SUMMER 2005

GReview

NEW TAX RULES FOR DEFERRED COMPENSATION

By David Arnburg, Partner

The American Jobs Creation Act of 2004 imposes new strict requirements on nonqualified deferred compensation arrangements. New Section 409A of the Internal Revenue Code governs elections to defer compensation, payment of deferred compensation, and methods of funding deferred compensation. Section 409A also requires that its rules be reflected in written plan documents. Failure to comply with these new requirements in the plan documents or in operation of the plan will result in immediate taxation of deferred compensation not subject to substantial risk of forfeiture at normal income tax rates plus a penalty of 20% of the deferred amounts. In addition, interest at the underpayment rate plus 1% will be assessed from the date the deferred compensation was first earned and vested.

What Compensation is Subject to the New Rules?

The new rules apply to arrangement, contract, method or agreement providing for deferral of compensation other than (i) qualified retirement plans, IRAs, SEPs, Section 457(b) plans, and tax deferred annuities and (ii) welfare benefit plans providing bona fide vacation leave, sick leave, compensatory time, disability leave, and death benefits. With certain exceptions, compensation is deferred if the service provider (e.g. employee) has a legally binding right during a taxable year to compensation that has not been actually or constructively received and such compensation is payable in a later year.

What Types of Plans Are Covered by the New Rules?

The new rules cover plans for one employee (including employment agreements), for multiple employees and for independent contractors (such as consultants and directors). Bonus plans, management incentive plans, supplemental employee retirement plans (SERP), certain stock appreciation rights plans (SAR), phantom stock plans, restricted stock unit plans, economic value added plans, and certain severance pay plans are examples of plans subject to the new rules.

What Requirements Govern Deferral Elections?

Generally, elections to defer compensation must be made before the calendar year in which the compensation is earned. However, performance based plans may permit elections to be made up to the last 6 months of the performance period and new participants may make an election within 30 days after commencing participation. Further, a participant may elect to change the time or form of payment only if (i) the change extends the deferral of the first payment by at least 5 years unless the change is elected in connection with death,

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A Newsletter from the Law Firm

GOULD & RATNER

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Comments, questions, and requests for additional copies of this newsletter can be directed to:

Laura W. Thompson
Gould & Ratner
222 North LaSalle Street
Eighth Floor
Chicago, Illinois 60601
(312) 236-3003 or
lthompson@gouldratner.com

ATTORNEYS IN THE SPOTLIGHT

- **Gerald Ratner** received the University of Chicago Medal for Distinguished Service of the Highest Order on May 6, 2005. The ceremony was held in Rockefeller Chapel at the University of Chicago.

- **John Mays** recently acted as a panel member in a three part forum titled **"Shaping our Regional Future – A Forum for the Homebuilding Industry of Chicago"** held at Roosevelt University and co-sponsored by the Institute of Real Estate, Roosevelt University, the Urban Land Institute, the Attainable Housing Alliance, and the Homebuilders Association of Greater Chicago. The series, which included presentations by government officials and staff, gave influential homebuilders an opportunity to discuss the future of the Chicago Region. John and the two other members of the panel responded to the presentations by the public agencies and then posed questions for general discussion. John is a partner in Gould & Ratner's Real Estate Group.

- **Fred Tannenbaum**, a partner in Gould & Ratner's Corporate/ Commercial Group, spoke before a nationwide web cast on governance issues involving family owned businesses. The presentation was a webcast seminar broadcast to participants throughout the country. It was estimated that 1000 participated and received continuing legal education credit.

- **Steve Gustafson** and **Mark Leipold** presented a teleseminar to approximately 115 attorneys across the country titled: "The Financially Distressed Limited Liability Company: Substantive Legal and Tax Aspects." The seminar was sponsored by WebCredenza, Inc. Steve is Chairman of Gould & Ratner's Tax and Financial Group and Mark is a partner in the Creditors' Rights and Bankruptcy Group.

- **Mark Leipold** recently completed teaching a course on Secured Transactions at DePaul University College of Law. Secured Transactions is the study of the law involving the granting of a security interest in personal property (i.e. not real estate) as collateral for the payment of some obligation. Security interests are critical to making many deals work.

