

**Heckerling Institute 2006**

Reports from the event, as posted to the ABA-PTL List Serve

## Report #9

A complete listing of the proceedings and speakers is available on [the Institute's Web site](#)

As we have done in January for the last nine years, and again with the permission of the University of Miami School of Law Center for Continuing Legal Education, we will be posting daily Reports to this list containing highlights of the proceedings of the 40th Annual Philip E. Heckerling Institute on Estate Planning that is being held January 9-13, 2006 at the Fontainebleau Hilton Resort and Towers in Miami Beach, Florida. A complete listing of the proceedings and speakers is available on the Institute's Web site. The URL for that site is <http://www.law.miami.edu/heckerling>.

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This Report contains coverage of some of the Thursday morning Programs on **Section 409A, Family Business Fairy Tales and Life Insurance Due Diligence.**

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Prefer or Defer? 409A May Make You Pay  
Thursday morning Program, 1/12/06  
Presenter: Donald O. Jansen

Reporter: Merry Balson Esq.

The American Jobs Creation Act added a new section 409A to the Code. Effectively January 1, 2005, Sec. 409A is the most significant change in the taxation of nonqualified deferred compensation since the addition of Sec. 83 in 1969. It is important that estate planners and advisors be familiar with 409A because many of our clients may have deferred compensation according to the government.

The pre-2005 deferred compensation doctrines are (1) the constructive receipt doctrine, in which compensation must be deferred before the employee is entitled to receive it without substantial limitations or restriction; and (2) the economic benefit doctrine, codified in Sec. 83, where the employee can avoid income taxation with an unfunded, unsecured promise to pay compensation in the future by the employer, or with a funded plan held in an escrow or a trust fund (i.e., nontransferable) so long as there is a substantial risk of forfeiture. While these two rules continue to apply, Sec. 409A adds new hurdles to ensure deferred compensation treatment.

### Thumbnail Sketch of 409A

Section 409A expands the constructive receipt doctrine by adding 3 new restrictions: restrictions on distributions; no acceleration of benefits; and restrictions on deferral and redeferral elections. Distribution events from the plan are limited to separation from service (or 6 months after separation of service for key employees of public corporations), disability, death, specified time or pursuant to a fixed schedule, change in ownership or control of a corporation, or an unforeseen emergency. For example, if a distribution is permitted when a child enters college, the compensation will be taxed immediately even if the employee has no children because there is a

possibility of an impermissible event. Neither the employer nor the employee can exercise discretion to accelerate benefits.

Note that there is no prohibition on acceleration of vesting, only on acceleration of benefits.

Generally, the initial deferral election must be made in the year before the services are performed, specifying the amount and the payment form. The 2 exceptions to this rule are (1) the employee may join the plan within 30 days after his initial eligibility; and (2) in certain performance based deferred compensation plans (i.e., if the employee meets certain goals they receive compensation) the employee is permitted to elect to join in the first 6 months of the service year. Once the employee has deferred and elects to redefer, the Code requires that (1) the election must be made within 12 months of the deferral (i.e., the effective date of the change), (2) the election cannot be effective until 12 months after making the election, and (3) the election must defer the payment for at least 5 years (except in cases of disability, death, or emergency distributions).

The second major impact of 409A is in the expansion of the funding rules.

Section 409A adds 2 new funding requirements: (1) offshore rabbi trusts are taxed immediately as deferred compensation unless substantially all of the services are performed offshore (note that domestic rabbi trusts are not affected); and (2) if the plan provides for a transfer based on the employer's financial health all deferrals will be taxed even if the trigger has not occurred (e.g., transfer of funds to a rabbi trust if the employer's net worth drops below \$x).

