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Headnotes

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- Tax Liens
- Phantom Stock Plans: Incentive Compensation Simplified
- Estate Planning Issues

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Do You Need to Worry About Estate Planning in These Tough Economic Times?

Paul Chmielewski, Esq., LL.M.

Many people have been affected by the current economic downturn. Understandably, this has caused people to focus on cutting expenses and saving more money. However, one area that is often overlooked at times like these is estate planning. This is usually a mistake. Here are some important reasons to make estate planning a priority:

Have Your Circumstances Changed? The recent death of Michael Jackson has been well-publicized. There appears to be a lot of uncertainty and speculation regarding certain issues related to his estate. Nevertheless, Michael Jackson's Will accomplished many important things. First, it created trusts to provide for his children. As a result, the courts will not be able to interfere with the financial affairs of the trust. Trusts for children are generally drafted to maintain protection from creditors of the children for as long as the assets remain in trust. Second, Michael Jackson's Will also appointed his mother as guardian of his children. Although Michael Jackson's former wife may decide to challenge this appointment, Michael Jackson's expression of intent in his Will provides important evidence of who he wanted to raise his children. The lesson to be learned is that without proper guidance from a decedent, many issues will be decided by state law or left to the discretion of the courts. It is very important to make sure your estate planning documents are up to date so your estate is administered in accordance with your current goals. Otherwise, your affairs will be administered based solely on the goals and desires of the government or the courts.

Estate Tax Laws Are Changing. It is expected that the current $3,500,000 estate tax exemption will remain in effect for persons with estates under $10,000,000. Furthermore, a Congressional proposal is under review to reduce the estate tax exclusion for estates worth over $10,000,000. Without proper planning, your heirs might end up paying 45% (or more) of your estate to the IRS at your death.

Limitations On Discounts. Many people gift assets to their children while they are alive. This results in the gifted asset plus all future appreciation being excluded from a person's estate. Many high net worth clients gift to family limited partnerships (FLPs) to obtain discounts on assets transferred to children. For example, if you gift $1,000,000 in FLP interests, the interests might only be valued at $750,000 for gift tax purposes (under current law) because the donee lacks control of the FLP and the FLP lacks marketability. A Congressional proposal would eliminate the use of discounts for transfers of FLP interests to family members.

Limitations on GRATs. Grantor Retained Annuity Trusts ("GRATs") are another commonly used estate planning tool. With a GRAT, a person contributes assets to an irrevocable trust for the benefit of their children. In return, the trust pays the donor a guaranteed income stream for a term of years based on the value of the contributed asset plus interest. Essentially, the trust beneficiaries receive the appreciation that occurs in

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Phantom Stock Plans: Incentive Compensation Simplified

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The tax treatment of incentive compensation plans is one of those areas of the tax code that is fraught with complications and pitfalls. A Phantom Stock Plan is one way to provide incentive compensation to key employees on a simplified basis that avoids many of the common tax and legal implications of other forms of incentive compensation (e.g., deferred compensation, non-qualified stock options, qualified stock options, incentive stock options and ESOPs).

As the name implies, a Phantom Stock Plan pays an employee incentive compensation ***as if*** the employee actually owned a part of the company (stock in a corporation or membership interests in a limited liability company). In reality, phantom stock is a contractual arrangement rather than actual ownership. Since it is part of the employment contract, it does not involve issuing stock certificates or membership interests, there are no management or voting rights associated with it and no need for a buy-back or separate shareholders agreement. Since it is compensation, the company gets a deduction.

The company and employee do not have to worry about the receipt of property for services and all of the tax ramifications of Section 83, including valuations of the company that have to stand up to IRS scrutiny. Since it is all contractual, the parties can determine the percentages of participation, the vesting schedule and valuations. Accounting for the phantom stock is much easier and the parties do not end up paying the IRS for just "circling cash" out to the employee and back to the company.

Phantom Stock Plans can vary in their terms, but usually have two components:

(1) A share of annual net income (Profit Share); and,
(2) A stock appreciation right (SAR).

"Phantom stock is a contractual arrangement rather than actual ownership."

The components are usually based upon some type of vesting table that provides incentives for the employee to remain with the company. Sometimes each of the two components are based on the same percentages, but sometimes they are not. For example, the Profit Share may become vested right away, yet the SAR (which is where the most value can be earned) may not become vested for several years or until certain events occur (such as increasing sales by 30%). If an employee participated in a Phantom Stock Plan at a 5% level and was fully vested, the general concept is that he will receive bonus compensation payments for his Profit Share and SAR as if he actually owned 5% of the company.

The Profit Share is usually a stated percentage of the company's net income for the year, and is typically paid shortly after the end of the company's fiscal year. Since it is bonus compensation, the amount is deductible by the company and ordinary income to the employee.

