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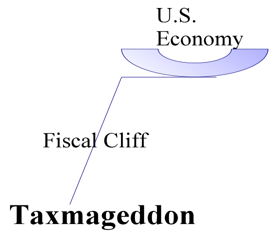
# NEWSLETTER

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**EVENTS:**

**Presentations and Continuing Education:**

CalCPA, San Diego Chapter Seminar: “Nontraditional Strategies and Checkbook Control Planning for IRA Assets”. Thursday, January 17, 2013, at the La Jolla Sheraton. Presented in part by Bradford N. Dewan. For more information visit our website at www.mmpph.com.

**In this Issue:**



## Revised Article - BUSINESS TRANSITION PLANNING: THE ROLE OF A STOCK APPRECIATION RIGHTS PLAN

Bradford N. Dewan, J.D.

As a business owner begins to focus on developing and implementing a plan that will allow him or her to transition away from the business both operationally and financially, the business owner will either acknowledge the importance of a few existing employees or determine that one or two experienced managers needs to be hired. It is these “key” employees whom the business owner determines will be his or her replacement in the management team (and possibly as the owner as well). Since the transition plan may well extend for five to ten years, the business owner will want these key employees to stay long term and to continue their contribution to the growth of the business. The business owner must now decide how to motivate these key employees to stay with the business and continue their productive performance.

Many times the first option considered to “attract and retain” the key employee is to offer stock in the company. Issuing stock at this point, however, is probably premature, most likely expensive, and may well have unintended consequences if the positive projections and expectations do not materialize. Indeed, this employee may prove not to be the right fit, either long term or possibly even short term. Moreover, the employee may decide that owning a minority interest in the company may not offer the best path for monetizing his or her hard efforts and contributions to the success of the business.

The second option often considered is offering cash bonuses. However, cash bonuses, typically paid annually, really do not create any “strings” or “ties” that bind the employee financially to the business long term.

As a third option, the business owner could create a deferred compensation plan with the future benefit subject to vesting (i.e. the “future benefit” can only be received if the employee stays with the business for number of years). The vesting may occur ratably over a period of years (e.g. 20% during each of the next five years), or, only at the end of the specified period (e.g. 100% on the fifth anniversary of the plan).

The “future benefit” potentially payable to the employee could be determined either by future profitability of the company, cash flow, or the value of the business.

This option becomes very worthy of further consideration, especially if the amount of the “future benefit” payable to the employee after vesting has occurred is dependent upon the increase in the business value measured from a date after the employee commences employment or the commencement date of the plan.

One tool, and certainly one of the best options, is a Stock Appreciation Rights Plan, or SAR Plan.

Stock appreciation rights are the economic equivalent of stock options but do not require the SAR recipient to have the cash necessary to tender an exercise price. Rather, on the date of grant, the employer extends to the employee a contractual right to an amount in the future that will be equal to the amount of appreciation of a specified number of shares of stock of the business (conceptually but not actually issued) that is realized between the date of grant and the date of exercise. The right to exercise a SAR is typically subject to vesting conditions, which are usually continued employment for a designated number of years or attaining a performance target. Upon vesting and exercise, the employee pays no exercise price, but will receive a payment, typically in cash, equal to the spread between the value of the specified number of shares of stock on the initial grant date and the value of such number of shares of stock on the exercise date.

A SAR Plan often meets the expectations of both the key employees and the business owner since it gives these employees, acknowledged to be “key,” something that is directly related to the stock (i.e. ownership) of the company. A SAR Plan also grows in value just like the actually issued stock of the company, and can in fact be converted into cash far more easily than actual shares of stock since there is likely no market for those shares (since they constitute only a minority and non-controlling interest) and any such shares would be subject to significant transfer restrictions.

As key employees strive to make the company more valuable, they are directly making their interest in the SAR Plan more valuable. Typically, participation in the SAR Plan corresponds to a specific number of shares and, therefore, a specific percentage ownership in the business but without the actual issuance of shares to the employees. As the value of actually issued stock increases, so does the value of the employees’ rights in these conceptually issued shares of stock.

**Tax Treatment.** The employee does not incur any income tax at the time of the grant because there exists only a promise by the company to pay the spread in the share value (typically in cash) at some point in the future. During the vesting period no deductions are available to the business. Upon exercise by the employee and a distribution of cash by the company, the employee has ordinary income equal to the spread. The company has a related deduction.

The success of a Stock Appreciation Rights Plan depends on a careful design of vesting, forfeiture, payment schedules and funding devices.

The following is an example of how a SAR Plan would work. Assume the key employee is granted a SAR benefit equal to five percent (5.0%) of the future growth of a business which has a current enterprise value of $5 Million. This infers that the other ninety-five percent (95.0%) of any future growth will be attributable to the efforts of the owner(s) or other key employees. Further, the vesting schedule is ten years and there is no partial vesting over the ten year period. At the end of the ten year term, the enterprise value has increased to $15 Million. The key employee’s vested benefit is calculated as follows:

1. Growth in value ($15 M - $5 M) = $10 Million
2. Key Employee’s SAR five percent benefit = $500,000

Clearly, one of the issues for the business owners is how make sure that $500,000 will be available for distribution to the key employee. Having a viable funding strategy is very important to giving the key employee a good level of confidence that the funds will actually be there for the distribution. Certainly a good strategy is to set aside some funds each year into a reserve that is specifically funded for this purpose.

In conclusion, SAR Plans work well as incentive plans when the company can expect significant future growth and to motivate newer employees (or recently promoted employees) whose past efforts have not contributed to the existing value of the business. Plus, the business owners avoid potential minority shareholder disputes since no stock of the company is actually issued to the key employees.

If you are considering succession planning for your business, please contact us to discuss it.

