

Views & Visions

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Wealth Creation & Preservation

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A Message from Our Managing Partner

*Tom Graff, Managing Partner
Bowles Rice McDavid Graff & Love LLP*

For all individuals, businesses and societies, one of the greatest challenges to the creation and preservation of wealth is the imposition of taxes. The very word “tax” causes sweaty palms and anxiety in general. To most, it means large expenses, the IRS, audits and countless hours of working with complex forms. Since 1773, when American patriots boarded British merchant vessels to have a “Tea Party,” taxes have been the object of fear and loathing in this country.

Yet, because taxes are also the price we pay for a civilized society and are said to be the only thing as certain as death itself, it is imperative that if we, as individuals and businesses are to create and preserve our wealth, we must intelligently address the rules and policies of taxation.

For those reasons, the Tax Team at Bowles Rice is always inspired by the words of the great jurist, Learned Hand, who declared that: “Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that path which will best pay the treasury; there is not even a patriotic duty to increase one’s taxes.” *Gregory v. Helvering*, 69 F.2d 809 (2nd Cir. 1934).

This group of skilled attorneys, who coordinated this issue of *Views & Visions*, includes some of the most experienced and respected tax lawyers in the region. Among them are those with

Masters of Laws degrees in taxation, a former state tax commissioner, a fellow of the American College of Tax Counsel and Certified Public Accountants. As the following articles show, they understand the complex issues involved in personal and business taxes and they appreciate the importance of using tax incentives for the success of businesses, for protection of family wealth and for improvement of our society.

We are also delighted to present articles by such distinguished experts as Dr. Calvin Kent on reform of West Virginia’s tax structure, CPA Kathy Eddy on efforts at tax simplification and Wood County Assessor Steve Grimm on elimination of the personal property tax. The importance of tax policy in promoting both philanthropy and economic development is explored in articles by leading non-profit executive, Becky Cain, and veteran economic development leader, David Warner. And WVU Law Professor Robert Lathrop and Tax Appeals Judge, Michael Reed, describe the training of future tax lawyers and the new, more independent process for resolving tax disputes in West Virginia.

We hope this issue of *Views & Visions* will give you a better insight into our tax system and the opportunities for wealth creation and preservation that it can present for the well-advised. ■



Tom Graff has served as Managing Partner of the firm since 1986. His practice focuses on business, commercial, banking and mineral law. He is Chairman and President of the Chemical Alliance Zone and an active member of the Roundtable. Under his direction, the firm has grown from 30 attorneys in one Charleston office to nearly 100 attorneys in six offices throughout West Virginia, Kentucky and Virginia.



Cal Kent came to Marshall University from Washington, D. C. where he was appointed by the first President Bush and unanimously confirmed by the Senate as Administrator of the Energy Information Administration of the US Department of Energy. In addition to an extensive background in energy, Dr. Kent is one of the nation's best known economics and entrepreneurship educators. As Herman Lay Chair in Private Enterprise at Baylor University, Kent was founder and former director of the Center for Private Enterprise and the National Center for Entrepreneurship Education. Before his work at Baylor he was Chief Economist to the South Dakota Legislative Research Council and Professor of Economics at the University of South Dakota. Prior to his service with I.D.E.A., Kent was Dean of Marshall University's Elizabeth McDowell Lewis College of Business.

Time to Act on Tax Reform

*Dr. Calvin A. Kent, Director
Institute for Development of Entrepreneurial Advances (I.D.E.A.)
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If one of the candidates running for Governor or the State Legislature this year were to advocate a new tax plan which:

- Encouraged people to stay on welfare;
- Discouraged investment in new plant and modern equipment;
- Drove business to locate in neighboring states;
- Provided an inadequate and unstable source of revenue for state government;
- Made it impossible for cities to provide quality services;
- Exempted some of the most wealthy while taxing some of the most poor;
- Taxed medical care;
- Was so complex as to be nearly incomprehensible to most citizens; and
- Created severe problems for enforcement and collection;

it is doubtful that candidate would be elected. Since the above statements are an accurate description of the current West Virginia state and local tax structure, why is a major overhaul of the tax structure missing from today's political debate?

Over a half decade ago after the most comprehensive evaluation of the State's tax policies in over a half century, Governor Underwood's Commission

on Fair Taxation identified these problems and spoke to their solution. What that Commission proposed was a comprehensive overhaul of the way we tax by:

- Replacing the retail sales tax with a **General Excise Tax** which eliminated most current loopholes and included most exempt services hereby increasing the yield over the current retail sales and use tax by 45 percent.
- Adopting a **Single Business Tax** to replace the current 11 narrow based business taxes now on the books and to allow for a repeal of all taxes on personal property and provide a more stable source of revenue for the State. A small business vanishing credit would encourage new business formation and reward entrepreneurial effort. The current corporate income tax with one of the nation's highest rates would be repealed as would the business franchise tax which now discourages investment in new plant and modernization of facilities. A 2 percent rate would be adequate to replace lost revenue from the other sources. This approach to the taxation of business in Michigan was so successful in stimulating and stabilizing that state's economy that it now can afford to gradually phase out the tax altogether over twenty-three years.

- Inclusion of a **Progressive Personal Income Tax** which would provide an exemption for the over 100,000 families who are working but earning less than the federal poverty level and still have to pay the State income tax.

- Maintenance of current taxes on **gasoline, spirits and natural resource severance** plus an increase in the **cigarette tax and inclusion of tobacco products**.

- Revamping **School Finance** by abolishing local property taxes for school funding (except for excess levies) and returning the responsibility for appropriating sufficient money to fund the State Constitutional requirement of a “thorough and efficient system of education” to the Legislature.

- Allowing **Cities and Counties** to use the full amount of real property taxes to provide expanded services and to allow repeal of the dreaded business and occupation tax which propels firms to locate just outside city boundaries.

- Repealing most **Tax Credits and Incentives** as there is considerable evidence that these are not effective in attracting new business to the State, but do increase the burden on businesses already here. The felt need to have these incentives is a vivid condemnation of the fairness and efficiency of current business taxes.

When the Commission proposed its reforms in 1998, the State was

enjoying relative prosperity and did not face a budget crisis. The Commission accurately predicted this would change and the current problem was a certainty. Yet little has been done. Taxes on cigarettes have been increased and the system of tax credits made less complex and more focused. But the fundamental problems have not been solved. Nor can they be solved merely by adjusting the rates of current levies.

West Virginia is classified as a “high tax need, low tax capacity” state. Translation: the demands for services placed on West Virginia governments are above average, but the capacity to meet those needs when compared to other states is below average. Because we have an older, more rural, more isolated, less healthy and less educated populace than most other states, the demands for health care, social services, education, and transportation access exceed those found elsewhere. These same factors mean the tax base is less capable of meeting the requirements for quality public services at a low cost. Since taxes will have to be higher than in most other states to provide even basic quality services, there is a compelling case for a tax system that is fairer, and more productive.

The current tax system was designed and passed for another economic era when mining and big, “smoke stack” corporations reflected economic reality. Fifty or more years ago that was appropriate, today it is not. The economic base of the state is following the national trend away from heavy manufacturing and resource extraction

to services and high tech industry. Yet the tax system has not changed to meet the new realities. We still use an approach to raising revenue based on heavy taxation of real property, equipment, resource extraction and corporate profits. The corporate income tax at both the federal and state levels is deteriorating as more enterprises are created as “pass through” entities which escape taxation.

An archaic and unfair tax structure is not the only reason placing West Virginia at or near the bottom of the rankings of states based on personal income or economic growth. But when one considers the impact of the current tax structure, the State’s dismal position should be no mystery. In recent years, State government has been saved from even greater fiscal problems by lottery proceeds, sale of liquor monopolies, tobacco settlements, legalization of slot machines and this year’s rising energy prices which have increased the yields of severance taxes on natural gas and coal. But our fiscal future lies before us and it is not bright. It is well past the time when it is imperative to again consider comprehensive tax reform. Otherwise, West Virginia will continue to be an island of poverty in a sea of prosperity. ■



Kathy G. Eddy is a shareholder in the accounting corporation of McDonough, Eddy, Parsons, and Baylous, A.C., in Parkersburg, West Virginia. Kathy served as Chairman of the Board of Directors of the American Institute of Certified Public Accountants (AICPA) for the year 2000-2001. She is the second West Virginian and the second woman to have held this position in the 116-year history of the AICPA. She is currently chairing the AICPA Special Committee on State Regulation and previously chaired the AICPA National Steering Committee for the Regulation of the Profession, and served on the AICPA Political Leadership Cabinet. In addition, she has served the West Virginia Society of CPAs and the West Virginia Board of Accountancy by holding all offices, including President of both organizations.

Tax Simplification – The Time Has Come

*Kathy G. Eddy, CPA, Shareholder
McDonough, Eddy, Parsons & Baylous, A.C.*

During my tenure as a member of the Board of Directors of the American Institute of Certified Public Accountants (AICPA), and then as Chairman of the Board, many issues were addressed that affected CPAs and the clients and employers they serve. Certainly, front and center were issues of taxation. One in particular that most might not imagine would be on our agenda would be that of tax simplification. In fact, most people would believe that we accountants would want to keep the tax law as complicated as possible so as to ensure the need for our services.

The membership of the AICPA is primarily made up of CPAs who practice in public accounting and CPAs who work in business and industry. Regardless of their place of employment, CPAs see the consequences of tax complexity at both the federal and state levels.

As we know, the U. S. tax system, as well as the tax systems in most states, is based on the concept of self-assessment. With this as the principal concept, the efficiency and effectiveness of the system is dependent on the ability and willingness of taxpayers to understand and comply with their obligations. The system also depends on the ability of those who administer the law to interpret and equitably enforce it. CPAs who practice public accounting in the tax arena, as well as

CPAs who work in business and industry and try to comply with the tax laws on behalf of their employers, indicate that the complex nature of tax laws is undermining the basic concept of self-assessment and therefore putting the entire system at risk.

Some of the impacts that tax professionals are seeing as a result of the complexity of the tax law are lower levels of voluntary compliance, increased public perception that the tax system is unfair, higher costs of both tax administration on the part of the government and higher cost of tax compliance on the part of the taxpayer. Because of the complexity, the agencies charged with providing assistance to taxpayers are having difficulty giving timely, accurate advice, it takes longer to promulgate regulatory guidance and to design understandable forms and instructions. And finally, financial decisions are not being made on the economics of a transaction, but rather, they are being driven primarily by tax considerations.

In 2002, the Tax Division of the American Institute of Certified Public Accountants issued Tax Policy Concept Statement 2 entitled “Guiding Principles for Tax Simplification” which outlines the following guiding principles to be used in the development of simpler tax legislation and regulations:

- Make simplification a priority;
- Seek simplest approaches;
- Minimize compliance burdens;
- Reduce frequency of tax law change;
- Use consistent concepts and definitions;
- Consider administrative burdens;
- Avoid limited applicability.

All of us, business and individuals alike, taxpayers and tax professionals alike, have just finished another tax filing season. We have each seen once again that the complexity of our state and federal tax structures continues to

increase. The economic and business environment in which we live today is complex and therefore to attempt to achieve an absolutely simple tax system would not be feasible. If, however, the guiding principles outlined above are considered with every proposed tax law or tax law change, a less complex system would evolve over time.

I invite you to review the details regarding these concepts in the Tax Division of the AICPA's Tax Policy Concept Statement "Guiding Principles for Tax Simplification" and two additional Tax Policy Concept Statements, "Guiding Principles of

Good Tax Policy: A Framework for Evaluating Tax Proposals" and "Guiding Principles for Tax Law Transparency," at:

www.cpa2biz.com/ResourceCenters/Tax/ConceptStatements.htm

These sources will convey to you the accounting profession's public policy concerns regarding the way tax laws are developed both at the federal and state level. ■

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Steve Grimm has served as the Wood County Assessor since 1997. Previous to that, he served as County Commissioner from 1987 to 1996. Steve has served on the Governor's Commission for Fair Taxation and currently is a member of the Council on Governing in the 21st Century. Steve is in support of the elimination of personal property tax in the State of West Virginia. He was named in 2002 Assessor of the Year in West Virginia. Steve served as assistant football coach at Parkersburg High School from 1987 to 2001. He is a 1969 graduate of Parkersburg High School and a 1973 graduate of Marshall University.

Moving Ahead of the Others

Eliminating Personal Property Taxes in West Virginia

*Steve Grimm, Assessor
Wood County, West Virginia*

In 1782, the general assembly of Virginia enacted a major revision to the Common Wealth's tax law. The act provided for a statewide enumeration on the county level of certain personal property and land. This created a permanent source of revenue for the operation of government in Virginia. This process of taxing personal property was extended into Western Virginia where the farmers were the earliest filers of personal property for tax purposes. This law caused the farmers to declare for personal property taxes all of their tools used in the assistance of farming.

West Virginia, after it became a state in 1863, still used the same common laws of Virginia to enact a collection of personal property taxes on all individuals. It was not until 1932 that the West Virginia legislature enacted a law as stated from the Michie's West Virginia Code Annotated Volume 4, that "all personal property in the state, though owned by persons residing out of the state, shall be entered in the personal property book, and be subject to equal and uniform taxation unless especially exempted by law." Out of this legislation began the taxing of all personal property, tangible or intangible.

Personal property taxes are not unique to West Virginia. Other states also use personal property as a means to raise revenues to support public services. As

of July 1, 2003, there were 38 states using some form of personal property to assist in paying for government services. Of the five states that border West Virginia, all have some form of a personal property tax.

Maryland has a personal property tax on business owned on personalty. This means usually that all equipment, machinery and inventories used in the operation of the business are listed and valued for tax purposes. Maryland does not place a personal property tax on automobiles.

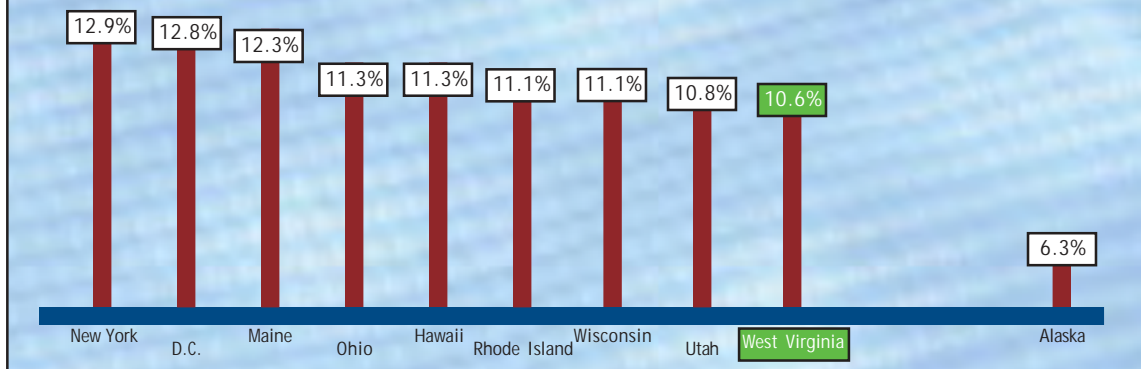
Personal property tax in Pennsylvania is a tax on various forms of intangible personal property such as stocks, bonds, and certain other forms of indebtedness. Pennsylvania does not value for tax purposes tangible personal property, such as machinery, equipment, inventory and automobiles.