The SAR is typically calculated based on some type of valuation of the company, and is paid when certain events occur. Those events typically include a sale of all or substantially all of the assets or ownership of the company to a third party, death, disability and involuntary terminations. The valuations are sometimes dependent upon the event that occurs. For example, if the triggering event is a sale of all or substantially all of the assets of the company, the SAR valuation is usually the net sales price of the assets to the company. However, if the triggering event is a death, it may be necessary to do an appraisal of the company or perform some type of pre-agreed formula valuation (e.g., two times the average net income of the company for the three fiscal years prior to death). Upon the occurrence of a triggering event,

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Are Tax Liens Really a Ticket to Easy Money?

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Television seems to be filled with "experts" claiming they can show you how to make a fortune buying real estate for a few hundred dollars. Generally, these claims are premised upon the concept of buying tax liens on properties with an implied understanding that you will then be able to obtain ownership of the property and sell it for a lot of money. Unfortunately, as is often the case, these claims are suspect.

"At a tax lien sale, investors are generally required to pay a 'premium'."

Tax liens are imposed by local governments when a property owner fails to pay its real estate taxes when due. At a tax lien sale, investors are generally required to pay a "premium" (5% or more) over the outstanding lien amount. However, interest on the tax lien accrues only on the outstanding lien amount. This means that even if the tax lien is paid off, the investor remains at risk for the premium paid to obtain the tax lien.

A successful tax sale bidder will be awarded a "Certificate of Purchase" ("CP"). A CP merely provides the investor with the right to collect the outstanding tax lien amount with accrued interest if the tax lien is ultimately satisfied. Interest on tax liens generally accrues at nine points over the applicable federal discount rate. It is not uncommon for a property owner to pay off the tax lien soon after the tax lien auction. In such cases, an investor can lose money because the accrued interest will not exceed the premium that was paid for the tax lien.

A property owner has three years to satisfy an outstanding tax lien. If foreclosure proceedings are initiated by a lender or another third party lien holder, they will usually pay off the tax liens to obtain clear title to the property. Regardless, there is no guarantee that a tax lien holder will ever obtain ownership of the property. This is especially true in situations where there is equity in excess of the outstanding liens on the property.

It should be evident that the purchase of a tax lien has risks like any other type of investment. In fact, many tax liens result in losses to investors. Although there are potential financial benefits for an investor in tax lien sales, don't believe the hype that they are a foolproof method of obtaining instant wealth.

Phantom Stock Plans: Incentive Compensation Simplified, Cont.

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the employee is paid a bonus equal to the SAR percentage times the applicable valuation for that type of event, just as if they had owned an interest in the company.

The only major disadvantage of a Phantom Stock Plan to the employee is that the SAR payment is ordinary income, where under some types of qualified incentive plans, payments for the sale of the ownership interests may qualify for long term capital gain treatment. However, the company can make up for the extra tax by increasing the amount of the bonus. Remember, the company gets a deduction.

In summary, Phantom Stock Plans are a relatively simple way of providing valued employees with a participation in the earnings and appreciation of a company. They are very flexible and avoid many of the complexities typically associated with other types of incentive compensation and employee stock ownership plans.

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Our goal is to provide cost-effective legal assistance to help our clients achieve their personal and financial goals.

Do You Need to Worry About Estate Planning…., Cont.

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the assets gifted to the trust. Under current law, the use of a GRAT can be fashioned in a manner that results in no gift tax consequences. As a result, if the appreciation in the assets owned by the trust do not exceed the payments to the donor, the only downside to the donor is the cost of creating and administering the GRAT. Many planners use rolling short-term GRATs (eg., two years) because they allow the GRAT beneficiaries to lock in short-term appreciation. Longer term GRATs tend to average out gains and losses over time and are less successful at transferring appreciation to GRAT beneficiaries. Recently, Congress has discussed legislation requiring that GRATs be in existence for at least 10 or more years. This would make it much harder for GRATs to pass on appreciation to GRAT beneficiaries. The elimination of GRATs that do not incur any gift tax consequences has also been discussed. If this occurs, every gift to a GRAT will have a gift tax consequence even if the GRAT is unable to generate appreciation in excess of the trust payments made to the donor.

Even though we in are in the midst of tough economic times, there is no excuse to avoid implementing basic estate planning strategies, such as powers of attorney and wills. These documents ensure that your assets will be handled by trustworthy persons upon your inability to act or at your death. These documents also eliminate the potential costs, burdens and delays associated with excessive court involvement in your affairs. Finally, these documents can be drafted to protect your assets from your children's creditors after your death. If you have an estate in excess of $3,500,000 you have an additional consideration: (a) risk paying the government 45% or more of your assets in excess of $3,500,000, or (b) implement a plan that will ensure your assets go to your heirs rather than be paid as taxes to the government. Given the investment losses that many people have occurred, this may be the best time to gift assets out of your estate because there is the potential for significant future appreciation. If handled properly, this appreciation will occur outside of your estate.