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TAX EXEMPT PRIVATE FOUNDATIONS – DISTRIBUTIONS CAN AFFECT EXCISE TAX OBLIGATIONS

By Phyllis Coffin, Certified Public Accountant

Private foundations that are otherwise exempt from federal income taxation are nonetheless subject to certain excise taxes. For example, private foundations that are not "operating foundations" are subject to an excise tax if they fail to distribute a minimum amount of the organization's assets every year, and are subject to an excise tax on annual net investment income. These rules are designed to encourage private foundations to fulfill their charitable purposes. The following is a brief overview of the current distribution requirements and excise taxes affecting tax exempt private foundations.

Required Distributions

Private foundations that are not operating foundations are required to make "qualifying distributions" every year in an amount equal to at least 5% of the foundation's average value of "noncharitable use" assets. For most private family foundations this means 5% of the average fair market value of all cash, securities and other real or personal property held by the foundation during the taxable year. Generally, cash and securities are valued on a monthly basis and other assets can be valued using any reasonable basis that is consistently applied.

Qualifying distributions include amounts expended directly for charitable purposes and grants made to other qualified charitable organizations. "Charitable purposes" include religious, charitable, scientific, literary, or educational purposes. Qualifying distributions also include reasonable and necessary administrative expenses incurred to accomplish the foundation's charitable purposes.

Any qualifying distributions in excess of the required 5% can be carried forward for five years to satisfy the distribution requirements in future years. If the full amount of the required distribution is not made, the undistributed amount is subject to a 15% excise tax, and will continue to be taxed at 15% for each full year it remains undistributed.

Tax on Net Investment Income

In general, private foundations that are not operating foundations are subject to a 2% excise tax on annual "net investment income." Net investment income is investment income minus investment expenses. Investment income includes dividends, interest, royalties and net capital gains. Investment expenses include all ordinary and necessary expenses incurred to produce or collect investment income. Contributions received, and amounts paid as qualifying distributions, do not increase or decrease net investment income. Capital losses in excess of capital gains in any year do not reduce net investment income and cannot be carried forward to reduce future capital gains.

Although amounts paid as qualifying distributions do not reduce net investment income, if qualifying distributions exceed 1% of the net investment income for the year, plus an amount equal to a certain percentage of the value of the private foundation's noncharitable use assets, the excise tax is reduced to 1%. This percentage is based on the qualifying distributions in certain previous years. First year foundations cannot qualify for the reduced tax.

There are many issues involved in determining the value of a foundation's assets, qualifying distributions, and net investment income for these excise taxes as well as other federal excise tax issues affecting tax exempt private foundations. If you would like additional information on this topic or other topics affecting private foundations, please contact Steve Gustafson, Chair of Gould & Ratner's Tax and Financial Group, at 312/899-1647 or by email at sgustafson@gouldratner.com.

ASSIGNMENT FOR THE BENEFIT OF CREDITORS: AN ALTERNATIVE TO BANKRUPTCY

By Mark Leipold, Partner

Some businesses cannot continue to operate and must therefore be sold or liquidated and the proceeds distributed to creditors. An Assignment for the Benefit of Creditors (hereinafter an "Assignment") is a well-established common law tool that is an alternative to bankruptcy that provides a benefit to troubled companies and presents an opportunity for potential buyers.

Assignments are structured to save time and expense in concluding the affairs of an insolvent company. Through an Assignment, the insolvent company's assets can be sold quickly and efficiently, and the liquidation proceeds can be distributed to creditors shortly thereafter. In general, after the secured creditors, tax and wage claims are paid next. Secured creditors frequently find an Assignment useful because the secured creditor is relieved of the legal costs and risks associated with the foreclosure and sale of its collateral. Secured creditors may be willing to allow some portion of the proceeds of its collateral to pay the fees and costs of the Assignee, as well as tax and wage claims.

Similar to a Chapter 7 Case

An Assignment is analogous to a Chapter 7 liquidation proceeding under the Bankruptcy Code. An Assignment is simply a contract whereby the troubled entity ("Assignor") transfers legal and equitable title, as well as custody and control of its property, to a third party ("Assignee") in trust, to apply the proceeds of the liquidation of the assets to the Assignor's creditors in accord with priorities established by law. However, unlike a Chapter 7, an Assignee can elect to keep the business operating while it tries to sell the company as an operating business.

