

DANZIGER & MARKHOFF LLP

Winter 2007

Danziger & Markhoff LLP
123 Main Street
White Plains, NY 10601

Telephone 914.948.1556
Fax 914.948.1706
www.dmlawyers.com

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Critical Tax Considerations When Selling Your Professional Practice

When a medical doctor, dentist or other professional is selling the assets of his or her practice, the structure of the transaction must be carefully considered in order to minimize the tax impact to the seller. Two Tax Court cases (the Martin Ice Cream case and the Norwalk case) present significant tax planning opportunities for owners of professional service corporations who are selling their practices.

Under current tax law, if a professional is conducting his practice as a C Corporation (or under certain circumstances as an S Corporation), the sales proceeds received by the professional from the sale of the practice assets may be subject to two levels of federal income tax; one at the corporate level (at a flat rate of 35%) and a second at the shareholder level. To avoid this double tax, the seller typically requests that a portion of the purchase price be allocated directly to the shareholder (e.g., in payment for a covenant not to com-

pete), resulting in only one level of tax at the shareholder level at ordinary federal income tax rates of up to 35%. However, there is a limit to the amount of purchase price that can be allocated to a covenant not to compete.

The two Tax Court cases referred to above held that a shareholder can own personal goodwill separate from the corporation where the customers of the business view the shareholder (and not the corporation) as the center of their relationship. This scenario can apply to many medical, dental or other professional practices since patients continue to be treated by the professional regardless of whether the professional is conducting his practice as a professional corporation. The true relationship is with the professional himself and the goodwill is created by the individual professional and not the professional's corporation.

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New Pension Law Allows Window of Opportunity to Increase Deductible Contributions to Existing Defined Benefit Plans

The Pension Protection Act of 2006 (the "Act") contains numerous provisions that can be used by the company sponsoring a retirement plan to increase their tax deductible contributions. This article will focus on one such provision -- the "150% of current liability" rule that allows sponsors of existing defined benefit plans to substantially increase their tax deductible contributions. This new rule is explained

in detail below. For purposes of our discussion, we will disregard other technical deduction rules that might otherwise apply. First, some short introductory comments.

This 150% rule will only be in effect for the 2006 and 2007 plan years. Starting in 2008, Congress has instituted an entirely

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New Pension Law

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different pension funding methodology which may actually reduce the permissible contributions made on or after 2008. Accordingly, it behooves sponsors of defined benefit plans to review their tax picture for this two-year window period and -- if appropriate -- to take advantage of the newly permitted increased contributions.

Importantly, even though we are already in the 2007 calendar year, there is still time left to take advantage of this new law with respect to funding a defined benefit plan for 2006. In the case of a calendar year plan, the funding deadline for the 2006 plan year is September 15, 2007. Thus, a sponsor of such a defined benefit plan who can make use of additional deductible contributions can make those additional contributions at any time until September 15, 2007 with respect to the 2006 year. Similarly, the 2007 contributions in the case of a calendar year plan can be made as late as September 15, 2008.

The best way to understand this new provision is by way of some examples. Take a look at Table A below.

Current Liability	\$400,000
Assets	\$300,000
Unfunded	\$100,000
Old Law Deduction	\$100,000

Table A shows the funding rules for a slightly underfunded plan under the pre-2006 provision. The plan has a current liability of \$400,000 (based on applicable IRS assumptions). This means that over the past years, the participants in the plan have accrued benefits that are currently valued at \$400,000. In other words, if the plan were to terminate today, the plan would need \$400,000 to pay out all

promised benefits to the participants. Since the plan only has assets of \$300,000, it is currently underfunded by \$100,000. Under the pre-2006 law, the maximum permitted deduction for this plan would have been \$100,000.

Now look at Table B to see the amazing result from the new law:

Current Liability	\$400,000
150% of Current Liability	\$600,000
Assets	\$300,000
Unfunded	\$300,000
New Law Deduction	\$300,000

Table B shows the same current liability of \$400,000. Under the new law, that amount is multiplied by 150% giving us a theoretical liability of \$600,000. When we reduce this amount by the \$300,000 of assets, we are left with a theoretical unfunded amount of \$300,000 which is the deductible amount under the new law. With the stroke of a pen, Congress has given us a 300% increase in the permitted contribution to this plan.

