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TAX & TRANSACTIONS BULLETIN

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State of Illinois enacts a new Estate Tax on June 20, 2003

- Illinois imposes a freestanding estate tax
- The Illinois tax is in addition to the Federal tax
- Illinois tax rate on large estates can be as high as 16%
- Effective date is January 1, 2003

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ILLINOIS LEGISLATURE ENACTS NEW ESTATE TAX ON JUNE 20, 2003

Effective January 1, 2003, the State of Illinois has imposed a "freestanding" estate tax. This new Illinois estate tax exists separately and in addition to the Federal estate tax.

Previously, the Illinois estate tax worked in harmony with the Federal system. Federal law imposed a maximum estate tax, and a portion of this Federal tax was shared with Illinois. This revenue-sharing system imposed no extra burden on heirs, since the Federal tax was reduced dollar-for-dollar by the amount allocated to Illinois. Under this prior system, the Federal government shared its estate tax revenue equitably with 37 States (including Illinois) and the District of Columbia.

In 2002 Congress began phasing out revenue-sharing with the States, pursuant to the *Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA)*. By phasing out revenue-sharing, the Federal government appropriated a larger share of estate tax revenue at the expense of the States. In turn, many States are increasing their own estate tax.

Illinois' new estate tax still follows the Federal model in many definitional respects. However, Illinois has established its own Exclusion. The Exclusion is the amount an individual can leave to heirs tax-free. An estate with a value below the Exclusion does not pay tax. An estate with a value above the Exclusion is subject to tax. The Federal and Illinois Exclusions, respectively, are as follows:

Year of Death	Federal Exclusion	Illinois Exclusion
2002 and 2003	$1,000,000	$1,000,000
2004 and 2005	$1,500,000	$1,500,000
2006, 2007, and 2008	$2,000,000	$2,000,000
2009	$3,500,000	$2,000,000

Notice that the Federal and Illinois Exclusions are identical through 2008. In 2009, however, the Federal Exclusion increases to $3.5 million, whereas the Illinois Exclusion remains capped at $2 million.

A few observations may be made. First, for single individuals and surviving spouses dying between 2003 – 2008, there is generally no Federal estate tax and no Illinois estate tax on estates valued below the Exclusion. For estates valued above the Exclusion, there will be both a Federal estate tax (at roughly a 50% rate), and a

ILLINOIS LEGISLATURE ENACTS NEW ESTATE TAX LAW ON JUNE 20, 2003 (cont'd)

separate Illinois estate tax (at rates varying from 5.6% on estates in excess of $1 million, up to 16% on estates in excess of $10.1 million). Moreover, the Illinois tax will only partially reduce the amount owed to the Federal government.

Second, for single individuals and surviving spouses dying in 2009, the Illinois and Federal Exclusions differ. Therefore, estates in excess of $2 million will pay Illinois tax, even though no Federal tax is owed unless the estate exceeds $3.5 million.

Third, for married individuals whose estate plan uses a traditional credit-shelter formula, upon the death of the first spouse the Illinois and Federal tax systems should cooperate for 2003 - 2008 (provided the couple's assets are properly titled). However, in 2009 the Executor of the first spouse's estate may be forced to either pay an upfront Illinois tax in order to reduce Federal tax in the future (i.e. allocate $3.5 million to the credit-shelter trust), or avoid current Illinois tax at the cost of greater Federal tax in the future (i.e. allocate $2 million to the credit-shelter trust).

Illinois is not the only State which recently amended its estate tax. Wisconsin capped its Exclusion at $675,000, effective October 1, 2002 through January 1, 2008. Additional States will likely follow suit. Taxpayers should remember that they face potential tax liability in multiple States, especially where real estate or other assets are located or owned outside their home State.

Considering that the new Illinois estate tax became law on June 20, 2003, this Article is merely a preliminary analysis. A more refined analysis will emerge over time as the new Illinois tax is administered. Two facts, however, appear to irrefutably favor Illinois taxpayers over their Wisconsin brethren: (1) the ceiling on the Illinois Exclusion ($2 million) exceeds the Wisconsin ceiling ($675,000) by a wide margin; and (2) the Chicago Bears enjoy a natural superiority over the Green Bay Packers.

AN APPROACH TO NEGOTIATING "NON-NEGOTIABLE" BUSINESS TRANSACTION AGREEMENTS

One tactic used by a party negotiating a legal agreement in connection with a business transaction is to give the agreement to the other party stating, "We do not allow any changes. Just sign the agreement and return it so we can complete the deal." The party receiving the agreement will hand it to their attorney with the instructions, "Please give this agreement a quick scan and give me your approval. The other side will not allow any changes." Such business transactions can take a variety of forms, including a real estate lease, franchise agreement, license agreement, employment agreement, or business acquisition agreement.