Virginia values tangible personal property for tax purposes. Virginia has a personal property tax on vehicles at a rate of 50% of book value, but if this vehicle is used for personal use at least 50% of the time, the taxpayer is entitled to a tax credit of 70% of the assessed value.

Ohio has both a tangible and intangible personal property tax. The tangible personal property tax is on machinery, equipment, furniture and inventory

Where Does West Virginia Stand?

When it comes to tax-friendly states, West Virginia ranks close to the bottom of the barrel. In 1990, West Virginia had a slightly below-average tax burden (10.0% compared to a national average of 10.3%). Since then, tax burdens in our state have risen substantially. Now at an estimated 10.6%, the tax burden in West Virginia outweighs **42** other states, with only 7 states and the District of Columbia ranking higher. Alaska has the lowest tax burden of all at 6.3%.



Source: 2004 Tax Foundation

with all taxpayers receiving a \$10,000 exemption. All intangible personal property is taxed in the State of Ohio but automobiles personally owned are exempt from taxes.

Kentucky taxes tangible as well as intangible personal property and has a personal property tax on automobiles. Kentucky, of all the states, most closely reflects the tax system West Virginia had used before it exempted all intangible personal property.

West Virginia initially taxed all personal property, but has made strides toward eliminating some areas of taxation. First, household goods and personal effects were exempted. Then, in 1986, finished goods were exempted under the Freeport Amendment, and in 2003, intangibles were eliminated.

As the Assessor of Wood County, I have served on a number of boards and panels dealing with our current local tax system. The most frequently asked questions arise from the assessing of personal property for tax purposes. Most often, the discussion centers around the complexity of submitting the proper information at the proper time to the assessor's office to ensure a fair value on personal property. Asking taxpayers to file a form that at times may be complicated and cumbersome can result in filing errors and oftentimes can be costly to the county and individual/business. The personal property division of the local assessor's office is more than happy to assist, but it is impossible for them to personally supervise the filing of all forms. As a result, errors do occur in the filing, causing a tremendous inequity in liability among like taxpayers.

As a member of the Governor's Commission on Fair Taxation, I have personally been a proponent of eliminating all personal property taxes. The taxing of tangible personal property is not a simple endeavor. The Commission received significant testimony from business taxpayers that tangible property tax poses a significant obstacle of West Virginia's competitiveness. While 38 states have tangible personal property taxes, only 16 include inventories in the tax base. When businesses close or move, and when tax issues are litigated, it affects the government's ability to pay for services. By eliminating the tangible personal property tax and replacing it with a broad-based, low rate tax, this would give West Virginia a distinct advantage over its neighboring states in its ability to attract businesses and residents to our state. ■



Becky Cain is the president and CEO of The Greater Kanawha Valley Foundation in Charleston, West Virginia. She is a member of the national Board of Directors of the Campaign Finance Institute and the Alliance for Better Campaigns. She also serves on the national Committee on Legislation and Regulations for the Council on Foundations and the Board of the National Institute For Chemical Studies, BIDCO, and the Charleston Chamber of Commerce. Ms. Cain is the Co-Chair of the Building Bridges and Empowering Citizens Steering Committee of West Virginia Vision Shared.

The Role of the Nonprofit Sector and Economic Development

*Becky Cain, President and CEO
The Greater Kanawha Valley Foundation*

The nonprofit sector has long played a vital role in the development of our economy. Because of the concepts of democracy and capitalism, our nation built complex systems – a health care system, an education system, a social service delivery system, and a retirement system – to care for us. These systems, until quite recently, developed first in the Nineteenth Century and evolved over the course of the Twentieth Century as not-for-profit businesses. The late Nineteenth Century gave birth to a number of nonprofit organizations. Jane Addams started Hull Houses and community organizations like the Young Men's and Young Women's Christian Associations and the Salvation Army came into existence. These organizations embodied notions of community, justice and mercy and the voluntary spirit of an independent people to care for themselves. They are the direct forerunners of the vast nonprofit social and human service delivery system in evidence today.

Nonprofits contribute in several ways to the economic development of our communities. Many contribute directly to the economies of their communities as employers. In a survey conducted by Johns Hopkins University and released by the Community Council of Kanawha Valley, the nonprofit sector in West Virginia accounts for 1 out of every 12 paid workers – nearly two-and-a-half times more than the state's entire

mining industry; over three times more than the state's largest manufacturing industry, chemicals and allied products manufacturing; sixty-five percent more than the state's entire construction industry; and forty percent more than state government.

The nonprofit sector plays a significant role in the U. S. economy by producing and providing public goods and services that are not, and in many cases cannot be, delivered within the framework of the market or by government. Nonprofits are the first to enter territory for-profit businesses have either abandoned or have not yet discovered; the production of affordable housing and the national loan fund movement are great recent examples. Revolving loan funds have created and retained over 280,000 jobs in distressed parts of this country. One revolving loan fund dollar leverages about \$4.50 in private capital.

Nonprofits have unique qualities that allow them to play this special role in economic and community development. These qualities include:

Flexibility – the capacity to react quickly to new needs and circumstances and to accommodate and encourage diverse approaches to challenges that development entails;

Relative independence – freedom from many of the constraints of the



The Greater Kanawha Valley Foundation

The Greater Kanawha Valley Foundation seeks to enrich the life experiences of those we serve — our contributors, our beneficiaries and our community. The Foundation is a charitable community trust organized in 1962 to accept contributions, create and administer funds, and make grants for the benefit of the people of the Greater Kanawha Valley. It is a collection of many separate Funds varying in size from \$10,000 to more than \$7 million. At the end of 2003, there were more than 374 Funds, each separate with its own agreement, its own donors, and its own philanthropic purposes. Contact us at www.tgkvf.org.

market place and the state and hence the ability to address neglected issues or needs;

Trustworthiness – a reputation for operating in the public interest and for serving public purposes;

Accessibility and Responsiveness – close ties to affected communities and groups, including many that are ignored by other institutions, and a special inclination to represent and give voice to their needs. These special qualities enable nonprofits to make distinctive contributions to the process necessary for economic and community development to thrive. These include:

Empowerment – the mobilization of grass roots energies through self-help, mutual aid and the promotion of participation by all sorts;

Issue Identification – identifying new issues and bringing them to public attention;

Resource Mobilization – mobilizing untapped human and financial resources and bringing them to bear on the task of development;

Mediation – serving as a bridge among social groups, between fields of interest and across political boundaries, thus reducing the social, professional, bureaucratic and geographic divisions that often impede effective action;

Promoting Change – exerting pressure outside the political system in order to produce change in public or private policies on unsolved issues;

Monitoring – serving as a watchdog to ensure the fair and effective implementation of public policies;

Leadership Development – facilitating the emergence of a new cadre of leadership by offering opportunities for meaningful engagement in public issues on the part of large numbers of community activists;

Ensuring Representation – representing alternative perspectives on important issues and ensuring that these perspectives are heard;

Legitimization – helping to secure popular support for needed policies and hence promoting their implementation;

Promoting Participation – securing the active participation of various social strata in development activities and thus minimizing dangers of exclusion, either of particular groups or points of view.

The nonprofit sector has long been a source of innovation, creating new medical technologies, developing new policy ideas, building communities, and pioneering major social movements. The tasks of economic and community development are not easy and nonprofit organizations cannot solve all the problems. But without the contributions that the nonprofit sector is especially equipped to make, the task of economic and community development may prove even harder than it now appears. ■



Marc A. Monteleone is a partner in the Charleston office of Bowles Rice, serves as the firm's Chief Financial Officer and manages the firm's real estate needs, including the construction of new facilities. He concentrates his practice in commercial law, federal and state taxation, construction law and real estate development. Marc has an extensive real estate practice in land use and development law, representing both large and small developers proposing commercial and residential projects. This representation has encompassed many aspects of development, including land use, financing, business structure and construction issues. Marc was appointed by Governor Cecil Underwood to Chair the West Virginia Design-Build Review Board, and continues to serve in that capacity.

Tax Increment Financing

*Marc A. Monteleone, Esquire
Bowles Rice McDavid Graff & Love LLP*

In 2002, the West Virginia Legislature approved tax increment financing as a development tool to help fund economic development and job creation in the state of West Virginia. On November 2, 2002, West Virginia voters ratified Amendment No. 1, allowing tax increment financing (TIF) secured by property taxes. As of April 8, 2004, seven TIF districts have been created and three TIF projects have been approved. The three TIF projects are projecting an increase in the appraised property value of more than \$379,000,000.

Tax increment financing is a development tool that allows a developer to use the increase in property tax revenue generated from the development of a district to pay for a portion of the development costs. Because the developer is able to use all or a portion of the revenue generated by the increased property values created from its development, less money is needed in the form of equity or debt. As a result of TIF funding, many developments that have been unable to obtain the necessary financing in the past may now proceed because developers can use the TIF funds to obtain the necessary funding.

All counties, Class 1 municipalities and Class 2 municipalities are eligible to use TIF. Class 1 municipalities are municipalities with more than 50,000 people. Class 2 municipalities are

municipalities with more than 10,000, but less than 50,000, people. Class 3 and Class 4 municipalities must work through their county commission in order to use TIF.

In order to create a TIF district, the district must promote economic development of a project area by eliminating a blighted area, preventing the deterioration of a conservation area into a blighted area, increase or preserve employment, or encourage the location of commercial or industrial activities and jobs in West Virginia.

A blighted area is an area with conditions that are detrimental to public health, safety, morals and welfare. Examples of a blighted area include an area with a dilapidated structure, unsafe conditions, overcrowding, unsanitary conditions or inadequate access. A conservation area is an area where 50% or more of the structures are more than 35 years old and there is a risk that this area may become a blighted area. An economic development area is an area not blighted nor a conservation area. In order for this area to qualify for TIF funding, the developer must prove that the development will not unfairly compete in the local economy, and that the development will discourage business from moving out of the State, increase employment or preserve the tax base.

Some examples of potential TIF projects would include the creation of an industrial site, including the installation of road, sewer, water and utilities to the site; the cleanup of an environmentally contaminated area and preparing the land for future development; building a road that improves access to an area; and creating a large, mixed use community.

In order to get a TIF district approved, a county or municipality must designate a project district. At the time the district is designated, there may, or may not, be a project in place for the district. Once the district is designated, the county or municipality must hold a public hearing to receive comments

on whether the district should be created. If it is determined that the district should be created, the county or municipality will submit an application to the West Virginia Development Office requesting approval of the district. If the Development Office approves the district, the county will adopt an order or the municipality will adopt an ordinance establishing the TIF district and creating the TIF fund.

In order to get a project approved for TIF funding, the county or municipality must receive a detailed application from the developer. The project may be for an area that is in an established TIF district or one that has

not yet been created. In the event the district has not been created, it may be created concurrently with the approval of the project. The project application must contain evidence that the development would not occur “but for” the TIF financing. This test is often called the “But For” test and essentially means that the project would not happen without the assistance of this TIF funding.

If the proposed project is going to include the issuance of bonds, the developer must consult with outside bond counsel and investment bankers and prove that the bonds will be feasible in the proposed project. The developer must also conduct an analysis of the

Continued on p. 14

Another Approved **West Virginia** TIF Project

GLADE SPRINGS VILLAGE Cooper Land Development



Glade Springs Village is a 2942-acre woodland and mountain development in Raleigh County which is slated to become 2900 lots of a recreational and retirement community, including golf, skiing, boating, and white water rafting. Phase I includes Stonehaven Golf Course, a 69-acre lake and additional infrastructure. Phases II and III will each include 1500 lots. When complete, Glade Springs Village will include a residential community, three world-class golf courses, a convention center and an equestrian facility.

Prior to development, real property assessments for the Cooper Development lands were \$750,000. When fully developed, the real property assessments after development will be \$81,000,000.



Monteleone . . . continued from p. 13

financial impact upon the local levying bodies. The county or municipality must review the application, verify that all the information in the application is correct and then hold a public hearing to receive comments on whether the TIF project should be approved.

If the county or municipality decides to go forward with the project, it must establish a memorandum of understanding with the developer indicating that the developer will use competitive bidding for the project, pay prevailing wages and follow local labor preferences. The county or municipality then submits the application to the West Virginia Development Office for approval. The Development Office has 60 days to approve the application, reject the application or request additional information for the application. Upon approval by the Development Office, the county will adopt an order or the city will adopt an ordinance approving the project.

Once a TIF district is created and/or a project is approved, the county or municipality must submit an annual report to the West Virginia Development Office setting forth the

progress of the development district or development project. The county and municipality must also publish an annual statement in a newspaper of general circulation in the county or municipality, including a summary of the receipts and disbursements by major categories of monies in a TIF fund during the fiscal year, a summary of the status of the project plan, the amount outstanding on the principal of any TIF obligations and any other information that the county or municipality wishes to publish. Every five years after approval of a project or district, the county or municipality must hold a public hearing to determine if the project is making satisfactory progress under the proposed time schedule in the original plan.

TIF funding can be provided in two forms: issuance of bonds or pay-as-you-go revenues. If TIF bonds are going to be used for a project, the term of the bond cannot exceed 30 years or the life of the district, whichever is shorter; interest can be taxable or tax exempt for federal income tax purposes; the costs incurred during the

approval process can be refunded; bonds can be publicly offered or privately sold; and the public improvements financed by the TIF bonds can be used to provide additional security for the bonds.

Since the passage of the Act in November of 2002, several developments and/or districts have already been approved. As of April 2004, the following seven TIF districts have been approved by the West Virginia Development Office: City of Morgantown TIF District No. 1; City of Morgantown TIF District No. 2; City of Wheeling TIF District No. 1; Greenbrier County TIF District No. 1; Harrison County TIF District No. 1; Marshall County TIF District No. 1; Raleigh County TIF District No. 1.

