TAX & BUSINESS LAW REPORT

FLASTER GREENBERG
ATTORNEYS AT LAW • A PROFESSIONAL CORPORATION

A Newsletter of the Tax & Corporate Practice Group

WINTER 2005

Editor's Note...


Richard J. Flaster

Our estate planning and administration capabilities continue to expand with the addition of Heike K. Sullivan. Although Heike has gained substantial concentrated experience in the estates field during her prior association with a large Philadelphia law firm, it remains the philosophy of our Firm to provide fully-integrated corporate and estate planning services to our clients involved in closely-held businesses.

If you or a colleague would like to receive the Tax & Business Law Report electronically, we will be happy to do so. Email addresses for our reader database can be sent to: firm@flastergreenberg.com.

In This Issue. . .

New Deferred Compensation Tax Rules Require Immediate Attention

BY ELLIOT D. RAFF

As a post-Enron reform measure, the newly enacted section 409A of the Internal Revenue Code compels every employer that provides any type of nonqualified deferred compensation to immediately review all existing and proposed plans for compliance.

What Is A "Nonqualified Deferred Compensation Plan"?

Under the American Jobs Creation Act of 2004 (enacted October 22, 2004), "nonqualified deferred compensation plan" or "nonqualified plan" is any plan that provides for the deferral of compensation other than a qualified plan. In lay terms, a nonqualified plan is any plan or agreement whereby a business agrees to make a payment in the future for services rendered now, deferring the payment and taxation of the compensation until a future date. It may be a plan covering a group of individuals or an agreement or other arrangement for a single individual.

Examples

- Nonqualified "401(k)" plan: Allowing voluntary salary reduction contributions in excess of the 401(k) plan annual limits ($14,000 for 2005), with or without an employer match or supplemental contribution.
- Nonqualified defined benefit plan: Providing an employer funded pension where one is not otherwise offered to employees or in excess of what a qualified pension would provide.
- Phantom stock/stock appreciation rights: Providing payments that simulate the economic effects of stock ownership without diluting actual ownership or control.
- Bonus deferral plan: Allowing employees to defer annual bonuses until a future date.

Why Sponsor a Nonqualified Plan?

The primary reasons employers sponsor nonqualified plans is to create a highly flexible, uniquely designed compensation/tax-planning program. Some employers create nonqualified pensions in order to recruit sophisticated executives who may be nearing retirement age. Others create nonqualified "401(k)" type plans to allow key, highly paid employees to minimize current taxable income during high income employment years and defer the income until retirement. Given the flexibility of such plans and the fact that most do not create current taxability to the recipient, nonqualified plans can provide valued incentives and serve as retention devices (*i.e.,* "golden handcuffs").

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Attorneys' Limited Duty of Care to Estate Beneficiaries

By Laura B. Wallenstein

When an attorney prepares an estate plan for a client or acts as counsel to a decedent's estate, there is often an assumption on the part of actual and potential beneficiaries that the attorney owes them a duty and/or represents them as well. Two recent California cases confirm that such an assumption is often ill-founded.

In one case, a child of a deceased mother sued her mother's estate planning attorney for not timely filing a deed in her favor, resulting in her failing to receive the property. The court stated the general California rule that despite not being the actual client the potential beneficiary could have a cause of action if the decedent's intention was clear, but was disregarded. In this case, however, conflicting testimony made the decedent's intent far from clear and the court ruled against the daughter. *Featherson v. Farwell,* 123 Cal. App. 4th 1022. In a companion case, the children of a decedent sued her estate planning attorney for preparing and seeing to the execution of documents favoring the decedent's boyfriend. Again, the testimony regarding the testator's intent was conflicting and the court held for the attorney. The court noted that if the attorney had a duty to each beneficiary there would be a conflict of interest between the testator and a beneficiary and among beneficiaries and such a rule would impose an "intolerable burden" on lawyers. The court also pointed out the extraordinarily low threshold needed for a testator to indicate testamentary intent and that a lawyer convinced of a testator's intent is not required to urge the testator to consider alternative plans. *Boranian v. Clark,* 123 Cal. App. 4th 1012.