The client's instructions are similar to a patient visiting a doctor and requesting a ten-minute medical exam to confirm good health. Furthermore, the patient insists the doctor not prescribe further tests or any medication.

The lawyer, similar to the doctor in our hypothetical, should inquire as to the client's goals and objectives before rushing to follow the client's instructions. As an Advisor, the lawyer should ask a series of questions. What result does the client wish to achieve from the transaction? What level of risk is the client willing to incur? What are the business terms of the transaction from the client's perspective?

AN APPROACH TO NEGOTIATING "NON-NEGOTIABLE" BUSINESS TRANSACTION AGREEMENTS (cont'd)

Nobody should believe everything they are told. Business decisions reflect the best interests of the owner of the business. A party will enter into an agreement only if in its best interests. The lawyer should view the transaction from the vantage point of the party providing the "non-negotiable" agreement. What is the economic environment surrounding the transaction? A landlord will be more likely to offer concessions to a prospective tenant in a weak real estate market. How long has the space been vacant? Are there other vacancies in the building? Have market rents decreased over the last several years?

We do not propose changes to an agreement merely to aggravate the other party. We propose changes to conform the agreement to our client's goals and objectives.

A client's goals and objectives often include:

1. The economic terms of the transaction conform to the agreement of the parties, which have been either memorialized in a written term sheet or letter of intent or agreed upon verbally.
2. The agreement will not subject the client to liability for matters beyond its direct control.
3. The agreement will not result in personal liability to the owners of the business executing the agreement.
4. The client will have adequate legal remedies if the other party breaches its agreement.
5. The client will not incur severe adverse consequences upon minor breaches of the agreement.

The following describes some of the issues we consider in reviewing an agreement to further our client's goals and objectives. Our discussion, not intended to be a comprehensive review of these contract issues, provides several examples of the concepts.

Conform Agreement to Economic Terms of the Transaction

We strongly advise that the client develop a written term sheet or letter of intent with the other party to clearly set forth the basic terms of the proposed transaction. This term sheet or letter of intent may be binding on the parties to proceed with the transaction or non-binding. We look at the term sheet or letter of intent as the blue print of the transaction. It is much easier to change the "blue print" when negotiating the terms of the transaction than to "move a wall" in the agreement. Our job is to verify that the definitive agreement conforms to the terms and conditions specified by the client. Besides verifying that the economics are correctly stated, we verify that all formula and other terms are clearly stated so that they could be understood by a third party reading the agreement for the first time without the benefit of the knowledge and background of the contacting parties.

Limit Liability to Matters within Client's Control

Many agreements contain indemnity and hold harmless provisions, which obligate one party to have economic responsibility to the other party for certain matters related to the transaction. For example, a real estate lease for a retail store could provide that the tenant indemnify and hold harmless the landlord for any claims for damages by tenant's customers occurring both in the tenant's store and in the common area's outside of tenant's store. Since the tenant has no responsibility to maintain the common areas, we suggest that the tenant's indemnity

AN APPROACH TO NEGOTIATING "NON-NEGOTIABLE" BUSINESS TRANSACTION AGREEMENTS (cont'd)

include only claims arising from accidents occurring within tenant's store and not include claims arising from accidents arising outside tenant's premises but still on landlord's property.

Limit Personal Liability

Quite often a party contracting with a closely held business will request that the individual owners of the business personally guaranty the obligations of the business. For example, a landlord leasing space to a closely held corporation may request that the individual shareholders of the corporation personally guaranty the lease. If the shareholders are uncomfortable making such a guaranty, the landlord may be willing to forego the guaranty upon receiving the financial statements of the corporate tenant. If the landlord is not overly impressed with the corporation's financial health, the landlord may be willing to limit the amount, scope and/or duration of the guaranty. For example, with a five-year lease, the guaranty could be limited to two months rent, cover only the obligation to pay rent, and expire in two years if the corporate tenant has fulfilled its rental obligations during such period.

Adequate Legal Remedies

We review the agreement to confirm there are no obstacles to our client's exercise of its legal remedies if the other party is in breach. For example, the agreement as presented by the other party may require that all lawsuits arising under the agreement be filed in that other party's jurisdiction. We will request that although the other party's jurisdiction is one place a lawsuit may be filed, it is not the exclusive place. Furthermore, there should be no restrictions on our client's right to seek all remedies available in both law and equity if the other party breaches the agreement.