The third significant change under 409A relates to when the deferred compensation is taxed, the application of interest, and additional tax imposed. Deferred compensation is taxed on the later of the date of violation of 409A, or the date of lapse of a substantial risk of forfeiture (if one existed). The employee is now taxed on the interest on deferred compensation from the date of the initial deferral through the date of taxation equal to the underpayment rate plus 1%. Additionally, there is a 20% penalty (additional tax) on deferred compensation included in gross income. Section 409A was effective January 1, 2005, but if amounts were deferred before January 1, 2005, those deferrals and their earnings are grandfathered. Note that only vested beneficiaries' deferred compensation are grandfathered. Additionally, if the grandfathered plan is materially modified after October 3, 2004, then 409A will apply to the grandfathered benefits.

### Changes in Nonqualified Deferred Compensation Rules

Section 409A was effective January 1, 2005, the IRS issued Notice 2005-1 in December 2004 giving preliminary guidance on some items, and issued proposed regulations on September 29, 2005. The proposed regulations failed to address several important issues. A deferred compensation plan is defined very broadly under the statute and proposed regulations as anything that defers compensation from one year to another year. Section 409A applies to both employees and independent contractors. Section 409A applies to any document or arrangement that has the effect of deferring compensation, not only to documents entitled "deferred compensation." Thus, there are many applications with executives involving fringe benefits where 409A might unexpectedly apply. Note that two types of plans are exempt from 409A: defined benefit plans (e.g., 401k, 457 eligible plans, etc.), and welfare plans (e.g., vacation time, sick time, disability leave, etc.).

Section 409A contains rules relating to the aggregation of plans.

Compliance with 409A is determined on a participant-by-participant basis, thus, a violation by one employee of 409A does not affect other participants in the same plan. The proposed regulations apply a partial aggregation rule where a participant is in several deferred compensation plans. Plans

are divided into 4 categories: account plans (e.g., defined contributions); nonaccount plans (e.g., defined benefit plans); separation pay plans; and all others (including equity based plans, SARs, and discounted stock options). All plans in the same category are taxed together, such that a violation of 1 plan in that category will cause a violation in the other plans in the same category.

### Exceptions from Deferred Compensation Under Proposed Regulations

The key exceptions to 409A under the proposed regulations are as follows.

(1) Short-Term Deferrals. Under Prop. Reg. Sec. 1.409A-1(b)(4), if compensation is paid out within 2 1/2 months after the end of the tax year in which the deferred compensation is vested, then the payment is not subject to 409A.

(2) Statutory Stock Options. Incentive stock options under Sec. 422 and employee stock purchase plans under Sec. 423 are not generally subject to 409A.

(3) Non-Statutory Stock Options and Stock Appreciation Rights (SARs).

Certain non-statutory stock options and SARs are excluded if they meet 3 conditions: (i) the exercise or measurement price for SARs cannot be less than the fair market value (FMV) of the stock on the date of the grant of the stock option; (ii) when the stock option or SAR is exercised, compensation cannot be greater than the spread between the FMV of the stock on the date of the grant of the SAR and the FMV on the date the SAR is exercised; (iii) the option cannot have any other feature that might be define compensation (eg, the option to swap stock option spread for a deferred compensation plan will subject the option to 409A). Basically, stock options and SARs are subject to 409A if they are discounted from the FMV price.

(4) Restricted Property. Stock subject to a substantial risk of forfeiture is not subject to 409A. Note that the employee must actually receive the property (i.e., the stock certificates, not restricted stock units) to qualify for this exception.

(5) Separation Pay Arrangements. Severance pay (referred to as severance pay in 409A) has 2 broad exemptions from 409A: (i) collectively bargained plans that cover separation pay; and (ii) non-collectively bargained separation pay arrangements that are paid upon involuntary separation or pursuant to a window program, where the separation pay does not exceed two times the lesser of salary for the prior year or a statutory dollar limit (\$220,000 in 2006), and the funds are received no later than December 31 of the second calendar year following the year of separation.

