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VOLUNTARY CORRECTION PROGRAM FOR NON-QUALIFIED DEFERRED COMPENSATION DOCUMENT FAILURES

Highly compensated employees often seek to defer tax by entering into non-qualified deferred compensation agreements with their employers. These plans and agreements are regulated by Section 409A of the Internal Revenue Code. Section 409A, which became law in 2005, is supplemented by Treasury Regulations that became effective in 2009. Together they provide an extraordinarily complex set of rules regulating elections to defer compensation and subsequent election changes. They also limit the events upon which deferred compensation may begin to be paid.

Because of the complexity of the rules, many deferred compensa-

tion plans and agreements inadvertently fail to comply with Section 409A. Failure to satisfy the 409A requirements has significant adverse tax consequences. Amounts that are improperly deferred are currently taxable to the employee or other service provider who is entitled to payment and are subject to a 20% add-on tax plus interest, even though he or she does not receive payment until the future.

On January 5th of this year, IRS published its long-awaited program for correcting documents that fail to satisfy Section 409A. This guidance, set forth in Notice 2010-6, is broad-reaching and pro-

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ENSURE YOUR ESTATE PLAN IS UP-TO-DATE

Insurance Review

As part of a comprehensive estate planning update, you should consult with your property and casualty agent and financial advisor to review your coverage. For asset protection reasons, you should consider increasing your umbrella insurance coverage to at least \$5,000,000 in order to protect you from lawsuits resulting from accidents on your

property as well as automobile accidents.

In the life insurance area, your financial advisor should review your policies to determine if they are performing according to the investment assumptions that existed at the time you purchased the policies. Very often, our clients have purchased life insurance policies on the

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FINANCING ESOP TRANSACTIONS

One of the major advantages to a business owner who sells all or a portion of his stock in his company to an employee stock ownership plan ("ESOP") is the opportunity to create a liquidity event. Typically, this is achieved via leverage, whereby the company borrows money from a bank or other lender and then lends the funds to the ESOP. The business owner then sells his stock to the ESOP and receives payment for his stock from the ESOP.

Although credit markets are tighter than they were prior to the financial crisis of the last two years, there has been an easing of credit in the last quarter of 2009 and the first quarter of 2010 and financing is available for ESOP transactions involving creditworthy companies.

There are three types of financing that are most common in ESOP transactions. The first, which is senior debt provided

by banks and other institutional lenders, is based on a company's assets and cash flows. Banks will usually advance 80-90% against eligible accounts receivable and 45-60% against eligible inventory. Fixed assets, such as equipment and real estate, and intellectual properties (trademarks and patents) may also be included as part of the collateral.

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VOLUNTARY CORRECTION PROGRAM

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vides helpful relief. It provides employers and employees with an excellent opportunity to bring their non-qualified deferred compensation agreements into compliance.

Under the Notice, certain document failures may be corrected without having to pay any taxes, provided that the corrected plan provision does not affect the operation of the plan within one year following the date of the document correction. If the corrected plan provision does affect plan operation within one year, the Notice provides limited relief, reducing but not totally eliminating the taxes otherwise applicable to a Section 409A document failure.

The types of plan document failures that may be corrected under this program include impermissible payment events, incorrect definitions of events

that are acceptable payment events, impermissible discretion to modify a payment schedule, impermissible discretion to accelerate payment events, and impermissible initial deferral elections.

In order to qualify for relief under the Notice, when taking the corrective action, neither the employer nor the employee may already be under audit for the item, the employee must pay any reduced taxes that are due under the program and the parties must satisfy certain disclosure requirements. Relief under the Notice is not available for a document failure unless, in addition to properly correcting the failure, the employer takes commercially reasonable steps to identify and correct all other non-qualified deferred compensation plans that have a substantially similar failure.

Significantly, the Notice includes a transition rule

whereby corrections which otherwise would have resulted in reduced taxes may be corrected by December 31, 2010 without the payment of *any* tax or penalty.

In order to avoid punitive tax results, employers and employees who have deferred compensation arrangements should actively review them to correct any deficiencies under the Notice. This would include reviewing separate deferred compensation plans and agreements as well as employment agreements that incorporate compensation deferral features. To get maximum relief, corrective action needs to be taken this year, while the special transition rule applies. ■

If you have any questions about the voluntary correction program, please contact Jay Fenster, Esq.

ENSURE YOUR ESTATE PLAN IS UP-TO-DATE

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presumption that the premiums would “vanish” after ten or fifteen years, but once that magical date has arrived, the insurance company sends a notice that a cash infusion is needed to keep the policies in force because returns earned by the insurance company were less than originally projected. On the other hand, some policies accumulate large amounts of cash surrender value that are not needed. In this case, the death benefit may be increased while the premium is decreased or kept constant. Also, as we learned in 2008, the ratings for some insurance companies have been lowered, leaving many people questioning whether their death benefit will be there when they die. Now is the time to review your coverages with your advisor before it is too late.