Avoid Severe Consequences for Minor Breaches

The agreement should provide that in the event our client is late in making a payment on its due date or otherwise does not fulfill its obligations that the other party notify our client and provide a specified number of days to cure the breach. Such a provision will avoid a termination of the agreement with substantial damages to our client in the event of an unintended breach by our client. Furthermore, we review closely any remedy clause that specifies a definite damage amount payable by our client as a consequence of its breach. Is such damage amount reasonable? Is it applicable in all situations? Is it necessary?

Conclusion

Fulfilling our client's goals and objectives in business transactions requires an analysis of the underlying agreements. Where the other party provides such agreements to our client with a warning that it never accepts any changes to "its" documents, we work with our client to obtain an acceptable agreement. We have found that "never" rarely means "never". Most people who seek advice from their doctors want good physical health for their person. Most people who seek advice from their attorneys want good legal health for their transaction.

DEFERRED COMPENSATION PLANNING FOR EXECUTIVES OF CHARITIES AND NONPROFIT CORPORATIONS

Retirement Planning is an important economic goal for most individuals. Many taxpayers defer salary through Qualified Plans (e.g. pensions and 401(k)/IRA accounts) to provide a stream of income following retirement. However, for executives to maintain their standard of living after retirement, they generally require an annual cash flow equal to two-thirds of their final year's salary. Qualified Plan benefits and Social Security benefits rarely provide this level of support.

Many executives, therefore, establish a Nonqualified Deferred Compensation Plan to make-up the shortfall. Nonqualified Plans provide additional retirement income to employees over and above pension and 401(k)/IRA accounts, thus providing an extra cushion following retirement.

Nonqualified Plans <u>may</u> be established for executives of for-profit businesses. Nonqualified Plans <u>may also</u> be established for executives of tax-exempt organizations, including charities and nonprofit corporations.

In establishing a Nonqualified Plan, a tax-exempt organization can choose between setting up an "Eligible Plan" and an "Ineligible Plan." Both types of Plans are governed by Code Section 457. However, an Eligible Plan is subject to numerous restrictions, most notably a limit on the maximum amount each executive can defer. For 2003, an employee can contribute no more than $12,000 annually to an Eligible Plan.

For many tax-exempt organizations, an Ineligible Plan becomes the plan of choice. Under an Ineligible Plan – also known as a "Section 457(f) Plan" – the executive may contribute far in excess of $12,000 each year. In fact, the deferred amount is often expressed as a percentage (e.g. 25%) of total salary. This deferred amount is contributed to the Plan each year. Since the employer is a tax-exempt charity or nonprofit organization, the employer pays no income tax on Plan earnings. Therefore, <u>the deferred salary grows tax-free, meaning that the executive enjoys a higher rate of return on her investment</u>.

An Ineligible Plan exacts a price for permitting the executive to benefit from tax-free asset growth. This price is that the executive initially must be <u>non-vested</u> in the Plan. Provided she remains employed with the organization, the executive vests in her deferred salary at a specified future date. This "vesting date" must be at least 2 years after the executive first participates in the Plan. During the pre-vesting period, the executive risks forfeiting her deferred salary if she voluntarily resigns or is terminated for cause. The executive will not forfeit her deferred salary during the pre-vesting period if her employment ceases due to death, disability, attainment of retirement age, or involuntary termination other than for cause.

The <u>mechanics</u> of the Ineligible Plan can be designed to protect the employee. Usually the charity or nonprofit corporation establishes a Committee to administer and oversee the Plan. The Committee ensures that the executive's deferred salary becomes a Plan asset. The Plan assets are held in a <u>Rabbi Trust Fund</u>. The Trust Fund then establishes an Account for the executive. The executive may make Investment Choices / Investment Designations for the Account. The Account grows tax-free. Upon vesting, the entire Account is typically distributed to the executive in a single lump-sum cash payment. At that time, the executive pays income tax on her distribution.