### Substantial Risk of Forfeiture

Substantial risk of forfeiture applies in two areas: (1) when using the short-term deferral exemption, the 2 1/2 month period does not begin to run until the later of the end of the employer's taxable year, or the time the is vested in the deferred compensation (i.e., the compensation is not subject to the substantial risk of forfeiture); and (2) plans subject to 409A are not taxed until the substantial risk of forfeiture lapses. The Sec. 409A definition of "substantial risk of forfeiture" is different from the Sec. 83 definition. Under Sec. 409A a substantial risk of forfeiture requires either the performance of significant services in the future, or other conditions relating to the purpose of compensation (i.e., performance based conditions). Note that a noncompete clause can be a substantial risk of forfeiture under Sec. 83, but can never be a substantial risk of forfeiture under 409A. Additionally, under 409A you can not extend a substantial risk of forfeiture (i.e., there are no rolling risks of forfeiture).

## Constructive Receipt Rules

The proposed regulations provide that the plan document must state when the payment is to be made (e.g., by x date of the year in which death occurs, or 3 months after the employee is determined disabled). Delays in the payment date are permissible under 4 limited circumstances: (1) when payment is not administratively practical; (2) when the payment jeopardizes solvency; (3) when there is a disputed payment; and (4) when the payment is made in the same calendar year or within 2 1/2 months of the due date.

Plans often use the employee's "separation from service" (aka separation from employment) as a distribution event. An employee is separated from service when he or she dies, retires, or otherwise terminates employment.

Employment is not terminated while the person is on a bona fide leave of absence (including sick leave or military leave) if the leave does not exceed 6 months, unless the leave is mandated by contract with the employer or mandated by law and the employee is entitled to get his or her job back at the end of the leave. The proposed regulations set out 2 anti-abuse rules, providing bright-line tests for termination of employment where the employee intends to ease into retirement, where the employee becomes a consultant, and where the participant is an independent contractor.

The proposed regulations modify the percentages for determining when change of control occurs. This is important where change of control is a distribution event. The proposed regulations do provide that the definition applies to partnerships, but it is unclear whether it applies to LLCs as they are not specifically mentioned.

Mr. Jansen discussed the major exceptions to the anti-acceleration rules, including the narrow exceptions for termination of a plan by the employer.

The regulations define "payment" for purposes of redeferrals (e.g., the first installment of an installment payment is the first payment).

## Transition Rules

Section 409A establishes 7 transition rules, which were all scheduled to terminate December 31, 2005. The regulations extended some of these rules, and 4 continue to be available. The 2 year transition and grace period rule applies if you operate a plan in good faith compliance under the statute, notice, proposed regulations, and under the terms of the plan (to the extent the plan is not contrary to the statute), and if you amend the plan to comply with 409A no later than 12/31/06, with the amendment being retroactive to 1/1/05, then there will be no violation of 409A.

Additionally, the proposed regulations extended the transition rule for amendments to provide new payment elections or conditions to December 31, 2006. However, those amendments cannot accelerate a payment in 2006 that would not have been paid in 2006, and you cannot defer beyond 2006 a payment that would have been due in 2006. Substitution of non-discounted stock options and SARs for discounted stock options and SARs remains available and the regulations describe the methods for accomplishing this.

Finally, in 2005 and 2006 only, the employee can make the same payment elections for nonqualified deferred compensation plans as he does for qualified plans (they are often tied together), but the employee will be required to follow the election requirements under 409A beginning in 2007 and the plan may need to amend its payment rules.

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They Lived Happily Ever After and Other Family Business Fairy Tales:  
Non-Tax Issues That Can Paralyze Succession and Estate Planning Thursday morning Program,  
1/12/06  
Presenter: Mike Cohn

Reporter: Barbara Dalvano Esq.

What might appear like a “fairy tale” is the Pritzker (spelling?) case. What could the estate planning attorney do to avoid the types of conflicts that appeared in this case (disputes over investment policies; trustee duties and related issues)? What checks and balances could the estate planning attorney add to the legal documents to make family business succession occur more smoothly.

Need to look at why clients procrastinate and what motivates clients in the family business succession arena. It is notable that 70% of first generation companies don't survive beyond the second generation. Reason for the failure is that the structure of the succession was not proper. Also, the estate and tax planning documentation is not integrated with the succession planning and the related family issues concerning business succession.

