DANZIGER & MARKHOFF LLP

Attorneys at Law

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S Corporation ESOPs: Creating a Tax-Free Environment for your Business

An ESOP (employee stock ownership plan) is a qualified retirement plan that invests primarily in employer securities. Typically, the ESOP does so by buying some or all of the common stock of a business from the business owner or owners.

Business owners sometimes establish ESOPs in order to incentivize their employees by allowing the employees to share in the growth of the business. Perhaps more frequently ESOPs are established by business owners as a mechanism to cash out all or a significant portion of their ownership interest without necessarily giving up effective control of their business. ESOPs are also established because of their extraordinary tax benefits which can improve the bottom line of a business.

While it was not always the case, currently, both C corporations and S corporations can establish an ESOP. S corporation status is very popular with closely held business owners because S corporations are generally not subject to federal income tax at the corporate level. Instead, shareholders are subject to tax on the corporation's income, whether or not such income is distributed.

The combined tax attributes of an S corporation and an ESOP are truly remarkable. If an S corporation is wholly owned by an ESOP, the income of the business is not subject to any federal income tax. Because of its S corporation status, all of the corporation's taxable income flows through to the corporation's sole shareholder, namely, the ESOP.

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Estate Planning Updates

Connecticut Estate and Gift Tax Changes

One of the main focuses of estate planning is to minimize federal estate tax since the 35% rate on estates greater than $5,000,000 is significant. In addition, eighteen states assess a separate state estate tax with New York, New Jersey and Connecticut among them. Connecticut was considered the tri-state "tax haven" because it had an estate tax exemption of $3,500,000 compared to $1,000,000 for New York and $675,000 for New Jersey. However, in an effort to

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In this issue:

ACCOUNTABLE CARE ORGANIZATION REGULATIONS: COMMENT PERIOD ENDS AND CHANGES EXPECTED

The comment period for interested parties to express their opinions on the proposed accountable care organization regulations ended on June 6th. The purpose of ACOs, as reflected in the Medicare Shared Savings Program, is to manage the care of a designated population of Medicare beneficiaries in a comprehensive manner, and to allow the ACO participants to share in any cost savings they may generate.

The Centers for Medicare and Medicaid Services (CMS) received numerous comments from, among others, the major hospital and physician trade associations questioning the proposed regulations on the basis that the ACOs are too complicated and expensive to set up and the prospect of achieving any real cost savings is remote. Even many of the cutting edge health care organizations, such as the Mayo Clinic, on which the ACO regulations were modeled have indicated that, as the regulations currently stand, they would not be interested in setting up their own ACOs.

Accordingly, it is expected that there may be significant modifications in the ACO regulations before they are issued in final form by CMS later this year. ■

Please contact Joshua S. Levine, Esq., with any questions about ACOs.

RECONCILING RETIREMENT PLAN ACCOUNTS AVOIDS POTENTIAL HEADACHES

Successful retirement plan administration requires annual reconciliation of the plan's *cash flow* and *asset holdings*. A plan trustee who fails to have this review performed exposes the plan -- and himself or herself -- to potential problems.

"Reconciliation" is nothing more than a sophisticated approach to "balancing the plan's checkbook". All cash transactions during the year should be tracked. The goal is to confirm that the plan's year-end cash balance is in fact the sum total of all transactions during the year.

This process requires reviewing all contributions to and distributions from the plan, purchases and sales of assets, interest and dividends received, and all other receipts or disbursements of funds by or from the plan. If any errors were made, the trustee can implement corrective action.

Tax Penalties

An example will clarify the issue. Assume that there is a one-person defined contribution plan and that the maximum annual permissible contribution for 2011 is $49,000. At the beginning of the year, Client deposits the maximum permitted contribution into the plan's account. In December of that year, Client forgets that the plan contribution was already deposited, and writes a second check for a $49,000 contribution into the plan.

In the absence of a "cash-to-cash" reconciliation, the second contribution of $49,000 would remain in the plan. In the event of an IRS audit, the IRS agent would discover the over-contribution (the IRS *does* believe in "cash-to-cash" reconciliations) and could assess penalty excise taxes.

Plan Disqualification

In other situations the absence of a plan reconciliation could result in something far worse -- potential plan disqualification. For example, Participant retires with a benefit entitlement of

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ESTATE PLANNING UPDATES

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raise revenue, Connecticut did the unthinkable on May 4, 2011 and *lowered* its estate *and* gift tax exemption to $2,000,000 effective January 2, 2011.