There are a number of additional mechanisms which can protect the employee. For instance, the employee can <u>vest serially</u> over a number of years, thus creating an annual stream of cash distributions. The employee can also postpone taxation through <u>rolling vesting</u>, in which the vesting date is extended. Finally, the Plan can be written to

DEFERRED COMPENSATION PLANNING FOR EXECUTIVES OF CHARITIES AND NONPROFIT CORPORATIONS (cont'd)

protect the employee against either (i) a change of management or (ii) financial hardship of the organization. Under this scenario the Plan automatically terminates upon either a Change of Control or the net asset value of the organization falling below a specific threshold (e.g. ten million dollars). Upon automatic termination, the employee is immediately vested and her Account balance is distributed to her. [IRS Private Letter Ruling 9508014 discusses this technique.] These protections are important because all Plan assets are subject to the claims of the organization's general creditors. Thus, if the organization goes bankrupt, the employee may receive nothing from the Plan.

Section 457(f) Plans provide valuable Retirement Planning opportunities for employees of tax-exempt organizations. These Ineligible Plans should remain popular since there is no limit on the amount an executive may contribute, and since contributed amounts grow tax-free. Charities and Nonprofit Corporations will likely continue to establish these Plans as a means of attracting and retaining qualified personnel.

INCOME TAX TREATMENT OF LITIGATION PROCEEDS

The tax treatment of cash or property received pursuant to resolution of a dispute is usually identical regardless of whether the dispute is resolved by a court-judgment or by a settlement. Generally, money or property received pursuant to a judgment or settlement is includible in the recipient's gross income under Code Section 61.

In personal injury cases, Code Section 104 excludes from income certain amounts received due to personal injuries or sickness. The tax policy behind this exclusion is that these amounts are intended to make the victim whole for the loss of physical well-being, and thus constitute a "nontaxable recovery of lost human capital." Specifically, Section 104 provides an exclusion from gross income in cases involving personal injury or sickness for amounts received: (1) under workmen's compensation acts; (2) as compensatory damages (but not punitive damages) for physical injuries; (3) through accident or health insurance; (4) as a pension, annuity, or similar allowance for injuries resulting from active service in the armed forces; and (5) as disability income attributable to injuries suffered in certain terrorist attacks.

In all other cases (i.e. non-personal injury cases), the tax analysis is different. Unlike personal injury cases, there is no statutory provision which excludes from gross income amounts received pursuant to a judgment or settlement where the taxpayer's lawsuit asserts a non-personal injury (i.e. a business injury). Instead, such amounts are includable in gross income under Section 61. In business recovery cases, the issue generally is not whether the amounts received pursuant to a judgment or settlement are includable in gross income, but rather the characterization of such income as ordinary income, capital gain, or return of capital.

To determine the character of amounts received in business injury cases, the test is "in lieu of what were the damages awarded?" Thus, the origin and nature of the claim is examined. If the proceeds represent a substitute for lost profits, they constitute ordinary income taxable to the recipient. If the proceeds represent a recovery for lost goodwill or harm to capital assets, then amounts received constitute capital gain provided the sale/exchange requirement is satisfied. Moreover, settlement proceeds received for sold or exchanged capital assets will represent a nontaxable return of capital to the extent of the taxpayer's adjusted basis in the asset. In some cases, the recovery may be attributable to both lost profits and harm to capital assets. In these cases, the taxpayer is required to allocate the amounts received to lost profits (i.e., ordinary income) and damage to capital assets (i.e., capital gains). The burden

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INCOME TAX TREATMENT OF LITIGATION PROCEEDS (cont'd)

generally is on the taxpayer to show that a recovery (wholly or in part) is attributable to harm to capital assets.

In summary, receipt of settlement proceeds for a business (non-personal) injury is taxed as follows:

- A recovery of lost profits is taxable as ordinary income.
- A recovery for lost goodwill or harm to capital assets is taxable as capital gain (provided the sale-exchange requirement is satisfied).
- A recovery for lost goodwill or harm to capital assets is a non-taxable return of capital to the extent of the taxpayer's adjusted basis in the assets taken or otherwise harmed.

The receipt of settlement proceeds raises another important tax issue: whether a plaintiff receiving taxable settlement proceeds must include in income that portion of the proceeds retained by her attorney as a contingent fee. Recently, a number of courts have focused on this tax issue. Although the plaintiff's payment of the contingent attorney's fees is generally deductible, this deduction may be worthless where the deduction (being unrelated to a trade or business) is a miscellaneous itemized deduction which is deductible for regular tax purposes only to the extent it exceeds 2 percent of adjusted gross income and is not deductible at all for purposes of the alternative minimum tax. The net result can be that a plaintiff pays tax on her attorney's fees, even though those fees are distributed directly from the defendant to her attorney and the plaintiff never has control or ownership of the fee-moneys. The tax treatment of contingent attorney's fees will be discussed in our Fall Edition.

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