An Assignee is generally an individual. The Assignee is charged with the responsibility of gathering all of the Assignor's assets and selling the Assignor's right, title and interest in those assets. The Assignee has a fiduciary duty to all creditors. The Assignor must turn over and assign all right, title, and interest in its assets to the Assignee together with a complete listing of all creditors, their addresses, and the amount of indebtedness shown on the debtor's books and records. The Assignee is required to give notice of the Assignment to the creditors and invite each creditor to file a claim in the Assignment estate. The notice may provide a "bar" date, by which all claims must be filed. After the bar date, the Assignee will reconcile the claims and object to those deemed to be improper.

Liquidation of Assets

As a general rule, the Assignee will assemble the Assignor's assets and advertise an auction sale. The assets will be liquidated either piecemeal or in bulk, whichever will yield the highest price. Circumstances may arise when a buyer exists for the entire asset pool and the Assignee is convinced that the price the buyer is willing to pay reasonably exceeds that which can be obtained at auction or in a bankruptcy trustee's sale. An Assignee will generally obtain at least one liquidation appraisal and if the sale price being offered exceeds the appraised liquidation value by a reasonable amount, the Assignment and immediate sale of the assets will go forward.

Fees and Costs of an Assignment

In general, the fees and costs associated with an assignment are about the same as a Chapter 7 bankruptcy case. In an Assignment, the Assignor pays the fees and costs of its professionals. These include the fees and costs of an attorney experienced in insolvency matters. The Assignor's attorney is retained to evaluate the financial situation of the business and consider the various options available. If an Assignment is to be the course of action, the attorney will assist the Assignor in selecting an independent Assignee and the preparation of the Assignment documents. The Assignee's fees and costs are paid from the proceeds of the sale of the assets. In general, the Assignee will prepare the Assignment documents.

Right, Title and Interest

The buyer of the assets will receive an Assignee's bill of sale establishing that the buyer has received the Assignee's right, title, and interest in the purchased assets on an "AS IS, WHERE IS" basis without any warranties, representations or covenants. The buyer at an Assignee's sale is best advised to obtain a thorough lien search before consummating such a purchase because the sale is free and clear of only known liens, claims, and encumbrances and to determine that there are sufficient assets to satisfy these claims, or the buyer and the claimant can enter into a settlement. This differs from bankruptcy in that the assets can

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ATTORNEYS IN THE SPOTLIGHT (CONTINUED)

- The Business Valuation Association was informally established in the 1980s by Chicago valuation and appraisal professionals to exchange ideas in the relatively new discipline of business valuation. It formally became a non-profit organization in 1991 whose mission was the education of its members and to promote professionalism in the industry. **John Worthen**, a partner in Gould & Ratner's Tax and Financial Group, was elected Vice President at the Association's May meeting.

- Four Gould & Ratner partners have been named Illinois Super Lawyers for 2005. The Super Lawyers are selected by their peers in a rigorous nomination and polling process conducted by Law & Politics and published in the May 2005 issue of *Chicago* magazine.

  The partners selected are: **Stephen Sandler** (Real Estate), **Fredric Tannenbaum** (Mergers and Acquisitions), **Robert Carson** (Intellectual Property Litigation) and **Edward Trio** (Tax).

  Law & Politics selected the Super Lawyers by sending a ballot to all active lawyers in the state who have been in practice for five years or more. The ballot asks lawyers to nominate the best attorneys they have personally observed in action. The nominees are grouped into practice areas. A blue ribbon panel reviews and scores the nominees. Law & Politics also conducts interviews, independent research and data verification.

- **Paul Carroll**, a partner in Gould & Ratner's Litigation Group, spoke at the National Golf Course Owners Association Solutions Summit in Orlando, Florida, in February. Paul's topic was "Accommodating Golfers with Disabilities." Additionally, Paul authored the chapter, "Land Use Litigation," in *Land Use Law Update in Illinois,* published by the National Business Institute.

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New Tax Rules for Deferred Compensation (continued)

disability or unforeseeable emergency, (ii) for a change in a payment to be made at a specified date, the change is elected at least 12 months prior to the first scheduled payment and (iii) the change will not take effect for at least 12 months after the date the change is made. No change can result in an "acceleration of benefits," a phrase very broadly defined in the relevant guidance.

What are the Restrictions on Distributions?