Four main points will be discussed in this general session on family business succession planning, as follows:

- (1) the need for a multi-generation planning process with the family business;
- (2) the benefits of a unifying structure for the family enterprise that will last for very long time;
- (3) the need for governance provisions that can be embedded in the unifying structure that, in part, serves to create checks and balances and exit strategies; and
- (4) the need for the family members to organize themselves in a fashion to continue forward, such as a family council

There are two aspects of succession planning: (A) ownership succession and management succession which are two distinct issues. Estate planning is not the same as business succession planning. Estate planning deals with issues of equalization, cash flow reinvestment vs. distribution, fiduciary obligations and beneficiary rights and similar issues.

Start with ownership succession. The founder generally does not understand how difficult succession of ownership is for the next generation. Governance and collaboration does not happen automatically – it needs to be discussed and built into the estate planning documents. On the management side, if the management succession is not handled properly, conflicts arise about decision-making, usage of excess cash, growth of the business, etc.

Procrastination in engaging in succession planning is high. Why is there procrastination? Founder does not want to give up control and resists letting go; founder has insecurity about retirement and finances; confusion over choices and the succession is personalized rather than considered as a business matter, among other similar reasons. The only way to change the procrastination treadmill

is to change the process or paradigm by which the succession planning takes place. What does this mean? It requires a review of the four principles listed above.

First, in multi-generational succession planning, the client needs to be identified. There needs to be a clear picture of the representation. This involves considering the needs of the next generation – for example, how can they exit or cash out of the business? The next generation may have its own novel solutions that the founder has not considered – for example, “put” rights for inactive children and “call” rights that the active children could use to buy out the inactive. These can be fallback or safety valve arrangements if the children cannot otherwise get along.

Second, what can be the unifying structure? Here, can focus on ownership responsibilities and separate the day to day operational responsibilities. Also, may need different entities for different operations – looking for a bucket to be used to hold all the family assets so members can understand the interrelated parts. Also, need an effective tax structure to get the family assets into the unifying structure. The unifying structure should encourage engagement by all family members and this is where the attorney can play a large role – to address the challenge of getting next generation to participate. Also, the documentation can address how the unifying entity actually works. The unifying structure should not be disruptive to current operations and should not necessarily change the current control. Finally, the structure should provide for exit strategies.

What type of unifying structure could be considered? Perhaps a family owned trust company but for most clients this is too complex. An LLC might work and there are advantages to that form of structure. Mr. Cohn’s preference is an irrevocable trust that can hold non-voting assets (non-voting stock; LLC interests, etc.) which bifurcates the control from value. In creating the unifying structure, the non-voting assets could even be given the right to vote on some major decisions such as sale of the business or the underlying assets. Also, another benefit of using a trust is that it can be converted to a grantor trust in the future if it makes sense to do so. Another aspect of a trust is that sub-trusts can be funded under the pot trust umbrella to operate separate segments of the business. The sub-trusts can be created and funded immediately and can provide autonomy to family beneficiaries. Also, sub-trusts can separate legacy assets (family values) from financial assets (excess cash flows). Non-voting shares are ideal for the trust. Often with aging parents, the non-voting ownership can be very attractive. The parents/founders can move substantial value into the entity and can retain voting rights with opportunity to gift the voting interests later.

What are the advantages of this type of unifying entity? Beneficiaries can exercise autonomy immediately and yet founder can retain the vote and see if the next generation can work together. This may be key feature of what founder may be looking for.

Ex. Founder was the settlor of the trust and sold the non-voting interest in multiple entities that he owned for installment note. The three kids who were active in the operations were charged with mission to generate cash flows. They got 20% of the business. Those who ran the company had to generate enough pre-tax earnings to pay the amounts due on the promissory note to founder and if they meet this goal, it affected the kid’s compensation. If the trust had excess cash, the family members sitting on the investment committee of the trust were then able to decide whether there should be reinvestment of assets in other enterprises, distributed to beneficiaries, etc.