The realization of these projects in such developments as Glade Springs Village, The Square at Falling Run (Morgantown) and the Pete Dye Golf and Sporting Club (Clarksburg) is an exciting example of how West Virginia is poised to compete with other states for businesses and jobs and to promote economic development and redevelopment in local areas. ■

Additional Information on TIF in West Virginia can be obtained from these sources:

West Virginia Development Office

Capitol Complex, Building 6, 5th Floor
Charleston, WV 25305-0311
Toll Free Phone: 1-800-WVA-DEVO (982-3386)
Phone: (304) 558-2234
Fax: (304) 558-1189
www.wvdo.org

West Virginia Association of Counties

2211 Washington Street, East
Charleston, WV 25311
Phone: (304) 346-0591
Fax: (304) 346-0592
Email: wvaco@wvaco.org
www.wvcounties.org

County Commissioners' Association of West Virginia

2309 Washington Street, East
Charleston, WV 25311
Phone: (304) 345-4639
Fax: (304) 346-3512
Email: ccawv@citynet.net
www.polsci.wvu.edu/ccawv

West Virginia Municipal League

2020 Kanawha Blvd., East
Charleston, WV 25311
Phone: (304) 342-5564
Toll Free Phone: (800) 344-7702
Fax: (304) 342-5586
Email: wvml@newwave.net
www.wvml.org

The Emergence of Risk Capital in West Virginia

*David Warner, Executive Director
West Virginia Economic Development Authority*

West Virginia continues to diversify its economy. Capitalizing on the strength of its research universities, its growing biometrics infrastructure and its high-quality work force, State leaders have increasingly turned to knowledge-based and entrepreneur-driven industries.

A concerted effort by the State, inspired by its Vision Shared strategic plan for economic development, enhanced the availability of risk capital and increased the support base for these types of entrepreneurial activity.

As recently reported in the Milken Institute's State Technology and Science Index, West Virginia's overall ranking increased from 48th to 46th in 2004. This is not a dramatic change, but a dramatic increase in the availability of risk capital and entrepreneurial assets – from 48th to 30th – fueled it.

Beginning in the 2000 West Virginia legislative session, the West Virginia Economic Development Authority (WVEDA) led an effort to radically change the West Virginia Capital Company Act by separating the investors receiving State tax credits from those making the decisions to invest funds in West Virginia businesses. The Act was changed to allow only Small Business Investment

Corporations (SBICs) to participate. This small change effectively created a risk capital delivery system entirely managed by full-time risk capital fund managers with a track record of experience and success. The 2001 legislative session again produced meaningful change by creating the West Virginia Venture Capital Act, which empowered WVEDA to recruit additional venture capital firms to West Virginia. It allowed investors seeking tax credits to have a choice of investment opportunities and strategies.

Gov. Bob Wise aggressively pursued legislation in 2002 that accelerated the entire process by providing up to a \$25 million loan from the West Virginia Investment Management Board to WVEDA for further investment into qualified venture capital firms established under the West Virginia Venture Capital Act. This prompted WVEDA to issue a request for proposals to local and regional venture capital firms interested in including West Virginia in their investment strategy. WVEDA received 14 proposals and invited nine firms to make presentations before a review committee comprised of public- and private-sector professionals. Upon recommendation by the review committee, the WVEDA board selected six fund managers to receive a



David Warner is the Executive Director of the West Virginia Economic Development Authority. David joined the staff of WVEDA in 1988 and was promoted to Executive Director in 1991. Mr. Warner is a board member of the West Virginia Infrastructure and Jobs Development Council, and serves on the loan committee of the West Virginia Capital Corporation and is Chairman of the loan committee of the West Virginia Rural Health RLF. David was previously a commercial loan officer with One Valley Bank in Huntington, and a Bank Examiner with the WV Department of Banking. Mr. Warner is a 1979 graduate of West Virginia University.

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Robert S. Kiss is a partner in the Charleston office of Bowles Rice, practicing in the areas of tax, estate planning and commercial law. Bob has been a member of the House of Delegates since 1989 and is currently Speaker of the West Virginia House, a position he has held since 1997. Pursuant to his legislative duties, Bob has been extensively involved in over a decade of major economic and fiscal legislation, including the West Virginia School Building Authority, water and sewer infrastructure development, state tax policy, state health care plans, including PEIA and Medicaid, State retirement systems, the State's Workers' Compensation system, and the State's Tax Increment Financing legislation (TIF).

2004 Developments in West Virginia Tax Law

*Robert S. Kiss, Speaker
West Virginia House of Delegates*

For most West Virginians, the most significant action of the West Virginia Legislature related to taxation was the decision by the Legislature to reject the Governor's proposals on tobacco taxes and a decoupling of the state inheritance tax from the Federal Estate Tax phase-out.

However, for businesses and tax practitioners, there was a substantial amount of activity undertaken by the West Virginia Legislature during the recently completed 2004 Legislative Session. These changes ranged from items which are of lesser significance or impact to taxpayers, such as: House Bill 4318, which imposes state personal income taxes on those amounts withdrawn from a prepaid college tuition program or savings plan and used for some purpose other than college tuition or expenses; House Bill 4295, which clarifies current law to make it clear that state bonds which are exempt from state and local taxes are also exempt from inheritance and property taxes; House Bill 4622, which provides clarification that lottery prizes are subject to state and local taxation; Senate Bill 701, which allows certain municipalities with underfunded firemen and policemen pensions to impose a municipal sales/use tax; and House Bill 4567, which revises existing limitations and terms under the Motor Carrier Road Tax.

As with any Legislative Session, there were also a number of tax initiatives which have far-reaching impacts on taxpayers, tax practitioners and businesses in the state of West Virginia.

Senate Bill 719 increases the Health Care Provider Tax on nursing home services from 5.5% to 5.95%. The Bill also creates a contingent increase in the rates of other health care providers such as ambulatory surgical centers, inpatient hospital services, intermediate care facilities and outpatient hospital services. While this contingent tax will not now be imposed or collected, it could potentially be triggered in the future upon the issuance of an Executive Order by the Governor and the approval of that Executive Order by a Joint Resolution of the Legislature.

The policy basis for the contingent tax is the continued erosion of Federal Medicaid funding and the desire to create a safety net for funding of these critical services within the Medicaid program.

Senate Bill 148 creates a West Virginia Tax Amnesty Program to be administered by the Tax Commissioner for a two-month period during the calendar year of 2004. The program will apply to all taxes except *ad valorem* property taxes.

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\$4 million direct investment from WVEDA: Adena Ventures L.P., Athens, Ohio; Anthem Capital II, L.P., Baltimore, Maryland; Mountaineer Capital L.P., Charleston, West Virginia; PA Early Stage Partners, L.P., Wayne, Pennsylvania; Toucan Capital Corp., Bethesda, Maryland; and Walker Investment Fund II, LLLP, Glenwood, Maryland. The total capital available among these firms approaches \$100 million.

The WVEDA board also directly invested \$500,000 with the Innova Group, Fairmont, West Virginia. Included in the group are four Small Business Investment Corporations (SBICs) and one new market venture capital company, all licensed by the U.S. Small Business Administration.

Since 2003, these seven companies have invested \$12 million in 14 West Virginia businesses.

Although capital is a vital element in the growth of any entrepreneurial business, other conditions must exist to support a vibrant entrepreneurial environment. A strong network of legal, accounting, engineering and marketing professionals must complement the entrepreneur's skills. Education and networking oppor-

tunities and a supportive state business climate are also essential. The existing fund managers have proven to be valuable mentors and advisers to many entrepreneurs; many have taken advantage of the operational assistance program provided through Adena Ventures, L.P. This program, established through the federal New Markets Initiative, provides matching money to supplement in-kind contributions of local professional service providers. The Innova Group, a division of the West Virginia High Technology Consortium, also concentrates on providing assistance to early stage entrepreneurs. Educational and networking opportunities are rising through the efforts of the West Virginia Entrepreneurship Initiative and the West Virginia Venture Connection.

The Vision Shared task force and the Legislature enhanced the State's entrepreneurial climate by creating a high-growth business tax credit for angel or private investors who financially assist R&D entrepreneurs.

West Virginia will continue to make great strides in improving access to risk capital and building an even better climate for entrepreneurs. ■



Visit the
West Virginia Development Office
website at www.wvdo.org

The West Virginia Economic Development Authority administers a program that provides for debt and equity venture capital investment to small business. Some of the firms which are qualified in West Virginia to make venture capital investments are listed below:



www.adenaventures.com



www.INNOVAWV.org



www.iNetworksLLC.com



www.anthemcapital.com



www.walkerventures.com



www.mountaineercapital.com

Kiss . . . continued from p. 16

The applicable period of taxes subject to the Amnesty Program is the calendar years January 1, 1986, through December 31, 2003.

Pursuant to the Amnesty Program, the Tax Department would waive any civil or criminal penalties or additions to tax, and fifty percent (50%) of the interest due for any taxpayer that is awarded amnesty. In order to be eligible for the amnesty, the taxpayer must apply, pay all back taxes due, and pay fifty percent (50%) of the interest due.

House Bill 4349 amends last year's Streamlined Sales Tax Act:

- Re-establishes the exemption of durable medical goods, mobility enhancing equipment, and prosthetic devices from consumer sales and service tax, which was inadvertently omitted when the initial streamlined sales tax act was passed in 2003;

- Provides for insertion of a necessary cross-reference to insure the continued exemption of propane gas sales;

- Includes the insertion of definitions excluding from taxable services incentive payments for product marketing;

- Defines special rules for determining sourcing of a sale subject to tax, and which location will determine the jurisdiction that will be entitled to the tax in the area of telecommunications and flower sales.

House Bill 4501 implements one of the major policy initiatives of the Vision Shared program and provides for a new sales tax exemption for certain technology purchases, including:

- The sale of computer hardware or software, including custom-design software directly incorporated by a manufacturer into a manufactured product;

- Sales of computer hardware or software, including custom designed software directly used in communication;

- Sales of electronic data processing services and internet advertising;

- Sales of some qualifying educational software.

This Bill also re-established for one year the one-week back-to-school clothing and school supplies sales tax exemption.

Senate Bill 204 amends West Virginia's current Strategic Research and Development Tax Credit and allows small research and development companies (those with gross revenues of not more than \$20 million dollars annually and an annual payroll of not more than \$2.5 million dollars) to seek a refund of unused research and development credits up to \$100,000 in any tax year, with an aggregate cap for all taxpayers of \$1 million. The credits are refunded on a first come, first served basis.

House Bill 4047 creates an entirely new business investment tax credit referred to as The High Growth Business Investment Tax Credit, to encourage investment by state citizens and businesses in certain companies started by West Virginians.

The Bill provides for an entirely new tax credit known as the High Growth Business Investment Tax Credit. The credit is equal to the amount of 50% of the seed investment made by an individual or business in another unrelated business determined to be eligible for the West Virginia Strategic Research and Development Tax Credit (West Virginia Code §11-13R-1, *et seq.*) The total amount of credits which can be provided under the act to all taxpayers is capped at \$1 million per year, and the total amount of credit for any one eligible taxpayer is capped at \$50,000.00.

House Bill 4624 encompasses a series of substantive amendments to West Virginia's relatively new property tax increment financing provisions.

The Bill makes several changes to the West Virginia Tax Increment Financing Act, including, but not limited to, the following:

- Allows tax increment financing to be utilized on both public and private capital improvements;

- Specifically adds project developers, consultants, professionals, financing institutions and trustees to the list of those with which counties

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and municipalities can implement a project plan;

- Requires the consent of the governing bodies of Class III and Class IV municipalities' for districts to be created within their boundaries;

- Eliminates the restriction limiting when a county or municipality can redeem a TIF obligation. A TIF obligation may contain provisions for redemption at any time.

Senate Bill 139 recognizes the growing importance of West Virginia's tourism potential by providing a tax credit to induce the creation and expansion of qualifying tourism development projects. The credit is available to be provided against consumer sales and service taxes collected on gross receipts generated directly from the operations of new or expanded tourism facilities.

There are specific type, size, investment level and performance criteria which must be maintained to qualify for the credit and the credit is subject to recapture if those standards are not maintained.

The credit must be taken over a ten-year period, one-tenth per year, and is equal to 25% of approved costs of a development or 50% if the site is located at or adjacent to a reclaimed surface mine operation. ■



West Virginia Sales Tax Holiday

August 6 - 8, 2004

In an effort to assist West Virginia families with the inevitable burden of back-to-school shopping, the state's first-ever Sales Tax Holiday was introduced in 2003. People from West Virginia and surrounding states poured into stores, restaurants and gas stations during the first weekend in August, giving retailers — as well as shoppers — a heavy benefit from the three-day tax break. Last year's effort resulted in \$28.3 million in sales and a \$1.7 million savings for tax payers. This year's savings is expected to grow to \$2.2 million.

During the tax holiday, the following sales are per se exempt from the 6% consumers sales tax:

- The sale of an article of clothing or footwear designed to be worn on or about the human body if the sale price for each is less than \$100;
- The sale of general school supplies to be used in the classroom if the sale price for each item is less than \$100;
- The sale of individual computers or computers and computer accessories sold as a "package" if the sale is less than \$750 after credit for manufacturer's coupons and/or manufacturer's rebate; and
- The sale of computer accessories and calculators if the sale is less than \$100 after credit for any manufacturer's rebate.

This exemption does not apply to the following:

- The rental of clothing, footwear or school supplies;
- Purchase of furniture;
- Purchases of tangible personal property for use in a trade or business;
- Purchases paid through the use of a business check or business credit card.

"Clothing" means any article of wearing apparel intended to be worn on or about the human body. Clothing does not include accessories and clothing or footwear intended primarily for use as athletic or sporting gear, such as golf shoes or football uniforms.

A full listing of exempt and taxable items is available on the West Virginia State Tax Department's website at www.state.wv.us/taxdiv



Anthony P. Tokarz is a partner in the Charleston office of Bowles Rice and serves as group leader for the firm's Intellectual Property Practice Group. His practice focuses on patents, trademarks, copyrights, trade secrets, and complex litigation involving scientific and technology-intensive cases. Tony is registered to practice before the United State Patent and Trademark Office and serves as Chairperson of the Intellectual Property Committee of the West Virginia State Bar. He is a member of the American Bar Association's Intellectual Property Law and Litigation Sections and the American Intellectual Property Law Association. Tony retired from the United State Marine Corps with the rank of Colonel.