Defined benefit plan sponsors with plans that are not underfunded (or possibly are overfunded) should not assume that they may not take advantage of this new provision. Take a look at Table C.

Current Liability	\$400,000
Assets	\$500,000
Overfunded	\$100,000
Old Law Deduction	-0-

In Table C, the plan is overfunded by \$100,000. Thus, under the old law, no contribution would be permitted. On the other hand, as shown in Table D, even though on a true funding basis, the plan is overfunded by

\$100,000, application of the 150% rule results in a theoretical underfunding of \$100,000. Result: The plan sponsor may contribute an additional \$100,000 to this overfunded defined benefit plan and take a full deduction for that contribution.

Current Liability	\$400,000
150% of Current Liability	\$600,000
Assets	\$500,000
Unfunded	\$100,000
New Law Deduction	\$100,000

This new rule has broad application. Nonetheless, it does not apply to all defined benefit plans. For example, it does not apply to plans established after 2003. Sponsors of defined benefit plans, in coordination with their accountant, financial planners and plan actuary, should determine whether they can take advantage of this exciting new rule and whether it makes sense to increase their tax deductible plan contributions. ■

We encourage you to contact Ira Langer, Esq., Andrew E. Roth, Esq., Jay Fenster, Esq. or William Miller, M.S.P.A., M.A.A.A., COPA if you have any questions concerning these topics or other issues relating to the new pension law.

Get Organized for Your Heirs

Even with a formal estate plan in place, it is a good idea to organize your personal paperwork and inform your heirs of basic decisions and wishes that will facilitate the settlement of your estate after your death.

In doing so, you can ensure that your preferences for funeral arrangements will be followed, friends and family that are important to you may be notified of your death, and items with sentimental value may be properly passed on. Without organized financial records, it will be difficult for your heirs to locate all of your assets, with the risk that certain stocks, bonds, partnership interests, bank accounts, real estate, or insurance policy benefits may go unclaimed.

An organized way to address these concerns is to prepare a personal letter of instruction that covers the following items:

The Rationale for your Estate Plan

Your letter of instruction is where you can discuss why you distributed your estate in the manner you did. You can give a general overview of your estate plan, or you can discuss your plan in specific detail, explaining to your heirs how each asset will be distributed. If you have selected only one of your heirs as executor or trustee, you might explain in your

letter the reasons why you chose that individual and why you did not choose another. You might also explain any significant lifetime gifts that you made to some of your heirs.

Itemized List of Assets

Include in your letter of instruction an itemized list of all of your assets and the location of all important documents concerning those assets. Prepare a list of all checking and savings accounts, including the bank name, account numbers and individuals on the account. You should also list any real estate or cooperative apartments that you own, including the details of any mortgages. Provide the details for insurance policies, including policy numbers, effective dates, levels of coverage and policy location. Also list your automobiles and the location of the automobile titles. In addition, you should also list your outstanding debts.

Important Contacts

List the names, addresses, and telephone numbers of important individuals your heirs may need to contact, including employers, attorneys, accountants, insurance agents, investment managers and financial planners.

Personal Papers and Account Statements

Indicate where personal records are kept, including your birth certificate, marriage certificate, divorce or sepa-

ration agreements, diplomas, military records, and naturalization records. At a minimum, you should keep at least three years of bank and brokerage account statements, tax returns and cancelled checks, and you should indicate where these are kept.

Safe Deposit Box

Indicate where any safe deposit box is located and what is contained in the box. You should note where the key is kept and who has access to the box. You might also consider adding a family member as a co-signatory to the safe deposit box in order to facilitate quick access to the box following death.

Disposition of Personal Items

All well drafted Wills contain a clause designating the beneficiaries of your personal tangible property. You might, however, wish to give your executor some further guidance as to how you would like such personal items distributed, including jewelry, photographs, personal collections, pets and furniture. You should be sure to check your homeowner's insurance riders for any scheduled jewelry or other items that you might like certain heirs to receive.