The third point is developing an effective governance system which could be defined as the right people coming together to do the right thing at the right time. It should involve a system of accountability and preserve and grow family capital consistent with family values and purposes. If

the family practices the governance model it develops, smart decisions can occur within the unifying structure that is formed. Unifying structures change trustee's traditional roles. Trustees and beneficiaries may communicate better with a governance and unifying structure. For example, one of the trustee expectations might be to mentor the next generation – is the trustee equipped to carry out this activity? The use of committees like investment committees (which may include family beneficiaries and outsiders) to create investment policy statements and similar decision-making responsibilities are very valuable. A legacy committee that creates family identity and institutionalizes family values and a distribution committee to interpret and make decisions regarding distribution of earnings are also valuable parts of a governance model.

The fourth point is organizing the family in a family council which is a type of organization for the family to begin to focusing on its own rules and policies for succession. The family council needs to be integrated in the documents the lawyer prepares. For example, a family council can create “white papers” as guidelines to the trustee – a “white paper” identifies goals and objectives for the growth and management of the assets of the trust. The council is a recommendation body, but it may also provide the family's expectations for the operating businesses, including valuation goals, risk levels, performance levels, etc. The council could also be used as a way to elect board members for the enterprises. The council can organize the family voice. The council does not replace the buy-sell agreements among the owners or the exit strategies, but it can address family employment policies; pre-nuptial agreements and establishing other policies for the next generation to join the family business. Another aspect of the council is that it can address conflicts of interest policies or statements regarding outside business activities of the owners.

In summary, succession planning is a fragile process and can get stuck in a variety of ways. Succession planning is really about defining a change in the system of the founder and his or her relationship to the business. Founders know succession planning needs to be done, but how actively the client listens to the advice that is provided depends on the process that the planner uses to get the succession planning underway. Mr. Cohn believes that following the four steps described in this outline will likely motivate the founder to make the necessary changes. The business succession case presents lots of opportunities for integrating the legal work with the business succession planning.

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Life Insurance Due Diligence or Everything You've Always Wanted to Know About Life Insurance but Were Afraid to Ask Thursday morning Program, 1/12/06  
Presenter: Jon J. Gallo

Reporter: Paul Hood Esq.

Gallo started with example of client who walks in with replacement policy proposals for an ILIT with a ten year old policy, and asks for help. He intimated that the stakes for getting the right policy from the right carrier are high, citing life insurance carrier failures since 1991.

Gallo advised all to not solely rely upon carrier ratings. Lots of rate inflation in recent years. Make sure that you have the right carrier evaluation-lots of name confusion.

Gallo referenced the Insurance Forum publication, which recommends selecting a carrier in the top two tiers by two ratings companies. Exclude any carrier ranked in the fourth tier or below by any

ratings service. Pick a carrier licensed in the state of New York.

Using a clever William Shakespeare analogy to turn to consideration of life policies, Gallo stated that life insurance by any other name is still life insurance. He went on to state that policies all boil down to (a) how is the premium funded and (2) the extent to which the carrier retains the risk or shifts the risk to the policy owner.

Variables in policy pricing: risk factors-mortality/claims experience, persistency/lapse, estimated expenses and investment experience—all combined in policy illustration. What are the hypothetical assumptions? An as-sold illustration is a “best case scenario” snapshot. Worst case illustration. Ask for illustrations in 100 basis point breakpoints from the as-sold scenario down to the minimum or guaranteed crediting rate scenario.

Ask what are underlying mortality assumptions. Industry standards. Ask that the illustration use “industry standards” mortality. Games also can be played with lapse supported illustrations. Ask whether the carrier planning to maintain interest crediting rate for the foreseeable future. Get Insurance Questionnaire (set forth in Life Insurance Due Care (2nd Edition-ABA Publishing) filled out by the carrier.

Cost of insurance goes up annually-no matter what projections say.

Went through history of interest rates and how that affected life insurance companies-disintermediation of carrier reserves.

He concluded with a brief discussion of the types of life insurance.

Whole life-available in the 1980's. Carrier absorbs all risk.

Universal life-new money based upon portfolio method of accounting. Accumulation Accounts. Flexible policy. As long as enough funds in the AA, the policy remains viable. Look at annual in-force ledger statement. Gallo has no problem with UL.

