ownership of assets and the division of assets between a husband and wife will also have estate tax significance.

The form of ownership of an asset may determine the ultimate recipient of that asset upon the death of an individual, irrespective of the terms specified in the individual's will or trust. For example, an asset owned in joint tenancy automatically and by operation of law passes to the surviving tenant upon the death of one tenant and is unaffected by the terms of the decedent's will or trust. The form of ownership of an asset may affect the recipient of the asset upon one's death which may in turn impact one's estate plan by bypassing one's will and trust.

Joint ownership is common for such items as checking or savings accounts, certificates of deposit, brokerage accounts, securities, and real estate. Other types of property, such as life insurance policies, retirement plan or IRA benefits and annuities will pass to the beneficiary designated, irrespective of the terms of one's will or trust. An individual should carefully consider the form of ownership of assets to be consistent with his estate plan.

If one spouse or the other own a disproportionate amount of their collective assets, they may fail to fully utilize each of their exemption equivalent amounts and thereby incur more estate tax than may be otherwise necessary. Equalizing the ownership of assets between spouses may be necessary. (Portability rules may mitigate to some extent the general planning techniques of equalizing assets between spouses for federal estate tax purposes but may not apply for State estate tax purposes).

Probate.
The process by which a deceased person's last will is determined to be a valid will, provides notice to heirs, creditors, and other interested parties, provides for the administration of estate assets, payment of claims and distributions according to the will.

<u>**Asset Ownership**</u>.

1. **Individually or solely owned assets typically subject to probate and creditor's claims. Tenants in common property are typically subject to probate.**

2. **Jointly held assets are typically not subject to probate, as ownership will pass to surviving joint tenant upon death of the other tenant. Tenancy by the entirety limited to married couples and residential property.**

3. **Payable on death accounts: Payable on death or transfer on death accounts are not probate assets as the account passes to the named beneficiary.**

4. **Life insurance and retirement accounts are generally not probate assets because of beneficiary designation.**