Distributions of deferred compensation may only be made on death, disability (as defined in Section 409A), a date specified or schedule fixed at the time of deferral (not tied to occurrence of an event), separation of service with all members of the same controlled group, change of control/sale of assets of a corporation only, or unforeseeable emergency (limited to the amount necessary to satisfy the emergency).

What are the Restrictions on Funding?

Employers may still utilize "rabbi trusts" to set aside monies to pay deferred compensation but use of offshore trusts and funding of deferred compensation triggered by a change in the financial health of the employer are prohibited.

Conclusion

The new requirements are effective January 1, 2005 subject to certain grandfather and transition rules. All plans and arrangements, including employment agreements providing deferred compensation, should be reviewed and revised, if necessary, to comply with Code Section 409A. Employers may also want to notify employees, directors and consultants of the new law and potential changes to their deferred compensation arrangements.

Gould & Ratner has dealt with the impact of Code Section 409A in a variety of circumstances. We would be happy to answer any questions you may have about its effect on your situation. *If you have any questions about any issues raised in this article, please contact David Arnburg at darnburg@gouldratner.com, or call 312/899-1600.*

Assignment for the Benefit of Creditors: An Alternative to Bankruptcy (continued)

be purchased through a bankruptcy sale free and clear of all liens, claims and encumbrances notwithstanding the purchase price or the agreement of the claimants. Even if the Assignee is willing to give the buyer a warranty, a representation or covenant, the Assignee liability is generally limited to the proceeds of the sale. If the breach of any of the foregoing is not discovered until after the assets are liquidated and disbursed, the Assignee will not have any funds to pay any damages. In some instances, if the Assignee's conduct amounts to gross negligence or willful misconduct, a court may require the Assignee to pay claims from its own resources.

Assignment for the Benefit of Creditors: Preservation of Value

Goodwill may be a significant asset whose value can be realized only through the sale of the business as a going concern. In fact, many potential buyers are located prior to the Assignment. An Assignee may also operate a business for a short period of time in hopes of locating a buyer for purposes of selling the company as a going concern, and/or conduct an orderly liquidation of the debtor's assets that would maximize the value over a straight public auction. A Chapter 7 Trustee has no incentive to undertake this type of extra work or spend the time and money required seeking court approval to pursue this type of turnkey sale.

Risk Factors

One of the risks inherent in an Assignment is that three unsecured creditors of the Assignor might file an involuntary bankruptcy proceeding. However, many bankruptcy courts will abstain from exercising jurisdiction over the case and will dismiss it if the Assignee can establish that the Assignee's administration of the estate is competent and continued administration by the Assignee will best serve the interests of the creditors.

Mark Leipold is a Partner in Gould & Ratner's Creditors' Rights and Bankruptcy Group. Mark may be contacted at 312/899-1651 or by email at mleipold@gouldratner.com.

Attorneys in the Spotlight (continued)

Lenders and sellers are often more likely to extend credit to borrowers and purchasers when they can be assured of first rights to collateral in the event of default. Everything from such familiar transactions as automobile loans secured by interests in the automobiles to less familiar multimillion dollar business financing secured by interests in inventory and accounts receivables to sophisticated and complicated financing involving the use of intellectual property as collateral, involve the law of secured transactions.

- On April 15, 2005, the DePaul University College of Law and the Commercial Law League of America jointly sponsored a symposium on Articles 2 and 2A of Uniform Commercial Code. **Mark Leipold** served as a moderator of a panel of distinguished academics and practitioners discussing proposed changes to the law which affects sales and leasing.
- **Ronald Mora**, a partner in Gould & Ratner's Corporate/Commercial and Tax and Financial Groups, is a director of The Ramsey Lewis Foundation. The Foundation was created by Ramsey E. Lewis, Jr., a world renowned jazz composer, pianist and media personality. The purpose of the Foundation is to contribute to the intellectual, social and musical capabilities of youth by promoting music and the playing of musical instruments in schools, families and community organizations.
- **Shannon Clark**, an associate in our Litigation Group, has been named to the Board of Renaissance Social Services, Inc. RSSI provides supportive services to disadvantaged families and individuals to enable them to obtain and maintain safe, affordable, and stable housing throughout their lifetimes. RSSI has developed an integrated model of providing social services that works in conjunction with property management and development that will encourage the entry of for-profit as well as non-profit real estate developers into the affordable housing market. To find out more about Renaissance Social Services, Inc., visit their web site at www.rssionline.org.