Snapshot of the Tax Consequences for Intellectual Property Transfers

*Anthony P. Tokarz, Esquire
Bowles Rice McDavid Graff & Love LLP*

Transfers of intellectual property rights can have substantial tax consequences. These transfers are influenced by the category of intellectual property, whether the transfer is viewed as a sale or license for tax purposes, whether the transfer involves a business acquisition or trade, whether the consideration is a one-time payment or contingent royalties, and the special tax rules pertaining to intellectual property.

Intellectual property commonly includes patents, trademarks, copyrights and trade secrets.

Patents. A patent is an exclusionary right granted to the owner of the patent to exclude others from making, using, selling, offering to sell and importing in to the United States products that are covered by the "claims" of an issued patent. The term of the utility patent is effective when issued by the U.S. Patent and Trademark Office ("USPTO") and expires 20 years after the application filing date.

Trademarks. A trademark is a word, name, symbol, slogan or device used to identify and distinguish the owner's goods or services. Trademarks are protected indefinitely under state common law. Trademarks may also be registered under federal law with the USPTO and may last indefinitely.

Copyrights. A copyright is granted by the U.S. Copyright Office to the creator of an original work of authorship or expression that is fixed in a tangible medium. Significantly, a copyright does not protect the underlying idea, only the literal form that the expressive work takes. A copyright normally lasts for the life of the creator, plus 70 years.

Trade Secrets. Trade secrets consist of a formula, pattern, compilation, program, device, method, technique or process that: (1) derives independent economic value, actual or potential, from not being known to, and not be readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use; and (2) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy. State common law and statutes provide protection for trade secrets. The Federal Economic Espionage Act of 1996 provides some limited protection as well. A trade secret can be indefinitely protected as long as it remains secret.

Sale versus License. The tax consequences for intellectual property transfers depend upon whether the transaction is characterized as a sale or license.

In sale transactions, the tax is imposed only on the excess of the payments

over basis; whereas, in license transactions, the tax is imposed on the full amount of the payments with no recovery of basis. Also, gain from a sale transaction may be taxed as long-term capital gain. License royalty income will be taxed as ordinary income. Additionally, gain from a sale transaction is usually reported in the year of sale. On the other hand, royalty income from the license transaction is reported ratably when accrued or paid, depending upon the licensor's accounting method. Finally, many Tax Code provisions can produce adverse consequences for royalty income, for example, the passive investment provisions for S corporations, the Subpart F rules and the passive loss rules, etc.

The Licensee must decide whether to deduct payments currently or amortize over some period of years. Payments to license intellectual property are generally deducted when paid or accrued. To the contrary, payments to purchase intellectual property must be capitalized and amortized.

The Common Law Test. The common law test for determining whether a transaction is a sale or license for tax purposes is known as the "all substantial rights" test. Under this test, a transfer of any category of intellectual property will be characterized as a sale if all substantial rights are transferred for the estimated useful life of the intellectual property.

A transfer of all substantial rights in intellectual property may be limited

either geographically, within the country of issuance, and/or to a particular field of use within trades or industries, and still qualify as sale for tax purposes.

Special Tax Rules for Intellectual Property

26 U.S.C.S. §1235. Sale or Exchange of Patents. Under Section 1235, certain transfers of patent rights are treated as the sale or exchange of a capital asset held for more than one year. Courts have construed Section 1235 to govern only the determination of when an inventor is entitled to capital gains treatment, but not meant to define what constitutes a sale of a patent. The "all substantial rights" test is generally used with Section 1235, with two important exceptions. Unlimited geographic transfers and limited use transfers are not permitted under Section 1235. Prior to Section 1235, professional inventors were denied long-term capital gains treatment because they were selling stock in trade. With Section 1235, they are eligible for long-term capital gains treatment. Indeed, Section 1235 can apply to the transfer of patent rights even before the patent application is drafted, if the invention is patentable.

26 U.S.C.S. §1253. Transfers of Trademarks. Under Section 1253, a transfer of a trademark is not treated as a sale or exchange of a capital asset if the transferor retains any significant power, right or continuing interest over to the trademark. Sale's income is required to be reported as ordinary income. Some examples of what

constitutes the retention of significant power, right or continuing interest are: (1) a right to disapprove any assignment of such interest, or in part thereof; and (2) a right to terminate at will.

26 U.S.C.S. §197. Amortization. Section 197 provides for 15-year amortization for the acquisition of certain intangible assets. Intangible assets are broadly defined, including: any patent, copyright, formula, process, design, pattern, know-how, format, package, design computer software or other similar item. Accordingly, all categories of intellectual property are Section 197 intangibles unless an exception applies.

Concerning exceptions, Section 197 does not apply to any interest in the patent, patent application, or copyright that is not acquired as part of a purchase of a trade or business. Also, amounts paid for a trademark interest that are deductible under Section 1253 are not subject to Section 197. Further, intangible assets created by a taxpayer are generally not covered by Section 197. However, this does not apply to capitalized cost incurred in the development, registration or defense of a trademark.

Computer Software. Computer software is distinctive because it can be protected as a patent and/or copyright or trade secret and is subject to additional special rules. License agreements are commonly used to transfer rights in computer software. However, the "all substantial rights" test is still used to determine whether a

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Professor Robert G. Lathrop joined the faculty of the West Virginia University College of Law in 1979, teaching in the area of federal, state and local tax. He served as the Vermont Commissioner of Taxes in the 1970s. Before that, he was an associate in the tax department of Davis Polk and Wardwell in New York City. He earned both his undergraduate degree and law degree at Washington & Lee University and his LL.M. in Taxation at New York University.

Tax Curriculum at West Virginia University College of Law

*Robert G. Lathrop, Professor of Law
West Virginia University College of Law*

The College of Law offers a broad array of fundamental tax courses to its students. Until this academic year, the basic individual federal income course was offered every semester and was required as far back as anyone here can remember. That course is no longer required, which is the result of the faculty's decision last spring to reduce the number of upper level required courses.

In addition to the basic income tax course, the College of Law traditionally offered estate and gift tax every year and corporate income tax, as well as state and local tax. For years, Professor Henry Collins was the tax professor teaching these courses. In the 1970s, Professor Tim Phillips came on board and taught some of the tax courses, as did Professor Tom Barton during those years. I came here in 1979 and took over Professor Collins' position as the primary tax instructor. In the mid-1980s, when I was Associate Dean, Professor Marion Crain taught the basic federal income tax course for two years.

The College of Law currently offers a basic individual income tax course, a four-hour corporate tax course (which used to be two separate three-hour courses), partnership tax, and estate and gift tax, the latter two taught by adjunct professors. In addition, the College of Law offers a course in estate planning with a heavy estate gift tax component, as well as a course in cyber

tax. If there is any substantial interest shown by law students in having state and local tax offered, the College of Law will do so. While the offerings in tax are basic course, they cover area which we feel are important for our students who plan to practice in the business area, family law, or estate planning.

In the basic individual income tax course, we explore the concept of gross income, largely to make the students aware that wages are not the only item that can be counted as gross income. We cover various exclusions such as gifts and employee fringe benefits, scholarships, gains and losses in dealings in property, divorce and separation, sale of a principal residence, business expenses and capital gains and losses related provisions.

In the corporate tax course, we cover the initial issue of whether a taxable corporation exists. Then we deal with the questions involved in forming a corporation, making distributions to shareholders in various contexts, completely liquidating, reorganizing corporations, and finally reviewing subchapter S.

In partnership tax, we cover the formation and operation of a partnership, the taxation of the partners, distributions to partners, death of a partner, and termination of a partnership. In estate and gift tax, we cover the whole gamut of both

estate and gift tax issues including whether a gift is taxable, the notion of what is included in the gross estate, and the calculation of both taxes. The course in cyber tax generally revolves around jurisdictional issues at both the state, national, and international level, as well as touching upon specific sales and use tax issues.

In state and local tax, we cover the different kinds of state and local taxes, namely, the personal net income tax, the corporate net income tax, the sales and use tax and local property tax. When the West Virginia business and occupation tax was in full force at the state level, that was a large component of the course. Much of the course involves interstate and international transaction and, therefore, is a mini-constitutional law course on the due process and commerce clauses, as well as the equal protection and import/export clauses.

To supplement the substantive tax courses, the College of Law offers two other tax opportunities. One is the

volunteer income tax assistance program which we have run as a student effort since the mid-1980s. In that program, the students take a self-administered Internal Revenue Service exam and then go out in the field to assist the elderly and the poor in preparing their tax returns.

In addition, as part of our live-client clinic, there are from two to four clinic students who are assigned tax cases in which there is a controversy with the Internal Revenue Service. That portion of the clinic is funded by the Internal Revenue Service. Through both of these programs, our students not only have the opportunity to learn substantive tax law, but also apply their knowledge in an attorney/client setting.

The enrollment in tax courses is generally small, but the students who have shown an interest in tax and who have pursued an LL.M. in Taxation have been extraordinarily successful. This measure of success predates my

joining the faculty in 1979, but it has continued, I am glad to report, to the present day. Our students have ranked at the top, or close to the top, of their classes at such well-known programs as New York University, the University of Florida, and Georgetown University.

Our tax students, whether or not they have taken an LL.M. in Taxation, have been successful tax attorneys in law firms in West Virginia and outside West Virginia. Some students have moved into the Internal Revenue Service with important responsibilities, for instance, in the corporate tax area, and at least one student has obtained employment in the civil tax division of the Department of Justice. Thus, while we are a small state law school and our enrollment in tax courses is modest, I believe that the course offerings are generous and that the tax program has been quite successful and will continue to be so in the future. ■

Tokarz... continued from p. 21

sale is taking place. Nevertheless, because a copy of software will typically constitute inventory, its sale will result in ordinary income. Also, under 26 U.S.C.S. Section 1221(3), a copyright held by the taxpayer who created the work is excluded as a capital asset. Thus, computer software sold by the “creator” may not be eligible for capital gains because software, though not registered with the U.S. Copyright Office, still automatically receives copyright protection under the Computer Software Copyright Act.

Trade Secrets. A few special tax rules apply to the transfer of trade secrets. Section 1235 applies to a trade secret that is otherwise patentable or that is incidental to a patent. The transfer of a trade secret is treated as a sale if all the substantial rights in the trade secret are transferred. Specifically, the transfer must convey the exclusive right to use the trade secret for its economic useful life and to prevent unauthorized disclosure.

The tax consequences flowing from the transfers of intellectual property can be substantial and problematic. Care must be taken to identify the categories of intellectual property involved in the transaction and to identify the applicable special rules. Otherwise, economic benefits to both the transferor and transferee may be appreciably diminished. ■



R. Michael Reed was appointed, for a six-year term on October 18, 2002, by Governor Bob Wise as the first Chief Administrative Law Judge of the new West Virginia Office of Tax Appeals. He holds a B.S. in Business Administration and Accounting from Morris Harvey College (Charleston, West Virginia, now the University of Charleston), and received his J.D. from the West Virginia University College of Law. He has been a speaker at the West Virginia Tax Institute annual meetings since 1999 on recent West Virginia state tax administrative decisions.

The New, Independent West Virginia Office of Tax Appeals

*Honorable R. Michael Reed, Chief Administrative Law Judge
West Virginia Office of Tax Appeals*

In the new, independent West Virginia Office of Tax Appeals, virtually the only “crud” we get are state tax cases, excluding the few charitable bingo license and charitable raffle license cases. Fortunately (Will Rogers’ sarcasm notwithstanding), for the benefit of all involved, more and more folks are letting lawyers, especially state tax practitioners, guide them, resulting in a more efficient operation of the new state tax administrative litigation system.

After about thirty years of attempted legislation on point, the West Virginia Office of Tax Appeals (OTA) began operations on January 1, 2003, pursuant to the provisions of W. Va. Code §§ 11-10A-1 [2002] *et seq.* OTA hears and decides primarily state tax disputes that are not resolved informally before the State Tax Commissioner’s Office. OTA is completely separate from and totally independent of the State Tax Commissioner’s Office, and is a quasi-judicial (court-like) tribunal that is part of the executive branch of state government (within the West Virginia Department of Revenue for administrative support and budgetary purposes only). OTA is comparable to the United States Tax Court, not to the Appellate Division of the Internal Revenue Service.

OTA’s independence from the State Tax Commissioner’s Office eliminates

the perception of unfairness in the prior process that had the same agency (the State Tax Commissioner’s Office) collecting state tax revenues and administratively adjudicating state tax disputes through the Commissioner’s former Office of Hearings and Appeals.

OTA is headed by a full-time Chief Administrative Law Judge (CALJ), who is appointed for a six-year term by the Governor, with the advice and consent of the State Senate, from a list of three qualified nominees submitted by the State Bar. The CALJ is a lawyer having, among other things, certain federal or state tax experience and expertise. OTA has two other full-time administrative law judges who also are lawyers having certain federal or state tax experience. OTA’s Executive Director is the “office manager” and “clerk of court.” OTA currently is budgeted for six other support staff employees.

OTA’s procedural rules are modeled in part after the United States Tax Court’s procedural rules. All cases are commenced by filing a written petition for reassessment or for refund with OTA, without any petition filing fee, and the State Tax Commissioner files and serves a written answer in all cases. Cases before OTA are processed either as small claim cases or as regular, non-small claim cases.

Cases eligible for small claim processing and determined by OTA to be treated as such are handled in a less formal manner, usually upon submission of documents only and without an evidentiary hearing in person. The brief written decision in a small claim case, issued within 90 days after the case is fully submitted, is not subject to any further administrative or judicial review.

Regular, non-small claim cases involve, among other things: a mandatory “counsel conference,” involving the parties’ representatives, the arrangements for which must be initiated by the taxpayer; the opportunity for discovery, in appropriate cases and, if necessary, prehearing motions; usually a prehearing conference involving the administrative law judge; and a relatively formal evidentiary hearing, audio-recorded or, at the parties’ expense, attended by a court reporter, at which hearing, under the statute and procedural rules, the taxpayer usually has the burden of proof. Hearings are normally held in OTA’s very own hearing facilities in the capital city of Charleston, with free, on-site parking, but may be held, upon request and in OTA’s discretion, at certain regional sites in the state (Bluefield, Bridgeport, Martinsburg, Wheeling), perhaps, in the near future, by videoconferencing. The written decisions in regular cases, always issued within the statutorily required six (6) months after the matter is fully submitted, may be appealed by the aggrieved party, either the taxpayer or the State Tax

Commissioner, to certain circuit courts in the State. Any appeal to circuit court is based exclusively upon the evidentiary record made before OTA, and no new evidence would be admissible into the record after the appeal to circuit court is filed, with rare exceptions as to certain procedural matters.