Although these cases may provide some comfort to attorneys who find themselves being threatened or actually sued by unhappy beneficiaries, the general rule should not be forgotten. In a California case decided less than a month after *Featherson* and *Boranian,* the court held that where a lawyer clearly understood the intent of a testator to benefit her sole beneficiary and failed to prepare documents that would effect that intent, an action by the beneficiary could be brought. *Osornio v. Weingarten,* 124 Cal. App. 4th 304.

The New Jersey courts have also put limitations on the potential responsibilities of an attorney to non-clients, and even to clients, where the client wears dual hats. In *Barner v. Sheldon,* 292 N.J. Super. 258 (Law Div. 1995), the court pointed out that the counsel to an estate is counsel only to the executor of the estate and not to beneficiaries or other parties. In *Fitzgerald v. Linnus,* 336 N.J. Super. 458 (App. Div. 2001), the court held that an attorney who was hired by an executrix simply to assist her in administering an estate and not to provide tax planning, was neither liable to her children or to her, in failing to advise of post-mortem tax planning which may have saved future estate taxes.

As each of these cases is fact sensitive, attorneys and testators (and beneficiaries to the extent involved) would be well served to foster clear communications and prepare thorough documentation regarding the intent of an estate plan. Moreover, counsel to executors of estates should promptly advise beneficiaries that they are not represented by counsel to the estate, while at the same time advising the executor of the duty to communicate to the beneficiaries and to treat them fairly in accordance with the executor's fiduciary duty. ◆

Estate Tax Valuation Discount Unavailable for Income Tax on Retirement Accounts

By Elaine J. Petruzziello

The highest 2005 federal estate tax rate is currently 47% and, while it will gradually decrease to 45% by 2007, it will jump back to 55% in 2011, unless Congress and the President decide otherwise. The estate tax is assessed against the fair market value of the decedent's taxable estate, which typically includes the value of a retirement account. In addition to an estate tax assessment, a retirement account is also subject to income tax if the decedent funded the retirement account with tax-deferred compensation, and this tax is payable by the beneficiary who receives the proceeds from the retirement account (at income tax rates which range from 10% to 35% in 2005). Without any adjustment for the potential double taxation of the retirement account, this tax structure means that at the current highest tax levels, every dollar of value in a decedent's retirement account could be subject to federal taxes over 65%, leaving less than 35% for the beneficiary—and even less when state income and estate taxes are taken into account.

These potential tax rates provide motivation for Executors to report the lowest permitted value of the assets held by a decedent's estate. Typically, Executors achieve lower values by applying lack of marketability and minority interest valuation discounts to assets such as partnership interests, limited liability company membership interests and closely held corporate stock, and sometimes a creative and aggressive taxpayer may even seek to assert a valuation discount for an interest in a retirement plan. However, to date, those efforts have not met with success. Indeed, in a recent case decided by the Fifth Circuit Court of

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Litigation Damages Take Account of Inherent Income Tax Cost

By Richard J. Flaster

Resolving a split among the Circuit Courts, the United States Supreme Court has recently ruled that attorneys fees in a tort settlement involving taxable damages are not netted against the award for income tax reporting but are deductible only as a miscellaneous itemized deduction for regular income tax purposes and not at all for purposes of the AMT. *Commissioner v. Banks,* U.S. Sup. Ct. January 24, 2005. As a result, the effect to litigation recipients is to dramatically reduce the net after-tax funds that are retained from such awards.

A recent unreported federal case outside this jurisdiction has held that this inherent tax cost can be taken into account as an "enhancement" to the amount of the litigation award. *See* Garcia v. Pueblo Country Club (September 3, 2004 Colo. D.C., Case No. 00-D-60).

- **Planning Point:** The impact of the *Banks* decision should prompt litigants to take this inherent tax cost into account not only in seeking higher litigation awards but also in fashioning settlements. ◆

NJ Partnerships and LLCs with 10+ Members Must File 2004 Returns Electronically

By Richard J. Flaster

A partnership or limited liability company with more than 10 partners/members must file its 2004 New Jersey income tax return (2004 NJ-1-65) and make payment electronically. N.J.A.C. 18:7-17.10.