What does this mean for you? Unless you become a resident of Florida, which has no estate tax, it is very likely that most estates in New York, New Jersey and Connecticut will be subject to some form of *state* estate tax. However, with proper planning involving the use of an Irrevocable Trust (to avoid estate tax on life insurance proceeds) and "credit shelter" Wills (which can be used to shelter non-life insurance assets from estate tax), state estate tax can be minimized.

Creditors and Asset Protection

In our litigious society, the greatest fear of most professionals (such as doctors, dentists, attorneys, accountants, engineers and architects), as well as real estate investors and business owners, is that their life savings can disappear overnight. The key to protecting assets is timing. Any planning implemented *after* a lawsuit will be considered a fraudulent conveyance and will be voided. Instead, the key is to take steps *before* an incident occurs.

Estate planning and asset protection go hand in hand and a number of the techniques which are used to avoid estate tax also help reduce exposure to creditors. Irrevocable Trusts, credit shelter Wills, limited liability companies and transfers to spouses who are in professions which are less likely to be sued all help discourage lawsuits. Qualified retirement plans, such as profit-sharing, defined benefit and 401(k) plans, offer the best protection from creditors since they are exempt under federal law. IRAs are governed by state law, but New York, New Jersey and Connecticut all have strong shield laws. Conversely, South Carolina, for example, does not offer any protection for IRAs, so please be sure to contact us before you retire if you are concerned about your exposure to creditors. ■

If you have any questions about estate planning, please call Michael Markhoff, Esq.

RECONCILING RETIREMENT PLAN ACCOUNTS

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$1,000,000 of which $50,000 represents the Minimum Required Distribution ("MRD"). The Plan Administrator instructs the fund custodian to issue two checks, one for the MRD and one for the balance of the benefit payment. Instead of subtracting the MRD from the second check, the custodian issues two checks, one for $50,000 and the second for the full $1,000,000.

Absent a year-end reconciliation, the extra $50,000 payment might not be uncovered. In an eventual IRS audit, the distribution of amounts to which the participant was not entitled could lead to an IRS assertion of plan disqualification.

Our administrative servicing clients can rest assured that our procedures include an annual reconciliation of plan assets. Plan sponsors whose plan administration is handled through other entities should confirm that this *important step* in their plan administration is not being overlooked, since the consequences of failing to perform an annual reconciliation can be severe. ■

Please contact Ira Langer, Esq., William Miller, Senior Actuary, or Aileen Palazzo, Director of Plan Administration, for further information.

S Corporation ESOPs

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The ESOP does not pay any tax because it is a tax-exempt entity. Accordingly, none of the corporation's earnings are spent on paying federal taxes.

If an S corporation is only partially owned by an ESOP (for example, the business owner sells a 40% interest to the ESOP and holds on to the other 60%), partial tax savings will still apply, but the cash flow analysis is different.

Because it is typically difficult to get bank financing for a purchase of 100% percent of a business, particularly in the current economic environment, sellers who are interested in establishing a wholly owned S corporation ESOP normally take back a note for some of the purchase price. In order to allow the selling shareholder to continue to participate in the future growth of the company, sellers often receive warrants in the transaction and continue to participate in incentive compensation programs that pay benefits based on the company's economic performance.

While ESOPs can be established by both C corporations and S corporations and are attractive in both, important differences remain. For example, an individual shareholder of a C corporation may sell his shares to an ESOP on a tax-deferred basis, provided certain requirements are satisfied. This tax break does *not* apply to a sale to an ESOP maintained by an S corporation.

Also, C corporations sponsoring ESOPs may deduct without limitation plan contributions that are used by the ESOP to make interest payments on a loan that the ESOP has taken to finance its acquisition of company stock, plus principal payments not in excess of 25% of compensation.

Further, S corporations are subject to Section 409(p) of the Internal Revenue Code. That section generally limits a selling shareholder's ability to become a participant in the ESOP.

Danziger & Markhoff LLP is experienced in establishing and servicing ESOPs for both C corporations and S corporations. If you are considering establishing an ESOP, we can assist you in weighing the benefits of making, or maintaining, the S election and structuring the transaction to achieve your tax and other business objectives. ■

Please contact Jay Fenster, Esq., or Robert B. Danziger, Esq., if you have any questions about ESOPs.

In Our Firm

Ambulatory Surgery Centers: An Alternative to Office-Based Surgery

Ambulatory Surgery Centers ("ASCs") are an attractive alternative to office-based surgery.

Danziger & Markhoff LLP provides comprehensive services to physicians and other professionals in connection with the establishment and operation of ASCs, including negotiation of the highly complex regulatory approval process in New York. We have organized numerous single specialty (*e.g.,* endoscopy) and multispecialty ASCs and have worked extensively with a number of nationally recognized ASC consulting firms.

Please call Joshua S. Levine, Esq., with any questions about ASCs.