Everyone Expects to Inherit, Including Your Son-In-Law and Daughter-In-Law

This is a topic we have discussed in previous newsletters, but it is the single most discussed topic with our clients. For individuals with married children or grandchildren, their second largest

anxiety (after estate taxes) is the fact that their assets might not pass to their grandchildren without proper planning. The fact pattern that concerns most parents is as follows: Mother and Father die and leave their assets to Daughter. Thirty years later, Daughter dies and leaves her assets (which include the inheritance from Mother and Father) to her Husband. Husband remarries Paris Hilton a month after Wife’s funeral (without a prenuptial agreement) and dies immediately thereafter. Husband leaves his assets (including his inheritance from Wife which includes the assets of his in-laws, Mother and Father) to Paris Hilton. You can hear Mother and Father spinning in their graves over the fact that the grandchildren have been disinherited.

To avoid this scenario, you should consider leaving the inheritance in the form of “generation-skipping trusts” for your children. These trusts provide income to the

children and distributions of principal with the consent of another trustee. When the child dies, the trust will be distributed to grandchildren.

The advantage of the generation-skipping trust is that the parents are, in effect, “dictating from the grave” where their assets will pass. It is as if the parents are preparing a Will for the children since the parents are setting

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the terms of the inheritance. The result is that the children cannot control who will ultimately inherit those funds after they die. As a side benefit, the advantage of the trust is that since the child

does not have control of the assets (the trustee has the control), creditors cannot attach the trust principal. Regardless of the size of your estate, if you are concerned with how your children will dispose of your assets after they die, this technique will ease this fear. ■

Please contact Michael Markhoff, Esq. to discuss these estate planning issues.

ELECTRONIC HEALTH RECORD RESOURCES FOR PRIMARY CARE PHYSICIANS

Last month the New York State Department of Health announced the receipt of three federal grants totaling \$70,000,000 to develop health information technology in New York. Among the awards were grants of over \$20,000,000 to each of the New York City Department of Health and Mental Hygiene and the New York eHealth Collaborative to sup-

port New York State's more than 9,000 primary care physicians in their efforts to select and implement electronic health records systems and qualify for federal incentive payments.

Both organizations (NYCDOHMH in New York City and NYeC in the rest of the state) will furnish educa-

tion, outreach and technical assistance to enable primary care physicians to transition to the use of electronic health records in a cost-effective manner which is also in compliance with applicable regulatory requirements. ■

Please contact Joshua S. Levine, Esq. with questions.

FINANCING ESOP TRANSACTIONS

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Although in the current environment lenders increasingly prefer to lend against liquid assets, asset-based senior lenders also occasionally "stretch" their loans, advancing funds in excess of their clients' collateral support based on company cash flow. While historically 18-24 month cash flow overadvances were available, presently this financing window has been shortened to 0-6 months.

Senior lenders typically price their loans as a function of Prime or Libor. Typical ranges in today's market are Libor plus 3% to Libor plus 5% or Prime to Prime plus 2%. Because of current low interest rates, banks often have rate "floors" of 4-5%.

Another type of financing that is quite prevalent in the current environment is mezzanine financing using subordinated

debt. Typically, mezzanine debt consists of a base interest rate plus warrants (rights to purchase stock at a fixed price) issued to the mezzanine lender. The mezzanine lender's total annual rate of return (interest and warrants) usually ranges from 16-23% of the loan amount. Mezzanine debt providers include private equity/mezzanine funds, designated groups within traditional banks and insurance companies.

Finally, the most inexpensive and readily available form of financing is seller financing, whereby the selling shareholders accept notes from the company for the stock that they sell to the ESOP. Sellers earn current interest (typically, 3-6%), taxable as ordinary income, and the company utilizes ESOP-related tax benefits to enhance its cash flow and amortize the seller notes more quickly than non-ESOP financing. If part of

the ESOP transaction is financed by a bank or other lender and part is financed with seller notes, the other lenders may, however, subject the seller notes to various covenants and defer the timing of their repayment.

In the current environment, seller-financed transactions have become increasingly popular, as clients desire the tax benefits associated with an ESOP without having to go through the arduous bank due diligence and approval process. Furthermore, market risk makes financial covenants and other limitations typically imposed by the third-party financing sources substantially less appealing. ■

Please contact Stanley E. Bulua, Esq. or Jay Fenster, Esq. with any questions about financing an ESOP transaction.

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