Careful Consideration Is Needed in Selecting Your IRA Beneficiaries

Andrew R. Gelman

With retirement plans becoming more prevalent and comprising a larger percentage of families’ net worth, beneficiary designation decisions have become more important. Although there are no restrictions on who may be named as the beneficiary of your IRA, the designation that you make may have profound income tax consequences. Whether your IRA is a traditional IRA, rollover IRA or inherited IRA, the original account owner received an income tax deduction when the funds were invested; consequently under federal law, when the proceeds are distributed, the distribution will be considered taxable income to the recipient.

When it comes to beneficiary designations, Congress has made a distinction between an owner's death after his or her Required Beginning Date (RBD), which is April 1 of the year following the year the owner attains age 70-1/2, and death before the RBD.

In the case of someone dying after his or her RBD without naming a beneficiary, the beneficiaries under the account owner’s will (or by state heirship laws if there is no will) would be required to withdraw the funds in the account at least as fast as the account owner had been required to withdraw them if he or she had remained alive. However, if the account owner’s surviving spouse is named as the beneficiary, he or she can roll the funds into his or her own IRA and defer taxation of the benefits. If the beneficiary of the account is someone other than the owner’s spouse (such as a child), the beneficiary can receive benefits over his or her own life expectancy (or the IRA owner’s remaining life expectancy under IRS tables, if longer).

On the other hand, if the account owner dies before his or her RBD and the owner has not named a beneficiary, the entire IRA must be paid out by December 31 of the fifth year following the owner’s year of death. If the owner’s surviving spouse is named as the beneficiary, he or she may elect to withdraw the account over the remaining life expectancy of the account owner (as if he or she had remained alive).

Although there are no restrictions on who may be named as the beneficiary of your IRA, the designation that you make may have profound income tax consequences.

Consider Naming a Designated Beneficiary or Creating a Credit Shelter

In order for the above income tax deferral benefits to apply, the beneficiary must be classified as a Designated Beneficiary (DB) under the Internal Revenue Code. An individual is always considered a DB but an estate or charity is not, which is one of the reasons that you should not name your estate as the beneficiary of your retirement accounts. If you do, and you die before your RBD, your IRA assets must be distributed within five years; if your spouse or another individual had been your beneficiary, he or she could have deferred the taxation of the benefits over a longer period of time.

Although a charity is not a DB you do not have to avoid naming a charity as a beneficiary of all or a portion of your IRA. Because a charity pays no income tax relating to its charitable purposes, using an IRA is an ideal way to pass

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Because a charity pays no income tax relating to its charitable purposes, using an IRA is an ideal way to pass your hard earned money to charity.

your hard earned money to charity. For instance, if you are contemplating making a gift to a public charity, a donor advised fund or a private foundation at your death, why not have that gift come from your IRA which otherwise will be subject to income tax (and possibly estate tax) when the assets are distributed to one or more members of your family?

A trust may also be a DB but only if certain requirements are met by October 31 in the year following the IRA owner’s year of death: (a) the trust must be valid under state law; (b) it needs to be irrevocable at the owner’s death; (c) the beneficiaries must be identifiable; and (d) the custodian must receive a copy of the trust or a list of all the present and contingent beneficiaries.

A common estate planning technique for married couples who have more than $2 million in assets is the creation of a credit shelter trust at the death of the first spouse. For many couples, the only asset available to fund the credit shelter

New Rules for Distribution

Distributions from qualified retirement plans follow many of the same requirements as distributions from IRAs. Under the Pension Protection Act of 2006 (PPA), effective for distributions after 2006, non-spouse beneficiaries have the option to transfer all or part of the deceased employee’s qualified plan account balance to an IRA where the benefits may be paid over the life of the designated beneficiary, instead of having to withdraw the plan proceeds within five years. The purpose of this provision of the PPA was to give non-spouse beneficiaries of qualified retirement plans the same distribution rights as non-spouse beneficiaries of IRAs.

However, in a recent notice, the IRS asserted that if a qualified plan offers only a lump sum form of payout, a non-spouse beneficiary must follow the plan requirements and may not rollover the benefits to an IRA for a payout over the non-spouse’s life expectancy. We expect that the IRS will be asked to re-examine its published notice in light of the contrary intent of the PPA.