In cases before OTA, an individual taxpayer may represent himself or herself, or by filing a completed power of attorney form, may be represented by anyone else, including an adult relative or friend, a lawyer, certified public accountant, registered public accountant, enrolled agent, as long as the other person does not engage in the unauthorized practice of law (which has been very broadly defined by the West Virginia Supreme Court of Appeals, even in proceedings before an administrative tribunal). Therefore, in regular, non-small claim cases, another person, representing a taxpayer, who is not authorized to practice law in this state may not, for example, conduct cross-examination of a witness, argue constitutionality issues, or argue the meaning of an ambiguous statute, regulation, or other document, for these types of procedural steps clearly constitute the practice of law as defined by the West Virginia Supreme Court of Appeals. Similarly, as required by the Supreme Court of Appeals, a corporate taxpayer must be represented by a lawyer authorized to practice law in this State if legal, not factual or accounting, issues are involved. Accordingly, a lawyer, including in-house corporate tax counsel, not authorized to practice law in this state

must be admitted to practice before OTA *pro hac vice* for purposes of representing a taxpayer in a particular case, upon following the procedural rules for the same, including payment of the required fee to the West Virginia State Bar and retaining as co-counsel a lawyer who is authorized to practice law in this State.

OTA’s decisions in non-small claim cases, redacted to maintain taxpayer confidentiality, are published in the State Register as required by statute. We will soon be publishing them, too, along with our procedural rules and forms and other information, at our own internet website, the development of which is nearing completion.

All proceedings (even small claim cases) before OTA are quasi-judicial (court-like) in nature and, therefore, like all “litigation,” involve some processing times, a degree of formality, and potential litigation expenses, such as a party’s own lawyer’s or accountant’s fees. Accordingly, OTA strives to be “user friendly” in various ways, such as by explicitly encouraging the parties at all times to resolve the matter informally outside the administrative litigation process. Optional mediation is also available.

Related to the latter point, the Legislature, as part of the legislation creating OTA, also required the State Tax Commissioner to propose alternative dispute resolution mechanisms. The Commissioner has done so and the Legislature recently approved the rules, involving very informal pre-assessment conciliation

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Rulemaking by Audit

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In taxation (as in many other areas of compliance with governmental regulatory schemes) stability of policy and predictability of requirements are often more important to business managers and investors than even the actual substance of those policies and requirements. A long-standing concern of the West Virginia business community has been the propensity of the West Virginia Revenue (Tax) Department to identify new areas of liability through field audit efforts instead of through formal rule-making or legislation.

Since the repeal of the broad-based business and occupation (B&O) tax in the 1980's, sales and use taxes have become a major area of emphasis of the Revenue Department's audit program. This is the result of legislative restrictions on formerly broad exemptions for purchases by businesses and the increased emphasis upon sales and use taxes as major revenue sources for the State.

Due to the retroactive nature of liabilities imposed by sales and use tax audits and the commercial impracticality of recovering additional taxes that, it is determined, should have been collected from customers, the practice of first asserting new theories of liability in such a context is particularly onerous for vendors of goods and services.

Audit targets are identified through an audit selection unit within the Revenue

Department's (Field) Auditing Division. Leads for audits come from various sources, such as referrals from other branches of the Department, through leads received by tax examiners in other audits, or from inclusion in the "audit program." The "audit program" is comprised of areas where substantial non-compliance is perceived to exist. Common areas understandably placed on the "audit program" include industries for which recent statutory changes generate additional taxes. Unfortunately, particularly in recent years, audit targets have also been selected in areas where only an overlooked or even new application of existing laws leading to tax liability is perceived by the Auditing Division.

Aside from audit selection, the accuracy of audit work is also a concern that good records can substantially mitigate. Once a taxpayer is selected for audit, written notice is given and the tax examiner contacts the taxpayer to arrange for a time to begin the audit. Vendors and purchasers are required by law to maintain adequate records documenting collection and payment of sales and use tax. The regulations describe, in substantial detail, the types of records that satisfy this record-keeping requirement. Generally, the records kept must be sufficient to allow the Revenue Department to determine the liability of each vendor and purchaser. Additionally, those

regulations require that taxpayers maintaining records outside of this State must make such records “available” for audit in the place where the taxpayer keeps its general records. Further, the Main Street Fairness Act of 2003 requires vendors to keep records necessary to account for gross proceeds from sales of personal property and services, gross proceeds from taxable sales, gross proceeds exempt from sales, and the amount of tax collected.

In terms of what it means to make records “available,” tax examiners often

appear to take the position that the Revenue Department has little or no responsibility to ask a taxpayer for records that will assist the Department in conducting the most accurate audit. Rather, they often take the approach that it is incumbent upon a taxpayer to provide the tax examiner, at the inception of the audit or shortly thereafter, with all information necessary to perform the audit.

In this regard, if he or she determines that a taxpayer’s records are complex, voluminous or possibly inadequate in some manner, the tax examiner will use

sampling methods to project the amount of tax due. Recent experience reveals that these “projections” can be highly inaccurate and as a result, the estimate of tax due is grossly excessive.

For example, in an audit for use tax, rather than examine the taxpayer’s financial statements, purchase journals and supporting invoices, the tax examiner may chose to simply pick a “sample” of invoices and project that sample to the entire population for all tax periods involved. In this particular example, assume that the tax examiner

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before the Commissioner, at the taxpayer’s option. The Legislature, however, has not funded the approved conciliation mechanism. It is critical that the Legislature fund this conciliation mechanism to provide the legislatively intended less formal, less costly, and quicker alternative to litigation before OTA, comparable to the process before the Appellate Division of the Internal Revenue Service.

I propose two additions or changes to the new OTA legislation: (1) OTA should be given jurisdiction to hear property tax cases, at least taxability or classification issues, in lieu of the State Tax Commissioner’s decision being reviewed by circuit courts. I realize that county commissions and others likely will oppose this suggestion, especially for property tax

valuation cases, for, frankly, “turf protection” reasons; and (2) appeals from OTA’s decisions should be directly to the West Virginia Supreme Court of Appeals, like workers’ compensation cases, to expedite finalizing this truly time-sensitive type of litigation, and with due deference to our expertise. Most circuit court judges do not have the interest in, or background for, state tax cases, and, for various reasons, usually do not timely issue rulings in state tax appeals.

“Taxes are what we pay for civilized society[.]” *Compania General de Tabacos de Filipinas v. Collector of Internal Revenue*, 275 U.S. 87, 100, 48 S. Ct. 100, 105, 72 L. Ed. 2d 177, 183 (1927) (Holmes, J., dissenting). On the other hand, “the power to tax involves the power to destroy[.]” *McCulloch v. Maryland*, 17 U.S. (4

Wheat.) 316, 431, 4 L. Ed. 579, 607 (1819) (Marshall, C.J.). Yet, as Justice Oliver Wendell Holmes, Jr., expressed in recognition of true judicial objectivity, “[t]he power to tax is not the power to destroy while this Court [or the West Virginia Office of Tax Appeals] sits.”

After this perhaps too lengthy article, I hope Winston Churchill’s witticism in the year 1954 about the then British Prime Minister, Clement Atlee, will not be believed by the reader to be applicable to me: “He is a modest little man who has a good deal to be modest about.” ■

Harlan . . . continued from p. 27

examined taxpayer's invoices for a three month period, totaled those purchases and divided that amount by gross receipts (pro-rated for the three month period), as reflected in taxpayer's income tax return for that year. Assume further that the percentage obtained from that calculation was then projected to a three year period to arrive at the estimated purchases subject to the use tax for each tax year in question.

This method of estimation incorrectly assumes that expenses as a percentage of revenues remain static over the period of assessment. Moreover, such an estimate fails to consider the effects that external factors, such as supply and demand, invariably have on the operations of any business. Given such circumstances, it is often advisable for a taxpayer to proactively offer the auditor sufficient other records, data, etc. to support a more realistic projection of the volume of transactions. Failing that, if a resulting assessment is challenged, the presiding administrative law judge should be asked to allow the taxpayer to submit its own estimation of purchases. This has, in recent cases, led the Department to reduce the assessment even at the administrative hearing stage. As of the date of this publication, however, there are no reported cases in West Virginia challenging the validity of sampling methods utilized in a sales and use tax audit.

Even more troubling than the sampling methods employed by the Auditing Division are the classes of taxpayers selected for audit in the first instance.

In recent years, there appears to be a growing trend by the Auditing Division to attempt to establish proper construction and application of the tax law through audit rather than by formal rule-making. In this regard, the Auditing Division has selected particular businesses as a "test cases" in order to advance its new theories of liability. Such new theories of liability, often unsupported by the plain language of the governing statutes, have involved adding the amounts of post-sale expenditures by purchasers to the gross receipts on which severance tax is paid by natural gas producers, imposing use tax on certain intangible, royalty fees paid to franchisors by franchisees in the restaurant and hotel industries here in West Virginia, and even on health care provider network access fees charged insurance carriers and employers by certain intermediaries.

Targeting West Virginia businesses for audit under such new but unsupported theories of liability in order to generate additional revenue does nothing to stimulate an already bleak economy in West Virginia and is not a sound way to make policy in this State. Importantly, the new independent Office of Tax Appeals ("OTA"), however, has shown a healthy inclination to reject the "rule-making by audit" approach of the Auditing Division when such theories of liability have been shown to be without merit. In addition, in certain recent instances, the Legislature has not hesitated to overrule such agency law-making when it was brought to light.

Therefore, if your company or any other member of your industry is targeted by the Auditing Division for an audit involving a novel theory of liability, experience tells us that it can be most beneficial to bring the matter to the attention of your trade association at the outset. In this manner, a unified front may be presented either in approaching the policy makers at the Revenue Department for reconsideration or for lobbying purposes. In all events, however, when litigation over a disputed tax liability cannot be avoided, engaging a legal representative with experience operating under the new OTA statute is vital in pursuing a challenge of that liability before the West Virginia Office of Tax Appeals. As long as West Virginia businesses face the threat of rule-making by audit, such representation must be seen as the best line of defense. ■

Payments in Lieu of Tax Agreements

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The relative burden of local property taxes among alternate jurisdictions is often a key factor to investors in deciding where to establish new business facilities – particularly those which require large investments in tangible assets. Unfortunately for West Virginia, with its constitutionally imposed property tax, economic development officials here do not have the same flexibility in offering tax reduction incentives as many of the states with which they compete for such investments. To mitigate that competitive disadvantage, development promoters in West Virginia have frequently turned to an arrangement commonly referred to as a payment-in-lieu-of-tax (PILOT) agreement.

Typically, under the PILOT arrangements, an industrial prospect will finance the construction of a new facility, convey it to a tax-exempt public body for nominal consideration, and then lease it back for operation. As a part of such an arrangement, the parties will negotiate amounts to be paid for an agreed period to the local government levying bodies that are less than the property taxes that would otherwise be paid on the facility if it were owned outright by the private entity and fully taxable. Generally, both the amount and the term of the PILOT agreement and terms of the lease are freely negotiable among the private entity and the local government bodies.

At the end of the agreed term of the lease and the PILOT agreement, the private entity reacquires title to the facility and starts paying taxes on it.

In working with PILOT agreements, it must be recognized that a formal property tax exemption only applies to the ownership (freehold) interest in the property of the public body. Under a line of decisions of the West Virginia Supreme Court, the private entity lessee's (leasehold) interest in the facility is not technically exempt. However, under those cases it is presumed that the entire value of the property is attributable to the ownership interest unless it can be shown that the leasehold interest has a separate value to tax.

Under State Tax Department regulations, a leasehold interest has a separate taxable value if it represents a "bargain lease" whereby the consideration paid by the lessee is below the fair market value of its right to use the property and the leasehold is freely assignable so that bargain could be liquidated. In light of such considerations, to enable the PILOT arrangements achieve their intended purpose, the leases must be structured in a manner to avoid being "bargains" for the lessee.

This is often achieved by requiring the private entity-lessee to pay – as advance rent - the entire cost of acquiring and

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constructing the facility. As a matter of simple financial reality, payment of that amount in advance of the inception of the lease term is inherently greater than the fair market rent that would be paid for the mere use of the property for a term of years. In addition, the leases used in conjunction with PILOT agreements typically require the reasonably granted consent of the public body owner/lessor before the private entity lessee can assign the lease to an unrelated third party other than as collateral.

Thus structured, during the term of the lease, no property taxes would be imposed on the facility because the public body's ownership interest is legally exempt and the private entity's leasehold interest has no separate taxable value.

Another typical feature of a PILOT agreement is that the payments under it must be distributed to the various affected levying bodies in the same portions as property taxes are allocated. In addition, under the leases, the public body is held entirely harmless for any loss or liability associated with the construction, ownership and operation of the facility. In addition, depending on the circumstances, sales tax considerations may require the involvement of the local development authority as well as the levying bodies (county commission, school board and municipality) in the PILOT arrangement.

Finally, although not directly essential to the tax savings object, industrial

development revenue bonds are often issued by the public body to formally finance the construction of facilities involving PILOT arrangements. In that case, the private entity or its corporate parent often purchases the bonds and the rent payments are encumbered to the debt service of the bonds. Despite what might appear to be a lack of economic substance to such bond financing, it does have a potential practical implication.

One of the greatest challenges to the use of the PILOT arrangement in West Virginia is the fact that local government bodies are generally not bound to any contract that has more than a one-year term. Thus, the efficacy of a PILOT agreement depends on the willingness of successive elected local officials, who constitute the local government bodies that are parties to it, to continue to honor their commitment to the arrangement from year to year. Of course, the leases in these projects always allow the private entity to reacquire the facility upon termination of the lease, but to the extent that reduced tax exposure for an extended period is a major inducement to have constructed the facility in the first place, such a reacquisition is not an entirely adequate remedy to the private investor.

As a practical matter, the primary force that assures that local officials will honor their commitments made under PILOT arrangements is the chilling effect on a county's economic development prospects and the political fall-out from failing to do so.

That is why the use of the industrial revenue bond device as a formal financing mechanism – and the more serious implication of default – often is seen as helping to better secure the full performance of the local government commitments in these circumstances.

There are other challenges to the continued efficacy of PILOT arrangements as effective economic development tools. These include the latent power of the Legislature to mitigate the benefit of PILOT payments to local school boards by using them to displace state aid. Although that authority has traditionally not been exercised, with looming state budget deficits, that circumstance may not persist. Even more troubling is the recent, highly ambiguous oversight authority the West Virginia Supreme Court and the Legislature has given the Public Service Commission regarding whether any given PILOT arrangement is in the public interest.

