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The Importance of Exit Strategies in Professional Partnership Agreements

Partnership agreements are vital for any size professional firm, large or small. Equity ownership and allocation of profits are business issues which are often addressed upon initial formation. However, one of the most important and most overlooked issues is the withdrawal of a partner or his/her retirement from the firm. The agreement should value the retiring, deceased or disabled partner's contributions to the firm, how such value is to be paid, and how such payments are characterized under the Internal Revenue Code. Agreements often fail to adequately address these issues, sometimes resulting in intense conflict and costly litigation upon the departure of a partner.

Events of withdrawal need to be clearly defined and should include voluntary withdrawal with the ability to continue to practice, involuntary withdrawal (expulsion), disability, retirement and death.

Upon withdrawal, a partner is entitled, at a minimum, to receive his/her capital account balance, his/her proportionate share of undistributed profits and his/her proportionate share of collectible accounts receivable of the partnership.

Upon a partner's withdrawal based upon death, disability or retirement, the agreement should also recognize the departing

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Initial Steps After the Death of a Loved One

Amid the grieving that accompanies the loss of a loved one, there are important arrangements to undertake and tasks to accomplish. The following is a summary of the steps you and your family should take during this difficult time.

Funeral Arrangements

Funeral arrangements should be made directly with the funeral home. If you advance the funeral costs, you will be reimbursed by the estate. If no cash is available to pay for the funeral, please call us so we can reassure the funeral home that funds will be available in the estate.

You should request that the funeral home obtain approximately a dozen death certificates. These will be needed

in connection with collecting the decedent's assets and the funeral home can obtain these quickly.

Assets Requiring Immediate Attention

If the decedent owned assets that require immediate attention, such as risky or concentrated stock holdings or margin accounts, please call us. We may need to petition the Court to receive preliminary authorization to sell assets that could rapidly lose their value.

If the decedent operated a solo professional medical or dental practice, please call us as we may be able to quickly locate a purchaser in order to preserve the value of the business.

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ESOPs for S Corporations

An employee stock ownership plan ("ESOP") is a type of qualified plan that invests primarily in employer securities. Beyond providing a very attractive employee benefit, ESOPs are frequently established by business owners for their strong tax benefits and as a mechanism for owners to cash out a significant portion of their ownership interest without necessarily giving up effective control of their business.

For many years, ESOPs could only be established by a C corporation, and not by an S corporation. S corporation status was, and still is, very popular with closely-held business owners because S corporations are generally not subject to federal income tax at the corporate level. Instead, shareholders are subject to tax on the corporation's income, whether or not such income is distributed. Because ESOPs were not available to S corporations, owners had to evaluate whether they were willing to part with S corporation status in order to reap the benefits of an ESOP.

However, as a result of tax law changes that were made in the late 1990s, an S corporation may now be owned, in whole or in part, by an ESOP. The combined tax attributes of an S corporation that is owned by an ESOP are extremely favorable. Generally, to the extent that an S corporation is owned by an ESOP, (i) there is no corporate-level income tax and (ii) the ESOP's pro-rata share of the corporation's income is not subject to current income tax.

For example, if an S corporation is 100% owned by an ESOP, all of its taxable income flows through to its sole ESOP shareholder, and there is no current federal or state income tax on its annual income. In effect, the income tax is deferred until the

employees who participate in the ESOP receive distributions from the ESOP. Even then, participants can further delay taxation by rolling over their ESOP benefits to their personal IRAs. Because the corporation and its ESOP shareholder have no current income tax liability, more money can be kept in the business.

If the S corporation is only partially owned by an ESOP (for example, the business owner sells a 40% interest to the ESOP and holds onto the other 60%), the tax savings still apply, but the cash flow analysis is different. Typically, the corporation will make cash distributions to the non-ESOP shareholders so that they have funds to pay taxes on their pro rata share of the corporation's income. Because all shareholders in an S corporation must have the same distribution rights, similar cash distributions will also be made to the ESOP, even though the ESOP will *not* have to pay any tax for its share of the corporation's income.

While ESOPs can now be established by both C corporations and S corporations and are attractive in both, important differences remain. First, an individual shareholder of a C corporation may sell his shares to an ESOP on a tax-deferred basis, provided certain requirements are satisfied, the most significant of which is that the ESOP must own at least 30% of the company after the sale. This tax break does *not* apply to a sale to an ESOP maintained by an S corporation. This limitation is often overcome by arranging a sale of stock to an ESOP while the plan sponsor is a C corporation and having the S election made after the ESOP stock purchase. It is important, however, to make sure that converting from C

to S status does not trigger the built-in gains tax or LIFO inventory recapture.