In conclusion, there are many opportunities and many pitfalls in designating beneficiaries of an IRA. Unfortunately, these decisions are often not made carefully. Given that IRAs often grow to become a significant part of an individual’s wealth, such designations are a key element in estate and tax planning and deserve careful consideration.

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Planning for an Effective Family Business Succession

J. Alan Jensen

One of the biggest challenges in estate planning is arranging for the successful transfer between family members of ownership and control of a closely-held family business. Such a transfer must address the divergent needs of the business’ founders, successors, non-family management, and family. Indeed, it is such a significant challenge that only 13 percent of family businesses survive to the third generation.

In addition, although 42 percent of family businesses planning to transition leadership in the next five years have not chosen a successor, simply drafting a succession plan is no guarantee of business continuity.

Instead, a successful transition plan identifies and meets the needs of both family members and non-family employees. It fosters objectivity and communication among family members. This article discusses the needs of each of these groups and strategies to achieve a family business succession plan that keeps the business and the family together.*

Preparing the Founder

Managing a family business provides its founder with a sense of purpose and dignity, fulfillment through tangible tasks, as well as personal and financial security. Transition, therefore, is a slow process. On average, founders are fully comfortable with turning over management and control of the businesses eight to 10 years after first considering the idea. A founder is more likely to effectively transition leadership if the founder believes his or her needs will be met after the transition, and is more likely to provide the successor generation with more opportunities to run the business while the founder is still involved in the business.

Founders can take several steps to prepare for an effective transition. First, the founder must be confident that he or she will be financially secure after the transition. Otherwise, the founder's dependence on the business for his or her livelihood will deter him or her from taking steps to transition control. The founder may consider transferring only a portion of the business at his or her retirement to ensure financial security. Second, the founder can communicate to his or her successor the nature and extent of barriers the founder perceives in transitioning control. This enables a successor to become a partner in overcoming these obstacles. Finally, a founder should identify his or her goals after the transition, such as taking on a different role within the company, or committing more time to an interest outside the business.

The successor generation can also increase the founder’s comfort with the transition. First, a successor should seek to have a period of employment outside the company. Founders naturally want to leave a business with a competent successor. Outside employment provides a successor with important experience (preferably within the same industry) and demonstrates to the founder that the successor has the skills to succeed. Second, a successor also must assume responsibility for his or her professional development and financial security. A successor who asks a founder for financial support raises questions about his or her ability to run a financially viable company. Finally, a successor who listens to and shows support for a founder's concerns regarding the transition becomes a partner with the founder, not an adversary. The important question is not when the founder is going to retire, but what the successor can do to make the founder's transition to retirement easier.

Preparing the Successor

In the period prior to the transition, the successor needs autonomy to run the business while living with the consequences of his or her decisions. Less oversight from the founder gives the successor learning experiences similar to those the founder had while starting the new business. Several strategies make it easier for the founder to give the successor this freedom.

First, the founder should consider a period of shared leadership with the successor. This strategy works especially well when the founder and successor have roles with complementary skills, such as sales and operations. Second, the founder can give the successor increasingly challenging assignments in different areas of the business. Third, the founder should ensure the successor has objective feedback through mentors inside and/or outside the company. Finally, the founder should respect the successor’s expertise which is often in areas different than the founder’s expertise.
Preparing the Business
Non-family managers want a clear strategic direction and a self-sustaining business under the successor’s leadership. To facilitate this, founders can select and develop managers with skills that complement the successor’s skills. Founders can also involve non-family management in succession planning by developing an emergency succession plan in the event of the founder’s inability to run the company due to sudden death, or a serious illness or accident. This exercise may raise succession issues the founder had not considered. Finally, the founder should communicate the goals and timelines for the transition to non-family managers.

Preparing the Family
A common succession planning pitfall is a plan focusing only on the ownership and management aspects of the transition. Because family issues ultimately affect business succession, a successful plan includes a family governance structure. A family governance structure facilitates family unity and harmony during and after the transition.