While PILOT arrangements have proven to be a highly useful economic development tool, their continued viability is not without misgivings. Absent fundamental reform of its property tax system, that is an uncertainty that economically-depressed West Virginia does not need. ■

Where Does Your WV Tax Dollar Come From?

(FY 2005 Estimate)



Federal Funds
30.7¢

Special Revenue
Funds
30.2¢

General Revenue
Funds
28.5¢

State Road Funds
10.6¢

TOTAL Revenue
\$10.83 Billion

Where Does Your WV Tax Dollar Go?

(West Virginia Governor's Recommended FY 2005 Budget)



Military Affairs &
Public Safety
4.3¢

Higher Education
12.3¢

Transportation
15.3¢

Other*
16.9¢

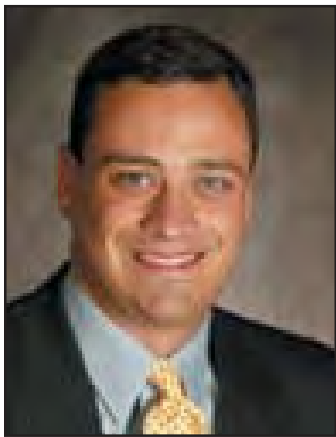
Education
20.1¢

Health & Human
Resources
31.1¢

TOTAL Expenditures
\$10.53 Billion

*OTHER	
Commerce	4.2
Environment	2.6
Tax & Revenue	2.5
Administration	2.3
Executive	1.6
Education & the Arts	1.1
Misc. Boards/Commissions	1.0
Judicial	0.7
Senior Services	0.5
Legislature	0.3
Employment Programs	0.1

Source: West Virginia State Budget Office



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Planning for the Future of Your Small Business — Buy/Sell Agreements

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When starting a new business venture, entrepreneurs face many difficult decisions that greatly impact the ultimate success or failure of the organization. While fortunes are not often made or lost during the “start up” phase, the quality of an organization’s early decision making can be indicative of its prospects for long-term success. Amid all of the early challenges facing a new business, one area which is frequently neglected by would-be Trumps everywhere is contingency planning.

For a small business, a common method of planning for the unknown involves a Buy/Sell Agreement between the owners and the company. The goal of a Buy/Sell Agreement is to help the company plan for, and to provide a mechanism for effecting, the transfer of an owner’s interest upon the occurrence of certain specified events. In short, a Buy/Sell Agreement attempts to eliminate the uncertainty typically associated with those rare, yet foreseeable, events which inevitably occur over the life of a small business.

Just as no two entities are exactly alike, a vanilla, “one size fits all” Buy/Sell Agreement is not likely to effectively address those concerns which are unique to your small business. In order to structure a Buy/Sell Agreement in a manner that best achieves the goals and objectives of your company, you must consider and

address a number of diverse issues, including the following:

Trigger Events. A company should first develop a list of specified events, the occurrence of which will trigger either an owner’s obligation to sell or the company’s or remaining co-owners’ right to purchase. Common “trigger events” include death, disability, divorce, personal bankruptcy, receipt of a third-party offer, termination or resignation of employment, retirement and loss of professional license. One factor to consider when determining which events will trigger the provisions of the Buy/Sell Agreement is the degree to which the owners desire to pass their respective ownership interests on to family members. Additionally, the Buy/Sell Agreement should provide whether the occurrence of a triggering event will require the company or remaining co-owners to purchase the transferred interest, or merely result in an option to purchase or a right of first refusal.

Tax Consequences. Characteristics such as choice of entity (*i.e.*, whether the business is carried on as a corporation, partnership or limited liability company), current ownership structure and the nature of day-to-day operations, all play a role in determining the tax implications of a Buy/Sell Agreement. Though income tax considerations are of primary

concern to most small business owners, the potential estate and gift tax effects of the company's Buy/Sell Agreement must be considered as well. In fact, income tax and estate and gift tax considerations are frequently competing interests which must be balanced in order to draft a Buy/Sell Agreement which meets the client's primary objectives.

Purchaser. If one or more of the remaining co-owners purchases the transferred interest, their respective ownership interest in the company will increase relative to those remaining co-owners who do not purchase the transferred interest. On the other hand, if the Buy/Sell Agreement provides that the company itself will purchase the transferred interest, the remaining owners' relative ownership interest in the company remains unchanged.

Valuation; Purchase Price. One of the most challenging aspects of drafting a Buy/Sell Agreement is establishing a mechanism for valuing the owners' respective interests in the company at some unknown future date on which a "triggering event" will occur. A Buy/Sell Agreement must also determine the purchase price which will be paid to acquire the owners' interest. Popular techniques for establishing the value of, and the purchase price to be paid for, an owner's interest in the company include establishing a fixed value and price, using a variety of mathematical formulas, employing an independent appraiser, accepting the amount of an unrelated, third party's offer, or some combination thereof.

All of these approaches have shortcomings and none are universally applicable, especially given the fact that concerns and priorities vary greatly from entity to entity.

Non-Competition. In some instances, a company and its remaining owners may want to limit the transferring owner's future ability to compete with the company. A Buy/Sell Agreement can address this situation with the inclusion of an appropriate non-competition clause that prohibits the former owner from engaging in certain competitive activities within a specified geographical area for a negotiated period of time.

Funding. In addition to the significant indirect costs (loss of leadership, management or business development skills) that frequently result from the occurrence of an unplanned triggering event, forcing the company or remaining co-owners to purchase an owner's ownership interest can create a large, unfunded, contingent liability which directly impacts the bottom line. A well structured Buy/Sell Agreement can require the company to purchase and maintain life and/or disability insurance policies or to establish a sinking fund to help limit the direct financial impact of the triggering event. In other cases, the company or its remaining co-owners may benefit from structuring the payment of the purchase price as a series of installments at a reasonable rate of interest as opposed to a one-time, lump sum distribution.

Dispute Resolution. If possible and desirable, the Buy/Sell Agreement should provide a mechanism for resolving the disputes that may, from time to time, arise thereunder. Determining the extent to which the parties will be obligated to attend mediation and arbitration, as well as conclusively establishing the jurisdiction and venue for any potential court cases, can measurably influence the resolution of disputes. Also, where a non-competition clause is employed, the Buy/Sell Agreement should also state that the parties are entitled to seek equitable relief (such as an injunction to prevent a party from improper competition in violation of the non competition clause).

Small business owners must navigate through a myriad of issues in order to devise a Buy/Sell Agreement that accomplishes their goals and objectives with respect to contingency planning. Although this may initially seem like a daunting task, a knowledgeable attorney can assist you by framing and addressing the issues that are important to the long-term success and viability of your organization. ■



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Health Savings Accounts

Employers Evaluate a New Health Care Option

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Beginning in 2004, there is a new tax-advantaged health care option available to individuals and employers, called the "Health Savings Account" or "HSA." Health Savings Accounts were included as part of the 2003 sweeping Medicare reform law. This new health care vehicle works in conjunction with a high-deductible health plan by covering an individual's medical expenses below the health plan's deductible amounts. Many employers are evaluating whether HSAs could play a role in providing health care coverage for employees.

What is a Health Savings Account?

An HSA is established as either a trust or custodial account through a bank, insurance company or other IRS-approved sponsor in combination with a high-deductible health care plan. A high-deductible health plan (HDHP) is either an insured or self-insured health plan that has specified minimum limits for the annual deductible and maximum out-of-pocket limits. The minimum deductible amounts are \$1,000 for individual coverage and \$2,000 for family coverage. Annual out-of-pocket expenses under an HDHP cannot exceed \$5,000 for individual coverage and \$10,000 for family coverage. The annual deductible and out-of-pocket limits will be adjusted annually in \$50 increments for inflation. Another important requirement for a health plan to be

considered an HDHP is that it cannot pay any benefits for a year until that year's deductible is met. The only exception to this requirement is that a HDHP is permitted to pay for "preventive care" before the annual deductible is met.

An HSA permits the individual for whose benefit the account is established to pay for certain qualified medical expenses. Contributions to the HSA can be made on a tax-advantaged basis by the employee, employer or a combination of both up to specified federal law limits. However, an employer that contributes to an HSA must make available comparable contributions on behalf of all employees with comparable coverage. Federal law generally limits the amounts of contributions that can be made in any year to an HSA to the lesser of the annual deductible under the HDHP or \$2,600 for individual coverage and \$5,150 for family coverage. These latter dollar amounts will be subject to adjustment in future years based upon inflation. These contributions limits are also increased for individuals age 55 or older.

Amounts in an HSA can accumulate tax-free over a number of years and are distributed on a tax-free basis if used to pay for qualified medical expenses. An HSA is also portable allowing it to be used regardless of whether a change in employment occurs. An HSA also may

be transferred to an individual's surviving spouse tax-free upon the individual's death, following which the HSA will be treated as the spouse's HSA. An HSA may also be transferred to a spouse or former spouse pursuant to a divorce or separation agreement.

Who is eligible for an HSA?

An HSA can be established by an individual or on the individual's behalf by his or her employer if the following requirements are met: (1) the individual is covered by a HDHP, (2) he or she is not covered under another health plan with the exception of "permitted coverage", (3) he or she is not eligible to be claimed as a dependent on another person's tax return, and (4) he or she is not entitled to Medicare benefits. For purposes of these requirements, "permitted coverage" includes workers' compensation, insurance related to ownership or use of property (such as car insurance), insurance for a specific disease or illness and insurance for a fixed payment for a period of hospitalization.

What are the tax advantages associated with establishing an HSA?

An HSA offers a number of tax advantages for contributions to an HSA, distributions to pay for qualified medical expenses and the accumulation of investment earnings on HSA assets.

Contributions to an HSA may be made by an employer or by the eligible individual or his or her family members. Contributions that are made by the employer are excludable from

the employee's gross income for federal income tax purposes and are also excludable from the individual's wages for federal employment tax (FICA and FUTA) purposes. Contributions that are made through salary reduction under an employer's Code section 125 cafeteria plan are considered to be employer contributions. The employer can also deduct the contributions to an HSA in the year made under new Code section 106(d) which permits deductions to an HAS as employer-provided coverage for medical expenses.

Contributions to an HSA by the eligible individual or his or her family members can be deducted by the individual, regardless of whether he or she itemizes deductions on his or her tax return. Contributions made by family members for another member of the family, however, will be subject to federal law gift tax provisions.

Distributions from an HSA are also excludable from federal gross income if used to pay for qualified medical expenses. Qualified medical expenses include expenses for medical care and payment for long-term care services, but only to the extent that these expenses are not covered by insurance or other-

ALERT! NEW COBRA REGULATIONS REQUIRE ACTION BY YEAR END

On May 26, 2004, the US Department of Labor through the Employee Benefits Security Administration issued final COBRA regulations regarding the standards, timing and content of COBRA notices to group health plan participants. These rules will affect group health plans, sponsors, administrators, fiduciaries and participants and beneficiaries. The new rules also provide model notices for use by administrators of single-employer group health plans to satisfy their obligations to provide general COBRA notices and election notices. For calendar year health plans, these new rules become effective on January 1, 2005.

For more information about the new COBRA regulations and obligations, please contact Lesley Russo at (304) 347-1717.

wise. Health insurance premiums are not considered to be qualified medical expenses, except for the following: (1) qualified long-term care insurance, (2) COBRA coverage, (3) health care coverage while an individual is receiving unemployment compensation under federal or state law, and (4) for individuals eligible for Medicare, premiums for Medicare Part A or B or a Medicare HMO, but excluding premiums for Medicare-supplemental policies which are not considered qualified medical expenses. An individual who establishes

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Medicaid — Preserving the Family Home for the Caregiver Child

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It is not uncommon for a child to move back into a parent's home to care for one or both parents as the parent becomes less able to care for himself or herself. In my experience, this occurs most often when only one parent is living. For purposes of this article, it will be assumed that the child is providing care to a single parent. Generally, the intention of the parent and child is to prevent the parent from going into a nursing home. At first, the care may only include maintenance of the home and minimal supervision of the parent's daily needs. However, as the parent's health declines, the amount of care increases.

Eventually, the child may be providing complete care of the parent and the home. Regardless of the good intentions of the child, the level of care required may be more than the child can provide due to the child's work schedule or the needs of the parent. Then, the family is faced with placing the parent in a nursing home and applying for Medicaid. Further, the child is faced with the possible loss of the family residence where he or she has been residing with the parent.

At the time the parent applies for Medicaid, all assets and income of the parent will be considered to determine whether the parent is eligible to receive

Medicaid. The residence is not counted as a resource available to provide support to the parent, as long as it is not producing income and the parent intends to return to it as his or her home.¹ If the West Virginia Department of Health and Human Resources (the "Department of Health") determines that it is not reasonably expected that the parent will return home during his or her life, then the residence will be counted as an available resource – which means that the residence will need to be sold.

A transfer of the residence by the parent after the parent qualifies to receive Medicaid, or within three (3) years prior to the date of application for Medicaid, without receiving full consideration of the value of the residence, may trigger a penalty period during which time the parent may not receive Medicaid benefits. In the event that the transfer is a gift and is not an exempt transfer, Medicaid would determine the value of the gift and divide that amount by the cost of nursing home care recognized by the Department of Health, regardless of the actual cost.² The parent would then be ineligible to receive Medicaid during the months in which the value of the residence could have paid for his or her care.

¹ Also, the residence is not counted as a resource when the spouse, a child under 21 years of age or blind or disabled, or a sibling with an equity interest in the home lives in the residence.

² Currently, the cost of nursing home care recognized by the Department of Health is \$3,380 for 2004.