Although the New Jersey Division of Taxation has indicated that it will not seek penalties and interest for not complying with this mandate for the 2003 return filings, it will apply a penalty of $100 per month for failure to file and pay electronically for each month until the electronic format is complied with. ◆

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New Deferred Compensation Tax Rules Require Immediate Attention

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In addition, such plans may be additionally appealing to employers because they can simulate the economic rewards of stock ownership without actually diluting stock ownership or creating minority shareholders.

Drawbacks of Nonqualified Plans

Benefits under a nonqualified plan are unsecured contractual rights to future payments, which must be unfunded, if they are to avoid current taxation of the recipient. For instance, in the event of the employer's bankruptcy, the nonqualified plan participant will join all other unsecured creditors and any anticipatory transfers of assets in the event of creditor claims may be reversed.

The sponsor can create a fund that will be available to pay the compensation when it is due and a nonqualified plan may obligate the business to do so. However, the fund must remain an asset of the business. As such, amounts contributed to this fund, and earnings, remain taxable to the business.

If these rules and/or section 409A are violated, the deferred amounts (*i.e.*, the amounts contributed to the fund) and earnings thereon will be deemed to be "constructively received," and will be included in the employee's gross income for that year—even though the employee would still not have a right to actually receive the funds.

New Requirements Under the Jobs Act

In general, under new Code section 409A, all compensation deferred under a nonqualified plan for all years, *and not subject to a substantial risk of forfeiture* is included in gross income unless the distribution, acceleration, and election rules are satisfied. This means that once the risk of forfeiture lapses, all deferred amounts will be included in taxable income unless the plan meets the requirements of section 409A *even if the executive has not actually received payment* nor has a contractual right to payment.

Therefore, the threshold issue is whether deferred compensation is subject to a *substantial risk of forfeiture*, and is deemed to be so subject only if the right is conditioned upon future performance of substantial services by the individual. For example, if a nonqualified plan provides for payment on a specified date only if the executive is continuously employed until such date, then there would be a substantial risk of forfeiture at all times. However, if he is entitled to payment upon termination for any reason, there will not be a substantial risk of forfeiture. It is likely that a substantial risk of forfeiture will exist if the employee has to forfeit the right to payment if he terminates employment without cause, although there is no "safe harbor" or bright-line rules for this regard.

Once the risk of forfeiture lapses, the following requirements must be satisfied—both as to the terms of the document and in actual operation:

Distributions—Payments of deferred compensation may not be made earlier than upon: (i) separation from service (*i.e.,* termination of employment); (ii) disability; (iii) death; (iv) a specified date provided for in the plan; (v) a change of control of the business; or (vi) the occurrence of an unforeseen emergency. Recent IRS guidance explains that, in general, a change of control occurs when a person or group obtains ownership of more than 50% of the fair market value or voting power of stock, ownership of the business, or obtains 35% or more of the voting stock ownership, or replaces a majority of the board of directors, or obtains ownership of more than 40% of the gross fair market value of the business's assets. This definition will cover most corporate transactions that give rise to the uncertainty whether the new owners will honor prior obligations. An "unforeseen emergency" is a severe financial hardship resulting from a sudden and unexpected illness or loss of property due to casualty or other extraordinary, unforeseeable circumstances. This is a much higher standard than the types of hardships with respect to which hardship distributions may be provided under a qualified 401(k) plan.

Acceleration—The nonqualified plan may not permit acceleration of the time or schedule of any payment. For example, if a plan provides for payment on January 1, 2010, the plan may not allow the executive to elect to receive payment on January 1, 2007. Similarly, if a plan provides for payment in ten annual installments, it may not allow the executive to elect a single lump-sum payment instead. However, there are certain limited exceptions (*e.g.,* in connection with a domestic relations order and for the payment of payroll taxes).