First, a family governance structure helps provide a family with a unified vision and culture so that people with differing views can work together on important business matters. All family members must agree about what it means to own a family business. It involves a passion about the business, a furthering of family values, stewardship (both of family wealth and of non-family employees) and an understanding that ownership does not equate to a right to liquidity. In short, owning a family business is more than a financial undertaking – it is a mission. All family members must agree to this mission for the business to continue to thrive.

Second, a family governance structure facilitates harmony when family members have different roles in the business. Some family members own and manage the business, some have only an equity interest, and others (e.g., spouses) have no ownership interest but are greatly impacted by business decisions. The family governance structure provides a forum to raise and resolve the conflicts that inevitably arise because of these different roles.

A family governance structure often involves a family advisory council which conducts the “business” of the family. It does this through educating the family about the family business, creating and using fair processes, and teaching family members about their different roles in the business as owners, shareholders and non-owners. Such a council can, in larger families, be made up of separate “subcommittees” that address everything from family employment policies and family education to family philanthropy as well as vacations and assemblies. This structure allows outsiders to have a significant family role in the business.

The family advisory council also has as its purpose providing input to management regarding the family’s expectations of the business regarding risk and reward, growth, liquidity and the business values that are important to the family. In turn, the council communicates and educates the family regarding the business’ expectations about family involvement.

In conclusion, succession in a family business is a process – not an event. The successful transition of a family business to the next generation begins not with a written succession plan, but with a conversation between the owners and their children regarding business succession issues. A successful plan requires time because, at its core, business succession involves family members listening and responding to the needs of each other with respect to the succession. All family members must have an appropriate level of participation.

A founder should identify his or her goals after the transition, such as taking on a different role within the company, or committing more time to an interest outside the business.

A successful plan includes a family governance structure which facilitates family unity and harmony during and after the transition.

* These and other issues were presented by Stephen McClure, a principal of the Family Business Consulting Group, Inc., at the second annual Family Business Seminar held in Portland, Oregon, that was hosted by Holland & Knight’s Private Wealth Services Group.

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Section 409A Compliance Review:
Stock Options and Other Equity-Based Compensation Plans

David O’Leary

On April 10, 2007, the Internal Revenue Service issued the long awaited Final Regulations under Section 409A of the Internal Revenue Code. Section 409A, which became effective January 1, 2005, may have a significant impact on stock option plans and other equity-based compensation plans and arrangements. It affects both public and private employers. It applies to agreements with a single employee as well as to plans and arrangements covering multiple employees, and it covers independent contractors as well as employees.

Although Section 409A became effective January 1, 2005, the IRS permitted employers and other plan sponsors to delay the amendment of the plan or arrangement until issuance of the Final Regulations, provided that they administer the plan or arrangement in good faith compliance with the requirements of Section 409A during the interim period. Now that the Final Regulations have been issued, **all affected plans and agreements must be amended to conform to the requirements of Section 409A prior to December 31, 2007**. The IRS has indicated this compliance date will not be extended.

Penalties

Failure to comply with the requirements of 409A may result in substantial penalties for employees and other service providers who are parties to stock option plans and other equity-based deferred compensation plans and arrangements. Employees and other service providers may be liable for (a) income taxes on all amounts deferred in the current and prior years; (b) interest on the tax from the date the amount was first deferred or vested; and (c) additional penalties equal to 20 percent of the deferred amounts included in the employee or service provider’s income.

If, at any time during the taxable year, an equity-based deferred compensation plan fails to meet the requirements of Section 409A, or it is not operated in accordance with those requirements, all amounts deferred for the taxable year, and all preceding taxable years, are includable in gross income of the employee or service provider for such taxable year, to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. Such amounts are also subject to interest and an additional income tax. Interest is computed at the IRS underpayment rate, plus one percentage point. The additional income tax is equal to 20 percent of the compensation required to be included in gross income.