Funeral Arrangements

Your letter of instruction should also include your preferences for funeral arrangements, including whether

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Alert: New Requirement for Post-Employment Benefit Valuations

The Government Accounting Standards Board (GASB) released Statement 45 concerning "post-employment" health and other non-pension benefits for public employees. These benefits are often the most costly for employers.

The intent of GASB 45 is to bring governmental accounting standards more

in line with private company standards. In general, all public sector employers offering post employment benefits - other than pensions - will be required to display the related liabilities of those benefits in their financial statements, and include not only current retirees, but current active employees who could become eligible.

Danziger & Markhoff LLP's actuarial staff has performed a number of valuations of these post employment benefits and are uniquely qualified to assist you and your clients in this area. ■

Please call Andrew E. Roth, Esq. for further information.

Selling Your Professional Practice

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Based on these cases, an allocation of a portion of the purchase price to personal goodwill of the selling professional should be considered. The amount allocated to personal goodwill is taxed only once (at the shareholder level) at capital gains tax rates (i.e., generally 15%). This technique can also be applied to an owner of an S Corporation which converted from a C Corporation within 10 years prior to the sale.

To illustrate the impact of this technique, if the selling professional is offered \$500,000 for the goodwill of his practice and if the purchase price is paid to the C Corporation for its corporate goodwill, the selling professional would realize after tax proceeds of approximately \$275,000. This occurs because the sales proceeds are taxed first at the corporate

level, yielding \$325,000 (based on a 35% federal corporate tax rate) and then taxed again at personal capital gains rates, i.e., 15%. On the other hand, if the same \$500,000 purchase price is paid directly to the professional for his personal goodwill, the selling professional would receive after tax proceeds of approximately \$425,000 (\$500,000 reduced by the 15% federal capital gains tax), for a tax savings of approximately \$150,000 (\$425,000 - \$275,000). It should be noted that the amount that can be allocated to personal goodwill varies in each case and should be determined by an independent qualified appraiser. State and local taxes would have to be factored into this calculation.

Several steps must be taken before a professional considers selling his practice in order to obtain the foregoing tax benefits. For example, the

employment contract with the professional and his professional corporation must be reviewed prior to implementing this technique and an appraisal of the personal goodwill must be obtained to substantiate the amount that can be allocated directly to the shareholder. In addition, the documentation for this type of transaction is vastly different from that of a traditional transaction and must be prepared properly to obtain the desired results.

Before selling your practice, professionals should consult with an advisor who is familiar with these issues as they relate to professional practices. ■

If you would like to discuss this planning technique in detail, please contact Robert B. Danziger, Esq. or Gregory R. Tapfar, Esq.

Get Organized For Your Heirs

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you want a religious or secular service, whether you want flowers or donations to charity, whether you want to donate your organs or body to medical institutions and where you would like to be buried or how your remains should be disposed of. These are items your heirs may feel uncomfortable asking about, but knowing your specific wishes can be a great relief and can be helpful in avoiding conflict after your death. You might

also list any friends or family you would like contacted after your death.

Update Periodically

As it is good advice to have your will reviewed periodically, you should also review and update your personal letter of instruction from time to time as your thoughts on these subjects can change over time. Finally, be sure to keep your personal letter of instruction in a place where heirs can find it immediately after your death.

We have prepared a checklist which you can use to organize your financial affairs. Please feel free to call our office if you would like us to send it to you. ■

If you have any questions or would like to further discuss organizing your financial affairs, please call Michael Markhoff, Esq. or Martin P. Daniels, Esq.

Out and About

The partners at Danziger & Markhoff LLP will be speaking on pension, estates and corporate law for a variety of professional associations in the upcoming months. We invite you to look at our website (www.dmlawyers.com) for more information about these presentations.

Let us know if you would like to receive future issues of our newsletters by e-mail. All we need is your e-mail address. Please either fax your request to our office, attention: Paula Peck at (914) 948-1706 or e-mail Ms. Peck at Ppeck@dmlawyers.com.

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