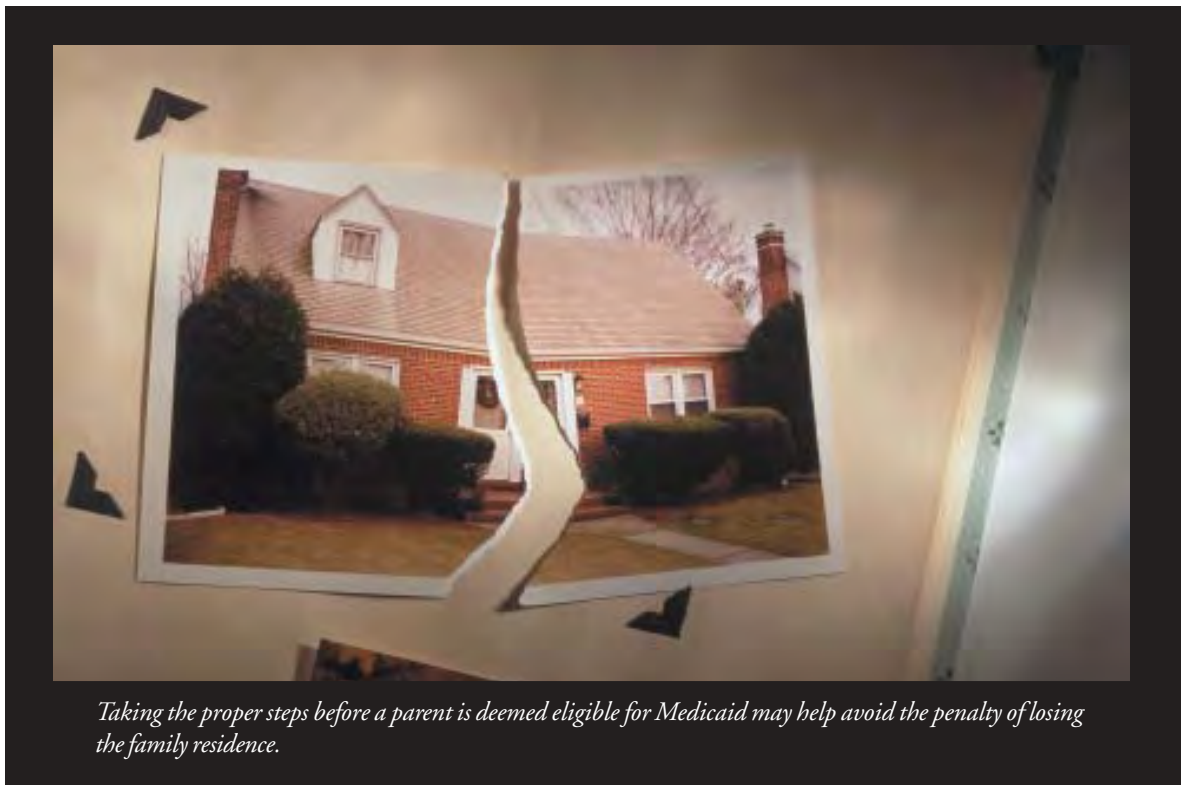
Nevertheless, Medicaid does provide an exemption for a transfer of the residence from a Medicaid recipient to the recipient's child, without consideration. In order to qualify for this exemption, the following requirements must be met:

- The home must be transferred to the recipient's child.
- The child must have resided in the home for a period of at least two (2) years immediately prior to the date of the recipient's institutionalization.
- During the two (2) years, the child provided care to the recipient which allowed the recipient to remain at home rather than being institutionalized. § 17.10(B)(4) of W. Va. Income Maintenance Manual.

In order to establish that the child meets the requirements for the exempt transfer, the Department of Health generally will consider the following: (1) income tax records to establish residence of child, (2) property tax records to determine if the child owns a residence, (3) proof of payment for any medically necessary supplies, and (4) affidavits. Affidavits are used to establish the type of care provided by the child and that, without the care provided by the child, the parent would have had to enter into the nursing home some time during the two (2) years prior to the date the parent actually entered the nursing home. An affidavit can be made by the parent (if competent), the child, the parent's other children, neighbors or doctors. Typically, the type of care provided by the child that prevents the parent from entering a nursing home includes,

without limitation, assistance with household chores, such as cooking, cleaning, laundry and yard care, supervision of the parent's medication, assistance with the parent's personal hygiene, and transportation of the parent to doctor appointments.

If the child meets the requirements of a caregiver, then the residence may be transferred to the child by the parent, without payment of any consideration, and it will not result in a penalty period. The transfer of the residence is accomplished by a deed of gift which, provided the transfer is made without any consideration or money being exchanged, is exempt from the West Virginia excise tax on the transfer of real property. Most importantly, the family home has been preserved for the use and benefit of the caregiver child. ■



Taking the proper steps before a parent is deemed eligible for Medicaid may help avoid the penalty of losing the family residence.



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Rick, also a Certified Public Accountant, assists clients in all aspects of estate planning, including the preparation of tax sensitive wills, revocable living trusts, irrevocable family trusts and charitable trusts. He handles complex corporate transactions, as well as the general representation of business entities. Rick represents businesses before the Internal Revenue Service, the West Virginia Department of Tax and Revenue and the United States Tax Court.

Flexibility in Drafting Estate Plans: Marital & Credit Shelter Trusts

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With the advent of the unlimited marital deduction in 1981 estate planners have been able to minimize estate taxes for a married couple through the use of fairly straightforward formulae allocating the assets of the estate of the first spouse to die into a marital trust and a credit shelter trust. The only questions were whether to use a pecuniary or a fractional share formula, what type of marital trust to use, what provisions to use in the credit shelter trust, whether to fund the credit shelter trust as a general or residuary bequest, and whether to use the unified credit against lifetime gifts or save it for use in the estate of the first spouse to die. Increases in the amount of the unified credit to \$600,000 and then to \$1,000,000 did not have much impact on the strategies employed by estate planners. Occasionally, disclaimers and partial Q-TIP elections were used to add some flexibility to the estate plan in unusual circumstances, such as an estate whose value is dominated by a qualified plan or IRA. However, these cases were unusual.

EGTRRA. The Economic Growth and Tax Relief Reconciliation Act of 2001¹ has introduced significantly more uncertainty into the analysis necessary to develop an estate plan for moderate and high net worth clients.

We are now within six years of the complete elimination of the estate and generation skipping taxes. We are also within seven years of the estate, gift and generation skipping taxes returning to the structure in existence before the enactment of EGTRRA. While these uncertainties are indeed substantial, they are not the only ones by far. We also face: (i) the decoupling of the gift tax from the estate tax, something estate planners have not been concerned with since 1976; (ii) the elimination of the state death tax credit, completely changing the dynamics of the credit estate tax employed by so many states, including West Virginia; and (iii) the prospect of a return to carry-over basis, with the additional wrinkle of basis adjustments for assets left to the surviving spouse and for assets left to others.

All of these uncertainties are actually a part of the estate tax law as it exists today. Many followers of the political side of tax policy are predicting further legislation. In the last session of Congress, the House of Representatives passed a bill permanently eliminating the estate and generation skipping taxes. Only the Byrd Amendment² prevented passage by the Senate. President Bush has stated on several occasions that he would sign such a bill if it reaches his desk. The

¹ P. L. 107-16 (June 7, 2001) (EGTRRA).

² The Byrd Amendment requires the approval of 60 Senators to pass a bill that will negatively effect the revenue of the United States for more than 10 years.

political circumstances are such that diametrically opposing views of tax policy are separated by the slimmest of margins in the polls. The future of estate, gift and generation skipping tax policy as it plays out over the next two presidential election cycles is speculative at best.

Problems Posed by EGTRRA.

Couples having estates currently exceeding the unified credit exemption equivalent by a moderate amount face the question of the extent to which they will need to fund a credit shelter trust. Although there is a great deal of flexibility available in structuring the terms of the credit shelter trust, there are still some restrictions that cannot be overcome, such as the need for an ascertainable standard for invasion of the principal by the surviving spouse. With the unified credit increasing to \$3,500,000 and elimination of the estate tax in 2010, the likelihood of imposing unnecessary restrictions on the surviving spouse's access to assets of the estate of the first spouse to die. The pre-EGTRRA formulae do not provide a satisfactory solution because they are structured to fund the credit shelter trust to the maximum possible amount.

With respect to somewhat larger estates that would have been candidates for generation skipping trust planning, a similar analysis applies to the restrictions placed on the trust benefits provided for the children of the married couple. A larger generation skipping tax exemption, not to mention the

prospect of complete repeal, increases the amount that can be set aside in a dynasty or generation skipping trust. At the same time, larger unified credits, along with possible repeal, reduce the likelihood of necessity for this type of planning.

By January 1, 2006, there will no longer be a credit allowed against the federal estate tax for the death taxes paid to states, effectively de-coupling the federal estate tax from any tax imposed by the states. Since many states, including West Virginia, have adopted a "sponge" or credit estate tax, this de-coupling will likely force some states which are already struggling to balance their budgets to look for alternatives to replace the funds lost by this relatively painless tax.

Beginning January 1, 2010, and lasting for one year, EGTRRA resurrects the idea of carry-over basis. Beneficiaries will not have the income tax basis of all of their inherited assets stepped up to fair market value; however, surviving spouses will retain this benefit for the first \$3,000,000 worth of assets passed to them from their spouse. Others will be able to share in the step up in basis of up to \$1,300,000 in assets passed to them. The record keeping necessary to manage the logistics of carry-over basis will be substantial. Record keeping may pale in importance when compared to the planning decisions that will have to be made regarding the allocation of the basis adjustments resulting from the limited step up provisions.

For the first time in thirty years, the estate tax credit or exemption is not equal to the gift tax credit or exemption. On January 1, the estate tax exemption equivalent increased to \$1,500,000, while the gift tax exemption equivalent remained at an even \$1,000,000. The gift tax exemption equivalent will remain at \$1,000,000 all through the scheduled changes in the estate tax exemption equivalent until the EGTRRA changes run their course. The lower gift tax exemption will have the effect of causing estate planning to focus more heavily on testamentary transfers rather than on inter vivos gifts.

Possible Solutions to the Problems Posed by EGTRRA.

How then can estate planners avoid the problem of subjecting the surviving spouse to unnecessary restrictions resulting from the increasing estate tax credit? The simplest solution is to cap the credit either by limiting the credit shelter bequest to the lesser of the capped amount or the amount generated by the marital deduction formula, or by eliminating the formula altogether. Simplicity, however, is not without its own limitations. For example, a fixed cap cannot adjust to changes in the values of the assets of an estate between the time the plan is implemented and the time of death. Likewise, it cannot adjust to the scheduled return of the estate tax credit to \$1,000,000, nor can it adjust to the potential elimination of the estate tax. Nevertheless, it might be a satisfactory solution under circumstances where non-tax factors are dictating the amount to be placed in the credit shelter trust.

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By giving the surviving spouse an opportunity to decide how to divide the estate between the marital bequest and the credit shelter bequest after the death of the first spouse the estate plan is made more flexible. There are several mechanisms which can be employed to give the surviving spouse such an opportunity. The most straightforward method is to leave the entire estate to the surviving spouse, in any manner that will qualify for the marital deduction and then provide that if the surviving spouse executes a qualified disclaimer with respect to any part of the marital bequest, the disclaimed portion will pass under the credit shelter bequest. By executing a partial disclaimer, the surviving spouse can determine exactly how much of the estate to leave subject to the credit shelter and how much to the marital deduction. This method, however, is dependent on the cooperation of the surviving spouse. In the case of a second marriage, this may not be practicable.

A second alternative to maintain flexibility addresses this concern. Under this method, the entire estate is left in a trust which will meet the requirements of a qualified terminable interest property trust and the marital deduction. After the death of the spouse, the executor can make a partial Q-TIP election³ and separate the trust into a marital trust and a credit shelter trust. In the simplest scenario, the two trusts will have the same provisions.

Only the Q-TIP election distinguishes the two trusts. The Q-TIP election ensures that the estate will pass to the beneficiaries intended by the deceased spouse, while at the same time preserving the estate tax benefits of the unified credit. However, it does not address circumstances where it is necessary or desirable for the credit shelter trust to have different beneficiaries or terms than the marital trust.

When such circumstances exist, a potential solution is to draft a trust for which a Q-TIP election can be made and provide that, to the extent the election is not made, the non-elected portion passes to a separate trust which may have entirely different beneficiaries and terms. Such a trust is sometimes referred to as a "Clayton Trust" after the principal case in the area.⁴ After some reluctance to do so the Internal Revenue Service finally amended the regulations to provide that such a contingency will not cause the disallowance of the marital deduction on the grounds that the surviving spouse does not have a qualifying income interest.⁵ Although much of the literature in this area refers to the making of a "Clayton Election," in fact, the only election is the Q-TIP election for the marital portion of the trust. It is the failure to make the Q-TIP election that automatically causes a portion of the trust estate to pass to the credit shelter trust. Thus, the Executor can actually shift the trust

estate away from the surviving spouse by not making the Q-TIP election.

Another feature that distinguishes the Clayton Trust from the Qualified Disclaimer method outlined above is the timing limitation. A Qualified Disclaimer must be made within nine (9) months of the decedent's death and before any of the benefits of the property disclaimed are accepted by the disclaimant. A Q-TIP election, on the other hand, can be made at any time before the estate tax return is filed, even if it is extended or filed late.⁶ Another feature of the Clayton Trust is distinguished from the standard partial Q-TIP election, in that a special power of appointment can be given to the surviving spouse in a Clayton Trust, whereas it is not possible to do so with standard trust eligible for the Q-TIP election.

There are a number of uncertainties that exist with respect to a Clayton Trust regarding the failure to make any Q-TIP election at all, as well as the case where the surviving spouse is the Executor. However, these uncertainties can be overcome by proper drafting and they have not discouraged the use of this most flexible option in drafting for the marital and credit shelter trusts. ■

³ I.R.C. §2056 (b)(7)(B)(v).

⁴ *Estate of Clayton v. Comm'r.*, 976 F.2d 1486 (5th Cir. 1992).

⁵ Treas. Reg. §20.2056(b)-7(d)(3).

⁶ Treas. Reg. §20.2056(b)-7(b)(4) and (5).

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an HSA must maintain sufficient records to substantiate that distributions were made solely to pay for qualified medical expenses. Neither an HSA trustee or custodian nor the employer have any responsibility for determining that distributions are used for qualified medical expenses.

Distributions from an HSA that are not used to pay for qualified medical expenses are subject to federal income tax and a 10% penalty. The 10% penalty will be waived in the case of death, disability or attainment of Medicare eligibility age.

In addition to the above tax advantages, investment earnings in an HSA also are not subject to federal income tax. Therefore, assets in an HSA can grow on a tax-free basis over time to the extent not distributed to pay for qualified medical expenses.

HSAs offer a new tax-advantaged vehicle that many employers are assessing with respect to health care options currently offered to employees. As part of this assessment, an employer must consider the health care options currently provided and compare the goals of its health insurance program to the cost and other features of HSAs. In particular, HSAs differ significantly from flexible spending accounts and health care reimbursement arrangements that many employers currently offer. However, the ability of an employer to obtain a high deductible health plan at significantly less cost than low deductible group health coverage is spurring great interest in the em-

ployer community regarding these accounts. This interest has resulted in many banks and insurance companies gearing up to offer HSA accounts. It is likely that within the next several years HSAs will become a common feature of many employer group health plan arrangements.