Variable insurance. Cash account invested in stock market as per choices in mutual funds. Not for the faint of heart. Like investing in stock options that mature when the client dies. Unlike other forms of insurance, the fund is owned by the policy-unaffected by carrier insolvency. Downside: investment risk.

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News From The Exhibit Hall

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TEdec Systems Inc. [[www.tedec.com](http://www.tedec.com)]

TEdec has just announced the release of Version 6.2 of it's Windows based Fiduciary Accounting System. Their Web site provides additional information, sample reports and a slide show showing how easy TEdec is to use. For the first time, TEdec is building bridges to the Lacerte Form 1041 (1/06) and Form 706 (9/06) programs, a very welcome addition to their product line. The software is designed for ease of use by legal assistants. This is accomplished by such things as one-time entry, standard transaction descriptions, pre-coding of all transactions, and point and shoot menus. For training TEdec provides both a hands-on tutorial and on-side and regional training

sessions. A single use version costs \$545. Network versions are also available ranging from \$795 (2 to 5) up to \$1,145 (10 or more). The President and CEO of TEdec, Teddar Brooks, has been in this business almost since the inception of software for preparing fiduciary accountings and the fact that he has stayed the course all this time is a testament to the quality and longevity of the product his Company provides.

WealthCounsel LLC - WealthDocs - [[www.wealthcounsel.com](http://www.wealthcounsel.com)]

Highlights from their 2005 year include the introduction of the WealthCounsel asset Transfer System (WDATS), the introduction of the joining of forces with the Business Enterprise Institute, and updated and improvements in their WealthDocs document assembly software. The current version of their software is 6.1, which has included since inception documents for revocable living trusts, ILITs, QPRTs, Intervivos QPRTs, Third-Party Special Needs trusts, Charitable Lead Trusts, Charitable Remainder trusts, Private Foundations (both trust and corporate) and FLPs. During 2005 the software was updated with Retirement Trusts and family Limited Liability Companies. The release of Version 6.2 is anticipated in February of 2006. When that is released, the system will also include business succession planning documents, including Buy-Sell Agreements, Employ Purchase/Bonus Agreements, Section 83(b) elections, deferred compensation agreements, Top Hat IRS Letters and a Stay Bonus Agreement. In addition, it will include modifications to the standalone Retirement Trust to include provisions granting a trust protector the authority to switch a conduit trust to an accumulation trust. Finally two new features will be included that will simplify the assembly of documents, Express Interview and Library File Folders.

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Our on-site local reporters who are present in Miami this year are Gene Zuspann Esq. of Zuspann & Zuspann in Denver, Colorado, Bruce Stone of Goldman, Felcoski & Stone, PA in Coral Gables, Florida (a member of the Institute's Advisory Committee), Herb Braverman of Walter & Haverfield, LLP in Cleveland, Ohio, Jeff Weiler of Benesch, Friedlander, Coplan & Aronoff, LLP in Cleveland, Ohio, Merry Balson of Wade, Ash, Woods, Hill & Farley in Denver, Colorado, Barbara Dalvano of Isaacson & Rosenbaum, PC in Denver, Colorado, Paul Hood of Dickenson, Peatman & Fogarty in Napa, CA, and Joanne Hindel of Fifth Third Bank in Cleveland, Ohio. The editor again this year will be Joseph G. Hodges Jr. Esq, a solo practitioner in Denver, Colorado who is the Chief Moderator of the ABA-PTL List.

#### GENERAL INFORMATION ABOUT INSTITUTE

Inquiries/Registration

Philip E. Heckerling Institute on Estate Planning University of Miami School of Law Center for Continuing Legal Education P.O. Box 248087 Coral Gables, FL 33124-8087

Telephone 305-284-4762 / FAX 305-284-6752

Web site [www.law.miami.edu/heckerling](http://www.law.miami.edu/heckerling)

E-mail [heckerling@law.miami.edu](mailto:heckerling@law.miami.edu)

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