Second, C corporations sponsoring ESOPs may deduct without limitation plan contributions that are used by the ESOP to make interest payments on a loan that the ESOP has taken to finance its acquisition of company stock, plus principal payments not in excess of 25% of compensation. By contrast, S corporations must include the interest within the 25% limitation. This can be mitigated by extending the term of the ESOP loan so that the annual contribution required to service the ESOP debt falls within the 25% limit and is, therefore, fully deductible.

Third, S corporations are not entitled to the special tax deduction provided by the Code for dividends paid on stock held by an ESOP that are used to pay principal or interest on the loan used by the ESOP to acquire company stock. To the extent that the ESOP owns a significant percentage interest in an S corporation, the benefit of the dividend deduction is mitigated by the tax-free nature of the ESOP's share of the corporation's income.

Danziger & Markhoff is experienced in establishing and servicing ESOPs for both C corporations and S corporations. If you are considering establishing an ESOP, we can assist you in weighing the benefits of making, or maintaining, the S election, and structuring the transaction to achieve your tax and other business objectives.

Please contact Stanley E. Bulua, Esq. or Jay Fenster, Esq. if you have any questions about ESOPs.

The Importance of Exit Strategies in Professional Partnership Agreements

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partner's prior contributions to the firm and the goodwill he/she is leaving behind. A common way to value this goodwill payment is by taking a percentage or multiple of the average compensation received by the departing partner during the three year period immediately preceding the event giving rise to such withdrawal. Such valuation could be subject to a specific year of service requirement or could vest over a period of time. Absent the availability of insurance, a large goodwill payment is not typically paid to an individual who has just become a partner. The payment terms and requisite tax characterization must also be considered. Deductibility of such payments is important absent insurance proceeds in the event of death or disability and such amount should be paid over a longer period of time to ensure the viability of the firm. The payment of the goodwill amount in the event of with-

drawal based upon disability or retirement must be conditioned upon such partner being bound to a restrictive covenant.

The Internal Revenue Code allows the parties in a service partnership to control the income tax consequences of payments. The payment schedule of the foregoing, as well as the appropriate tax characterization, can be crucial to the firm's ability to make these payments and the ultimate longevity of the firm. The deductibility of such payments in the year they are paid could be the difference between the firm being able to make such payments to the withdrawing partner (or his/her estate) or ceasing operations because the remaining partners cannot draw enough income to earn a living.

The agreement also needs to provide the departing partner with the comfort that the amounts due him/her by the firm will be paid. Such payout should be guaranteed by the remain-

ing partners subject to their own death, disability or retirement. Additional safeguards should be included to ensure that the remaining partners do not dissolve the firm or voluntarily withdraw to avoid paying the withdrawing partner while utilizing a new entity to enjoy the benefits of the goodwill left behind by the senior partner.

Partners should review their partnership agreement to ensure that all withdrawal issues are adequately covered and that the agreement reflects present realities and the current intentions of the parties. The time spent doing so will be well worth the benefits of a smooth transition and the avoidance of ill will, unnecessary disputes and possible costly litigation.

Please call Gregory R. Tapfar, Esq. if you have any questions about partnership agreements.

Deferred Compensation Regulations Issued

On April 10, 2007, the IRS issued long-awaited final regulations under Section 409A of the Internal Revenue Code. Code Section 409A, which was enacted as part of the American Jobs Creation Act of 2004, imposes a variety of rules and requirements on non-qualified deferred compensation arrangements. Generally, these rules relate to the timing of deferral elections, distributions and changes in distribution elections.

Deferred Compensation that is subject to Code Section 409A is not limited to amounts payable under deferred compensation plans and agreements. In addition to elective and non-elective deferred compensation plans and agreements, many employment agreements that provide for payment on termination or other deferrals, severance agreements, deferred bonus arrangements, and eq-

uity compensation arrangements are subject to the new rules. *Failure to comply with these rules can result in significant and detrimental tax results.*

The Final Regulations are significant in three regards. First, they address and resolve many interpretation issues raised by Section 409A. Second, they set an absolute deadline of December 31, 2007 for amending plans and agreements to comply with Section 409A. Third, they provide that transitional relief previously granted by the IRS – including the ability to change previously made deferral elections – expires at the end of 2007.