All Equity-Based Compensation Plans and Arrangements Should Be Reviewed Immediately

All stock option plans, stock appreciation rights plans (SARs), phantom stock plans, restricted stock plans and other equity-based plans and arrangements must be carefully reviewed to determine (a) if they are subject to the requirements of Section 409A and (b) if they are, what amendments are necessary. For those plans and arrangements that are subject to Section 409A, there is a transition period until December 31, 2007, which may provide plan sponsors with significant planning opportunities.

STEP ONE: Determine if the equity-based plans and arrangements are exempt from the requirements of 409A.

Amounts deferred under an equity-based plan or arrangement will be subject to Section 409A unless: (a) the plan or arrangement qualifies under one of the statutory exemptions; (b) the amounts are subject to a substantial risk of forfeiture; or (c) the plan or arrangement is grandfathered.

1. Statutory exemptions.

Certain stock option plans and other equity compensation plans and arrangements are specifically exempt from the requirements of Section 409A. These exemptions are the following:

- Statutory stock options (ISOs) and employee stock purchase plans

This includes plans which provide for the grant of an incentive stock option, as described in Section 422 of the Code, and the grant of an option under an employee stock purchase plan described in Section 423 of the Code.
Certain stock option plans and other equity compensation plans and arrangements are specifically exempt from the requirements of Section 409A.

- Certain non-statutory stock options
  A non-statutory stock option is exempt from 409A only if: (i) the exercise price is never less than the fair market value of the underlying stock on the date the option is granted; (ii) the receipt, transfer or exercise of the option is subject to tax under Section 83 of the Code; and (iii) the option does not include any separate feature for the deferral of compensation other than the deferral of the recognition of income of the option.

- Certain stock appreciation rights
  The grant of stock appreciation rights is exempt from 409A only if: (i) the compensation payable under the stock appreciation right does not exceed the difference between the fair market value of the stock on the date of the grant and the fair market value of the stock on the date of exercise; (ii) the stock appreciation right exercise price does not exceed the fair market value of the underlying stock; and (iii) the stock appreciation right does not include any feature for the deferral of compensation other than the deferral of the recognition of income on the exercise of the stock appreciation right.

- Restricted property and stock plans covered by Code Section 83
  Section 409A does not apply to restricted property and stock plans covered by Section 83 if (i) the restricted property is non-transferable and subject to a substantial risk of forfeiture and is, therefore, not currently includable in income under Section 83 by the service provider; or (ii) the restricted property is includable in income under Code Section 83 solely because a valid election was made by the service provider under Section 83(b).
  
  **Note:** To be exempt, stock options and SARs must have an exercise price at least equal to the fair market value of the underlying stock on the grant date. An accurate determination of fair market value of stock is necessary when determining if stock options, stock appreciation rights and other equity-based compensation agreements are exempt from Section 409A. Section 409A has specific rules for determining fair market value. In general, if the stock is readily tradable on an established securities market, the fair market value of the stock may be determined with respect to actual transactions immediately before or after the grant or exercise, so long as the determination is made on a reasonable basis, consistently applied. In addition, an average price during a specified time period within 30 days before or after the grant or exercise can be used if the commitment to grant the stock right based on such valuation method is irrevocable before the beginning of the specified period and the valuation method is consistently applied. In the case of stock that is not readily tradable on an established securities market, the value must be determined by the reasonable application of a reasonable valuation method. The Final Regulations under Section 409A set forth several permissible valuation methods.

2. Benefits are subject to a substantial risk of forfeiture.
   Equity-based compensation is subject to a substantial risk of forfeiture (and therefore not subject to Section 409A) if the service provider's receipt of payment of an amount of compensation is conditioned upon (a) the performance of substantial future services by any person, or (b) the occurrence of a condition related to the purpose of the compensation, and the possibility of forfeiture is substantial. An amount will not be considered subject to a substantial risk of forfeiture beyond the time in which the service provider could have elected to receive the compensation. An amount is not subject to a substantial risk of forfeiture merely because the right to the amount is conditioned, directly or indirectly, upon the refraining from performance of services (i.e., a non-compete agreement).
   
   A substantial risk of forfeiture will be disregarded if it is used to manipulate the timing of the inclusion of income or if it is illusory. It will also be disregarded if the enforcement of the forfeiture is not likely to occur. This is a possible problem if the service provider is a substantial shareholder or exercises control over the service recipient.
   