Elections—In general, an executive's voluntary election to defer compensation for services provided during a tax year must be made by the last day of the preceding tax year. For example, the election to defer compensation earned during 2006 must be made by December 31, 2005. "Re-deferral elections" (*i.e.,* elections to further postpone payment) are allowed but must be made at least 12 months prior to the original payment date and must defer the payment by at least 5 years. For example, if a payment is scheduled to be made on January 1, 2010, a "re-deferral election" must be made prior to January 1, 2009 and must postpone the payment date until at least January 1, 2015.

Consequences of Violating 409A

These tax requirements must be met both in the formal terms of the nonqualified plan and in its operation. If the risk of

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forfeiture lapses and section 409A is violated, then all amounts previously deferred are included in the executive's taxable income.

Example of Violating 409A:

- Elective deferred plan provides for payment upon reaching age 65.
- Executive aged 60 has deferred $100,000 of compensation, which earned another $15,000.
- Employer allows Executive to change his deferral election mid-year and also to receive $25,000 to buy a vacation home.
- That year, $115,000 is included in Executive's taxable income.
- Executive must also pay additional 20% tax.
- Executive must pay $69,000 in additional taxes without having received his full benefit.

Effective Date, Transition Rules, and Immediate Steps to Take

The requirements of section 409A are effective for all compensation deferred on and after January 1, 2005. Thus, a plan established prior to 2005 which allows new deferrals after 2004 (such as 2005 compensation) must comply. Amounts deferred prior to 2005 will not become subject to the new rules and will be "grandfathered" under the pre-2005 plan and law. However, this status will be lost if there is a material modification to the plan.

Fortunately, the IRS has given sponsors and practitioners a temporary reprieve. The deadline for amendments necessary to comply with section 409A does not have to be adopted until December 31, 2005. However, during 2005, existing plans must be operated in accordance with the new requirements.

Planning Pointer

Given all the foregoing, any business that currently provides any form of deferred compensation should immediately take the following steps:

- ✓ Identify all plans, agreements, and arrangements that may potentially meet the definition of a nonqualified plan under section 409A and review with counsel to determine if each meets the definition.
- ✓ Determine whether each nonqualified plan, in its current form and operation, complies with section 409A, and if not, what would need to be changed.
- ✓ Communicate conclusions with affected employees.
- ✓ Determine how to bring non-compliant plans into compliance, carefully taking into account whether such action would constitute a "material modification" and the effects thereof.
- ✓ Communicate proposals to affected employees.
- ✓ Implement decisions by December 31, 2005. ◆

Estate Tax Valuation Discount Unavailable for Income Tax on Retirement Accounts

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Appeals, the Court held that the rationale supporting valuation discounts could not be applied to lower the value of the decedent's interest in a retirement plan account by the income taxes payable by reason of the beneficiaries who received the account assets. *Smith v. US,* 94 A.F.T.R.2d 2004-6891.

In *Smith,* the Executor initially reported the decedent's interest in two retirement accounts holding marketable stocks and bonds at the fair market value of the accounts as of the date of the decedent's death. The Executor later filed a claim for refund of estate tax on the ground that the value of the retirement accounts should have been discounted by 30% to reflect the income taxes that the beneficiaries would pay on distributions from the accounts. The IRS and the Court rejected the Executor's argument. The Court pointed out that while beneficiaries must pay income tax on the retirement account distributions they receive, the beneficiaries will also be allowed an income tax deduction in an amount equal to the estate tax paid on the retirement accounts, to mitigate the potential double tax noted above. The Court also stated that the hypothetical "willing buyer–willing seller" test should be applied to properly determine the fair market value of the retirement account. Since the "willing buyer–willing seller" test is an objective one, it does not consider the income tax burden of the beneficiary or the estate tax consequences for the estate. Using this test, the Court found that the hypothetical willing buyer would pay the value of the marketable stocks and bonds as determined by the applicable securities exchange prices, and the hypothetical seller would likewise sell the applicable securities for that amount without reduction for income or estate taxes. ◆

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