What To Do Now?

Identify All Nonqualified Deferred Compensation Arrangements.

Review all Plans and Arrangements for Compliance. Because there are differences between the Final Regulations and previously issued IRS guidance, even arrangements that had already been drafted or revised to comply with Section 409A need to be reviewed again for compliance with the Final Regulations.

Prepare Needed Amendments and Execute by December 31, 2007. In order to comply with the new rules, plans and agreements must be revised by the end of this year.

Review Existing Deferral Elections.

Please call Jay Fenster, Esq. or Ira Langer, Esq. if you have any questions about these regulations.

Initial Steps After the Death of a Loved One

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Checks and Bills

Any checks belonging to the decedent and received after death (including dividend checks, insurance reimbursements, paychecks, etc.) should be held for deposit into the new estate account once it is established. Social security benefits for the month of death (usually received at the beginning of the following month) must be returned.

Bills addressed to the decedent should generally be held for payment or rejection by the estate. Some bills like real estate taxes, utilities and mortgage payments can be paid if there is sufficient cash.

Initial Estate Administration Meeting

You should call us to schedule an appointment one or two weeks after the death to review the steps involved in administering the estate. Unless we have the original Will in our safe, please bring the original Will with you. You should also bring the names and addresses of the decedent's children, and if there are minor children, their dates of birth. Bring any death certificates that you have together with a brief summary of the decedent's assets including their location and how title was held (e.g. owned solely, jointly or as tenants in com-

mon with another).

If the Will needs to be probated, a probate petition can be prepared in advance and signed at the initial meeting. Probate is the process of requesting a Court to declare the Will to be valid. Generally, a Will can be probated fairly quickly. Notice of the petition must be given to certain family members. The family members then have the right to object to the Will, but in practice objections are rarely made. If the family members waive their right to receive notice, probate will often be granted sooner. Once the Will has been probated, the Court will issue "letters testamentary" as evidence of the executor's authority to act for the estate.

Estate Bank Account and Asset Collection

Once letters testamentary are issued, we will open a checking account in the name of the estate on which only the executor can sign. All cash assets are placed in this account in order to pay administration expenses, taxes and bills. Title to other accounts and assets will subsequently be changed into the name of the estate, until the assets are ultimately distributed in accordance with the provisions of the Will.

Life Insurance

Life insurance claims can be made by

the policy beneficiaries, or we can assist with filing the claims. We will order a Form 712, which contains the policy details for estate tax purposes, from the life insurance company.

Estate Tax Returns

Federal and state estate tax returns are due, and the estate tax is payable, within nine months after death. Preparation of the estate tax returns requires an extremely detailed review of the decedent's assets, and we will ask you to provide us with extensive documentation of the decedent's financial assets, including three years worth of income tax returns, bank and securities statements, and retirement account statements. Since this information is reviewed by the Internal Revenue Service on audit, we review this material when preparing the estate tax returns so that any potential issues are discovered and addressed in advance of an audit.

While the estate settlement process can seem daunting when coping with the death of a loved one, the attorneys at Danziger & Markhoff LLP can provide you with experienced and compassionate counsel during an emotionally stressful time.

If you have any questions or would like guidance with settling the estate of a loved one, please call Stanley E. Bulva, Esq., Michael Markhoff, Esq. or Martin P. Daniels, Esq.

Changes in Funding Rules for Defined Benefit Pension Plans

On August 17, 2006, the President signed the Pension Protection Act of 2006 (PPA) into law. This legislation took many years to develop and completely overhauls the minimum funding requirements pertaining to defined benefit pension plans. The new funding requirements generally set higher minimum levels than currently apply and reduce an employer's flexibility in determining its plan contribution. The new funding requirements apply to all defined benefit pension plans, including cash

balance plans, beginning in 2008.

The IRS has not yet provided full technical guidance concerning the funding requirement changes. Nonetheless, we strongly believe that clients and others who currently maintain a defined benefit pension plan, and in particular those who will find it difficult to deal with an increase in minimum contributions or a reduction in contribution flexibility, should be considering *in advance* what impact the new rules will have on their

Plan and what changes in Plan design might be adopted to address their concerns. To that end, we will be sending all of our defined benefit pension clients a letter authorizing us to analyze the effect this new law will have on their funding goals.

If you want to discuss these rules before you receive our letter, we encourage you to contact Bill Miller, Aileen Palazzo or your Plan Administrator at our offices.