   Once the substantial risk of forfeiture lapses, the plan or arrangement is no longer exempt from 409A (unless one of the other Section 409A exemptions applies, such as short-term deferrals) and the documents and operations of the plan or arrangement must comply with the requirements of Section 409A.
   
   For example, if a stock option plan provides that a participant will vest in his or her account at the rate of 0 percent
for the first two years of employment and 25 percent per year thereafter, with 100 percent vesting after six years, the plan would be exempt from Section 409A for the first two years. However, in year three, the plan would have to comply with the requirements of Section 409A.

3. Benefits are grandfathered.

Stock options and other equity-based compensation in which the participant has a legally binding right to receive payments and which are fully vested and non-forfeitable on January 1, 2005, and earnings thereon, are “grandfathered” and not subject to Section 409A unless the plan or arrangement is materially modified after October 3, 2004. A plan is materially modified if a benefit or right existing on October 3, 2004, is enhanced or a new benefit or right is added. Amending a plan to conform to the requirements of Section 409A is not considered a material modification. However, amending a plan to add a provision permitted by Section 409A, such as permitting distributions upon a change in control, if the provision wasn’t previously in the plan, is considered a material modification.

For example, if in January 2003, a participant in a stock option plan was granted stock options to acquire 100 shares of the company’s stock at a price of $50 per share, the participant was fully vested in such right on December 31, 2004, and no material modification was made to the options, the value of such options (and any increase in value thereof) would be exempt from Section 409A.

Payments under stock option plans may be paid only upon the occurrence of specified “events.”

1. Determine if the underlying stock qualifies as “service recipient stock.”

Section 409A requires that the underlying stock qualify as “service recipient stock.” Generally, any class of common stock will qualify, even if there are transferability restrictions or buyback rights at fair market value. However, preferred stock and common stock with certain preferences, such as dividend rights, will not qualify. In general, service recipient stock includes stock of the employer and any company in an upward chain that has a controlling interest in the employer. As a result, grants of stock in brother-sister companies and grants of a subsidiary’s stock to employees of a parent company should be reviewed carefully.

2. Determine if the plan or arrangement permits exercise of options or distributions of benefits only upon the occurrence of a permitted “event.”

One of the most significant effects of 409A has to do with the time and form of payments. One of the most common provisions of stock option plans and other deferred compensation plans and agreements was to provide the service provider or the service recipient (sometimes both) with substantial discretion as to when and how the stock options would be exercised. This discretion has been substantially restricted.

Under Section 409A, at the time a stock option is granted or an amount is deferred, the plan documents must specify the amounts to be paid and the time and form of payment. Amounts may be paid or stock options exercised only upon the occurrence of one or more of the following “events,” and the “events” must be properly defined in the plan documents:

- Separation from service
  Generally, an employee is deemed to have separated from service with the service recipient when the employee dies, retires or otherwise has a termination of employment with the service recipient. An independent contractor is deemed to have separated from service with the service recipient upon the expiration of the contract (or, if more than one contract, all contracts) under which services are performed for the service recipient if the expiration constitutes a good-faith and complete termination of the contractual relationship.

- The date an employee becomes disabled
  An employee is considered disabled if the employee: (i) is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or which can be expected
to last for a continuous period of not less than 12 months; or (ii) is, by reason of any medically determinable physical or mental impairment which can be expected to result in death or which can be expected to last for a continuous period of not less than 12 months, receiving income replacement benefits for a period of not less than three months under an accident and health plan covering employees of the service recipient.

- A specified time or pursuant to a fixed schedule
described in the plan

To qualify, the amounts must be paid or the options exercised at a specific time or pursuant to a fixed schedule that is objectively determinable at the time the amount is deferred or the stock option is granted. Any subsequent change in the fixed time or schedule will constitute a change in the time and form of payment, subject to the subsequent deferral election requirements.

- The death of the employee
The death of the employee is a distributable event.

- A change in control
The Regulations under Section 409A define what constitutes a change in ownership, a change in the effective control or a change in the ownership of the assets of a service recipient.