The Internal Revenue Service has recognized that because of the novelty of HSAs many individuals and employers have not yet had an opportunity to fully consider HSAs as a health care vehicle. It has therefore granted transition relief for 2004 which provides that an HSA established on or before April 15, 2005 may pay or reimburse on a tax-free basis otherwise qualifying medical expenses incurred in 2004 on or after the individual becomes eligible. The IRS has also announced plans to issue further guidance on HSAs in the summer of 2004 to address many issues that have been raised in public comment, such as the coordination of HSAs with flexible spending accounts, a model trust/custodian document for HSAs, administrative procedures on employer establishment of HSAs for employees, application of Code section 125 for HSAs that are a part of a cafeteria plan, corrective procedures where employer contributions exceed the statutory contribution limits, and other similar topics.

If you would like additional information on HSAs or how this new health care vehicle might fit into your health care financing options, please contact Lesley Russo. ■



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Paul represents clients before the Internal Revenue Service and the West Virginia Department of Tax and Revenue.

Elder Law: Estate Planning for the Community Spouse

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Most of the time, when a client comes to my office in regard to "Elder Law" planning, he or she is inquiring about Medicaid. Often, there is one spouse whose health is deteriorating and likely will need to enter some type of long-term care facility (or maybe already has). This spouse is referred to as the "Institutionalized" spouse. The other spouse, at least for now, will remain in the home and is referred to as the "Community" spouse. A great deal of time is then spent discussing the couple's income and assets to determine the likely eligibility of the Institutionalized spouse for Medicaid assistance. However, what is often overlooked, by both couples that will qualify for Medicaid and couples whose assets will prevent their qualification, is the estate planning needs of the Community spouse.

Most of these couples have been married for several years and their assets have been intertwined for some time. However, under their current circumstances, there may be many reasons for separating their assets.

First, for those clients that will qualify for Medicaid. If, after everything is said and done (that is, the "snap shot" taken; the assets allocated between the spouses for Medicaid qualification purposes; the Institutionalized spouse's spend down process accomplished), the Institutionalized spouse then

qualifies for Medicaid, now, steps should be taken to ensure he or she does not become disqualified at the Community spouse's death. For instance, if the Community spouse still has a "sweetheart" will that leaves everything to his or her spouse, then upon the Community spouse's death, the Institutionalized spouse would inherit everything and presumably have to start the spend down process all over again in order to re-qualify for Medicaid. Also, keep in mind that assets owned jointly with "rights of survivorship" will create the same problem.

In this situation, consideration should be given to changing wills and asset registration to possibly disinherit the Institutionalized spouse and leave the assets directly to the next generation. Although this sounds like a relatively simple concept, it can have significant pitfalls. One new development of concern is the position some states are taking at the death of the Community spouse. The state's position is that an Institutionalized spouse must elect to take against the will if that spouse has been disinherited. The failure to avail oneself of the election will cause the assets to be deemed countable assets anyway and will likely disqualify him or her from Medicaid eligibility.

What is this "election against the will" and how can we deal with it? Most states have laws that are designed to

prevent a spouse from being completely cut out of his or her spouse's estate. In West Virginia, this provision is called the "Elective Share."¹ This is accomplished by allowing the survivor a percent of the estate based upon the number of years married in the event his or her share of the estate under the decedent's will is little or nothing. It is not automatic, but instead must be instigated by the surviving spouse in order to avail themselves of that right. Typically, families have been happy to have the survivor receive nothing and continue to qualify for Medicaid; therefore, the disinheritance was ignored. Some state Medicaid agencies are arguing that the failure to elect the statutory right is the same as giving away assets and can disqualify a recipient from Medicaid benefits.

One answer to this dilemma is to include as a part of the Community spouse's estate plan a "special needs trust" for the benefit of his or her spouse instead of disinheriting him or her altogether. A "special needs trust" is a carefully drafted trust that allows a decedent to leave in trust assets for the benefit of an individual that is already receiving governmental benefits, such as SSI or Medicaid, without causing him or her to lose eligibility. This should also satisfy the disinheritance concern.

Second, clients not likely to qualify for Medicaid. Estate planning is also a concern for couples that may not likely qualify for Medicaid based upon their level of assets and income. Some couples come to me for planning with

her affairs, it may not be wise for them to inherit the estate of the other spouse. It still may be best to leave the estate to the children or a trust to see that the assets are properly managed.

Finally, in both the Medicaid and non-Medicaid situations, the Community spouse, in addition to being concerned with his or her will and changing beneficiaries, probably needs to reconsider such issues as Medical and Financial Powers of Attorney, Executors, and Trustees. In a lot of the documents I see, the spouse may be the only individual named to fulfill those roles. If that person is no longer able to act in that capacity, then the Community spouse should name new individuals now while they are able.

It is easy to see how the practice of Elder Law includes much more than just qualifying for Medicaid. This estate planning aspect is just one of the many issues that an attorney practicing in the area of Elder Law can assist you with. ■



If an Institutionalized spouse becomes eligible for Medicaid, be sure to take measures to prevent the possibility of disqualification in the event of the Community spouse's death.

estates that are large enough that it is just not likely they will ever qualify for Medicaid. Even those couples should be aware of their planning needs. If one spouse is already facing a disability or otherwise unable to care for his or

¹ West Virginia Code Section 42-3-1, *et seq.*

Top Ten Reasons Why Estate Planning is Still a Good Idea

Since the 1997 tax act¹ and the 2001 tax act² created an ever changing estate tax environment, tax professionals have been constantly revising their planning tools to best take advantage of the changes in the estate and gift tax laws. At the same time, as the Unified Credit increases and we creep closer to 2010 when the estate tax is gone for one year, many clients are asking their advisors, “Why do I still need estate planning?”

Well, the truth is that, even though the rules have changed, the basic reasons for estate planning still exist, including estate and gift taxes. In fact, there may be even greater opportunities for planning under the new tax laws. So, we put together our own “Top Ten” reasons why clients should consider their estate planning needs. While they are in no particular order, we do feel these are some of the highlights as to why estate planning is still a good idea.

10. The estate and generation-skipping taxes were repealed, but only temporarily, and not right away. The gift tax is still with us.

The Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) provides for the repeal of the Federal Estate and Generation Skipping Taxes effective January 1, 2001.³ Until then, these taxes remain in effect with regular increases in the unified credit and regular decreases in the maximum tax rates. Estate tax planning for persons dying before January 1, 2010, will still be necessary in cases where the values of their estates require.



In addition, EGTRRA contains a sunset provision which provides that effective January 1, 2011, the Federal Estate and Generation Skipping Taxes will be applied and administered as if the provisions and amendments of EGTRRA had never been enacted.⁴ Unless Congress and the President decide to work together and make any or all of the EGTRRA provisions permanent, we return to the situation in existence as of December 31, 2000, with a unified credit of \$1,000,000. Although there appears to be considerable public and political support for permanent repeal, this support may waiver in the face of increasing budgetary pressures from the war on terrorism and annual deficits.

The repeal of the Estate Tax generally and the phase-out of the State Death Tax Credit by January 1, 2006,⁵ wreaks havoc with state death taxes, especially those like West Virginia with the so-called “sponge” or “pick-up” tax. Some of these states will lose revenues in the billions of dollars. Although the impact in West Virginia will not be nearly as severe, any negative impact on the State’s budget will be felt.

EGTRRA increased the exemption against taxable gifts to \$1,000,000 effective January 1, 2002.⁶ The

¹ The Taxpayer Relief Act of 1997.

² The Economic Growth and Tax Relief Reconciliation Act of 2001.

³ EGTRRA §901(a)(2).

⁴ EGTRRA §901(b).

⁵ EGTRRA §531(b).

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maximum rates were also decreased in accordance with the same schedule as the decline in the estate tax rates. On January 1, 2010, the maximum rate will be equal to the maximum individual income tax rate.⁷

Planning for transfers during lifetime will still be necessary since Federal Gift Tax remains in effect. The interplay between the Federal Gift Tax, the lack of an Estate Tax and the new carry-over basis rules will change the focus, but not the necessity, for planning for these transfers.

9. With the adoption of new carryover basis rules, people need to plan in order to take advantage of the \$1,300,000 general basis step-up and the \$3,000,000 marital basis step-up.

For estates of sufficient size, it will be necessary to plan for the most effective utilization of the basis step-up rules recently adopted.⁸ These new basis rules become effective for the estates of decedents dying after December 31, 2009. Qualifying transfers to the surviving spouse will receive a basis step-up of as much as \$3,000,000. In order to get the step-up, the transfers will have to be either outright or in a trust that will be similar to the current Q-TIP Marital Trust. Transfers to other beneficiaries will be eligible for a basis step-up of as much as \$1,300,000. Perhaps the new marital formula in these cases will be allocating basis step-up rather than the unified credit.

8. The opportunity to create real “Dynasty Trusts” may not last.

Nothing lasts forever, not even tax relief. This may prove to be an opportunity to exclude wealth from taxation for multiple generations. Many states have repealed or substantially modified the rule against perpetuities which limited a Settler’s ability to keep wealth in trust for generations. Since “tax reform” is seldom retroactive, trusts established after the repeal may never be subject to the Estate or Generation Skipping Tax even if it comes back later in the guise of tax reform. Some of this country’s great personal financial empires were created in this manner.

7. Planning for non-traditional relationships and second marriages with “Q-TIP”-like provisions.

In situations like non-traditional relationships and second marriages, people will want to provide for lifetime benefits while controlling the ultimate disposition of their wealth. Trusts will remain an effective mechanism for doing so.

6. Business succession planning is still necessary.

Business owners will still want to retire and realize the value of their businesses in their retirement, whether they sell their businesses to unrelated purchasers or transfer them to younger generation family members. If the Estate and Generation Skipping Taxes are indeed repealed and the Gift tax remains, Trusts will likely become a popular mechanism for transferring businesses in such a way that the effective time will be at the death of the

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⁶ EGTRRA §521(b)(2).

⁷ EGTRRA §511(d).

⁸ EGTRRA §542(a).

Top Ten Reasons Why Estate Planning is Still a Good Idea

older generation owner and will not be subject to a gift tax.

5. Avoiding intestate succession.

If someone dies without a will, it is said they died “intestate.” Intestate succession relates to the provisions under the West Virginia statutory law that determine how the decedent’s assets will be distributed. Thus, someone who dies intestate gives up control of their assets and how they are distributed to the statutes. Therefore, the laws of intestate succession can cause unnecessary delay and expense and certainly do not ensure that the decedent’s assets are left to the beneficiaries he or she would have wanted to receive them.

4. The traditional reasons for wills and trusts (*i.e.*, beneficiaries, executors, guardians, bond, minimizing probate, avoiding ancillary administrations and privacy) still exist.

Some things never go out of style. Long before people worried about estate taxes, they worried about which beneficiaries received what assets and when. Wills and trusts are the documents that provide the type of control people want, even to the extent of controlling those assets beyond the grave. Wills and trusts take back the control that the intestate succession laws do not provide. At the same time, avoiding the unnecessary delays and expense that can be associated with dying intestate. A will allows you to name not only your beneficiaries (and their shares), but also the Executor that will administer the estate and the Guardian for minor children.

Under West Virginia law, a Testator can excuse an executor in his or her Will from the need for posting a bond. Fiduciary bonds are more difficult to obtain than they used to be and they can be quite expensive.

A typical annual premium is about \$3.30 per \$1,000 value of an estate. Waiving bond cannot be accomplished through the intestate succession laws.

Trusts allow you to control your assets even after your death. You can delay payout until such time as a beneficiary reaches a certain age or completes his or her education. Trusts can provide additional privacy from the public aspects of probate and even funding the trusts during your lifetime can provide a level of avoiding or minimizing the estate administration process. Trusts can also provide more sophisticated estate benefits such as including charitable beneficiaries or multiple generations.

3. Trusts are still the best way to provide professional asset management for Grantors and for Beneficiaries with special circumstances.

Another significant advantage to trusts is to allow for professional management of the assets held in the trust. By naming a bank or other institutional trustee, the Grantor can gain the benefit of their expertise in investments or management of the assets. Grantors can enjoy this benefit even during their lifetime by funding the trust and still ensuring the assets are preserved for future beneficiaries. The lifetime funding is a good way to ensure the Grantor is provided for in the event of subsequent incapacity.

The same advantage is provided for future beneficiaries that may be minor children or young adults who are too young to properly manage their bequests or perhaps a son or daughter (at any age) that is just not good at handling his or her finances. Whenever a beneficiary is unable to manage his or her own affairs, a trust can be used to separate the beneficial ownership of property from its management. Such cases may require professional investment management, restraint from the exercise

Top Ten Reasons Why Estate Planning is Still a Good Idea

of poor judgment, or simply maintenance until the beneficiary reaches maturity.

Trusts can also be used to manage special circumstances like a disabled beneficiary or for Medicaid planning for a disabled spouse. Recipients of many governmental benefits risk losing them when they are the prospective beneficiaries of estates. By utilizing “special needs” trusts, these beneficiaries can receive benefits that enhance their lives while retaining their governmental benefits.

2. Lifetime planning with Advance Directives.

Advanced Directives is the term used to collectively refer to a Living Will, Medical Power of Attorney, and a Financial Power of Attorney. These documents allow you to control your life and who will handle your affairs should you become incapacitated or incompetent.

A Living Will is your declaration or statement that, should your condition be deemed terminal, you do not want any life sustaining measures taken merely to artificially prolong your life or maintain you in a vegetative state. It does not authorize someone to make decisions on your behalf; it is simply a statement of your wish as they pertain to life sustaining treatment.

In a Medical Power of Attorney, you appoint a person to make medical decisions for you if you are unable to make your own decisions. Recent Federal law changes known as “HIPAA” require specific language to ensure that the person you appoint as your power of attorneys can have access to your medical information.

A Financial Power of Attorney appoints a person to make financial decisions for you if you are unable to make those decisions. Financial Powers of Attorney are critical to avoiding the much more

painful step of a guardianship or conservatorship proceeding. The Power of Attorney can be used in conjunction with a funded trust.

1. It is still the best way for people to transfer their accumulated wealth to their beneficiaries when they want and in the way they want.

The very first question estate planners should ask their clients is how they want their wealth to be transferred to their beneficiaries upon their deaths. If the plans we develop do not incorporate this basic and fundamental principle, then they are failures despite any other benefits they achieve. Most clients will come up with their own reasons for the estate plans we develop. After all, they came to us with problems seeking our help in overcoming them. If we are listening, we will not have a hard time selling our services. ■

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