- The occurrence of an unforeseeable emergency
An “unforeseeable emergency” is a severe financial hardship to the employee resulting from an illness or accident of the employee or his immediate family. An “unforeseeable emergency” also includes loss of property due to casualties or similar extraordinary and unforeseeable circumstances arising as the result of events beyond the control of the employee. Amounts payable for an unforeseeable emergency must not exceed the amount necessary to satisfy such emergency, plus applicable taxes on such payment.

3. If the plan or arrangement involves a public company, make sure the plan provides that payments to “specified employees” will be delayed for six months.

A plan subject to 409A must prohibit payments on account of separation from service to a “specified employee” of a public company prior to a date that is six months after the date of such employee’s separation from service (or, if earlier, the date of death of the specified employee). A specified employee is generally defined to mean a key employee (as that term is defined under Section 416(i) of the Code) of a publicly-traded corporation. Section 416(i) of the Code provides that a key employee generally includes up to 50 officers of the employer having annual compensation greater than $130,000 (indexed, $145,000 for 2007), 5 percent owners and 1 percent owners having annual compensation greater than $150,000.

A plan subject to 409A must prohibit payments on account of separation from service to a “specified employee” of a public company prior to a date that is six months after the date of such employee’s separation from service.

4. Determine if plan or arrangement permits an acceleration of the payment of benefits or the exercise of stock options.

Section 409A generally provides that no acceleration of the time or schedule of any payment or exercise of any option may be allowed, except (a) payments pursuant to a domestic relations order, as defined in Code Section 414(p)(1)(b); (b) payments pursuant to a certificate of divestiture, as defined in Code Section 1043(b)(2); (c) a de minimis amount if the payment is not greater than $10,000 and represents the payment of a participant’s entire benefit; (d) payments of FICA taxes on vested balances (e) payments made to avoid a non-allocation year under Code Section 409(p); and (f) payments linked to qualified plans.

If a plan or arrangement is terminated, acceleration of payments is permitted if: (a) all like plans or arrangements are terminated; (b) no payments are made for 12 months following the termination date; (c) all distributions occur within 24 months following plan termination; and (d) no similar type plan or arrangement is adopted for five years following the date of termination. Different requirements apply when a plan is terminated in connection with a change of control.
5. Review provisions pertaining to a delay in the payment of benefits or exercise of stock options.

Generally, under 409A, delay of payments or exercise of options is not permitted. However, if the payment would violate loan covenants or other contractual terms that would cause material harm to the service provider the payment may be delayed. Also, payments may be delayed in the event of bona fide disputes between the service provider and the service recipient or upon the dissolution or bankruptcy of the service recipient. In some instances, a delay based on the terms of an escrow or similar arrangement is permitted.

Also, if the period during which a stock option or stock appreciation right is exercisable is shortened due to a separation from service or other reason, the term may be extended to the earlier of the original maximum term of the option or 10 years from the original grant date.

6. Review provisions pertaining to a delay in the changes to the timing or form of benefit payments or exercise of stock options.

Generally, an election which changes either the time or form of distribution must meet all of the following requirements:

- the change must not take effect until at least 12 months after the date on which the election to make the change is made
- if the change relates to a distribution payable upon (a) the service provider’s separation from service, (b) a specified time or (c) a change of control, then the first payment with respect to which such election is made must be deferred for a period of at least five years from the date the payment otherwise would have been made
- if the change relates to a distribution which otherwise was to be paid at a specified time or pursuant to a fixed schedule, the election must be made at least 12 months before the date of the first scheduled payment

Summary

The discussion in this article is only a brief overview of the review process necessary to determine whether a stock option plan or other equity-based compensation plan or arrangement must be amended to conform to the provisions of Section 409A. The requirements of Section 409A are very complex and confusing. To receive further information, or to arrange for a more detailed review of your equity-based deferred compensation plans and arrangements, please contact your Holland & Knight attorney.

For more information, e-mail David O’Leary (Chicago, IL) at david.oleary@hklaw.com or call 312-715-5851.

This article was also sent out as an ERISA, Employee Benefits and Exec Compensation alert on June 5, 2007.