## WELCOME TO TAXMAGEDDON: TAXES AND THE NEW REALITY FOR 2013

DeEtte L. Loeffler, J.D., LL.M. Taxation

The 112th Congress appears to have let us down again, this time by failing to agree on a way to avoid the tax problems expected to arise January 1, 2013. "Taxmageddon," as that day has been dubbed, is expected to occur when the combination of the expiration of the Bush Tax Cuts, the 2010 Tax Relief Act, new Medicare and investment income tax increases under Obamacare, return of the payroll tax, and the February 2012 sequestration cuts to government spending all go into effect at the same time. All this will be compounded by the pressing need for government to address the debt ceiling early in 2013. Some of the effects which you can expect to feel, if Congress does nothing, are addressed in this article.

1. Increased Income Tax Rates

As of January 1, 2013, federal income tax rates will increase from the current 10, 15, 25, 28, 33 and 35% to 15, 28, 31, 36 and 39.5%. California state income tax brackets will rise as well. See No. 4, following.

Federal Long term capital gains rates will rise from 0 or 15% to 15 or 20%. Short term capital gains and all dividends (including "qualified dividends") will be taxed at ordinary income rates.

2. Obamacare (Medicare) Taxes.

A new Net Investment Income tax of 3.8% will be imposed on "net investment income" ("NII"). NII is interest, dividends, royalties, rents, gross income from a trade or business involving passive activities, and net gain from disposition of property (other than property held in a trade or business). NII is reduced by the deductions that are allocable to that income. (The new tax will not apply to income in tax-deferred retirement accounts such as IRA and 401(k) plans). The tax will be imposed on individuals with Adjusted Gross Income ("AGI") of more than $200,000, and couples with an AGI of more than $250,000 ("high income earners"). In addition, trusts with more than $11,650 (adjusted for inflation) in retained income will be subject to this tax. This is expected to impact holding and discretionary trusts, including gift trusts.

In addition, a new 0.9% Medicare tax will be imposed on wages of high income earners.

3. Alternative Minimum Tax: Increased Taxes, Delayed Returns and Penalties

The 1969 Alternative Minimum Tax ("AMT"), originally enacted to ensure wealthy Americans pay at least a minimum tax on income, applies to an increasing number of taxpayers each year because the original bill was not indexed for inflation. Rather than amend the tax code to fix this problem, Congress has enacted a "patch" each year to reduce the number of taxpayers subject to the tax. In 2012, Congress failed to pass such a patch, and Senate Majority Leader Harry Reid said in December that the Senate would not even consider a stand alone bill to patch the AMT.

Taxes will therefore increase for tens of millions of Americans, with the tax **due by April 15, 2013** for the 2012 tax year. The average new AMT filer is expected to pay an additional **$2,500** in taxes. The AMT is expected to apply to single taxpayers with income of $33,750, and to couples with combined incomes of $45,000. The IRS estimates that new AMT filers will owe $64 billion in additional taxes. AMT filers are required to calculate their taxes twice, then pay the higher of the two taxes calculated. Taxes calculated under the AMT do not allow for the taking of certain deductions, including state and local taxes and dependent exemptions.

Even if Congress does act to patch the AMT in 2013, the IRS expects millions of Americans to file late income tax returns in 2013. On December 19, 2012, the IRS Acting Commissioner, Steve Miller, warned that as many as 100 million taxpayers may delay filing tax returns in 2013 in hopes that Congress will fix the problem retroactively. "Many people don't realize that they could potentially face a significantly delayed filing season and a much bigger tax bill for 2012," Miller said.

Tax penalties may also be a problem for taxpayers who did not expect the AMT to apply to them and so did not withhold sufficient taxes from their 2012 income. The IRS normally imposes tax penalties on taxpayers who fail to withhold sufficient funds from their wages. In addition, those who are unable to pay the increased taxes by April 15, 2013 may incur additional penalties for late payment.

4. California Tax Increases

In the November 2012 elections, Californians raised income tax rates, **retroactive to January 1, 2012**, on single taxpayers with AGI of more than $200,000 and married taxpayers with AGI of more than $250,000. Married taxpayers will pay the following increased rates:

| | |
|---|---|
| $250,001-300,000: | 10.3% |
| $300,001-500,000: | 11.3% |
| $501,000-1,000,000: | 12.3% |
| $1,000,001 +: | 13.3% (12.3+ 1.0% mental health tax) |

Sales taxes will rise on all Californians from 7.25% to 7.5% for the years 2013 through 2016.

As a result of this tax increase, Californians with income in excess of $1 million will be subject to a combined federal and state rate of **57.6%** (44.3% federal and 13.3% state).

5. Transfer Taxes

Taxes on those making gifts or dying in 2013 will significantly increase. The estate, gift and generation-skipping transfer tax exemptions will decline from $5.12 million in 2013 to $1 million (with the GST tax exemption indexed for inflation). Tax rates will increase from 35% to 55%. As a result, the estate of a person dying in 2013 with a taxable estate of $3 Million could be subject to over $1 million in estate taxes.

Planning Options

It is now more important than ever to do estate and tax planning. If you have over $1 million in assets, or income in excess of $200,000, there are techniques available to reduce your income taxes as well as your potential future gift, estate and generation skipping taxes. Marital deduction planning, Grantor retained annuity trusts (GRATS), family limited partnerships (FLP) and limited liability companies, qualified personal residence trusts (QPRTs), charitable trusts (CRATs and CRUTs), and 529 plans are just some of the options available to you.

If you are interested in exploring ways to reduce your income and/or estate taxes, please contact us.

## STATE TAX NEWS: STATE HAS $14M OF UNCLAIMED INCOME TAX REFUNDS; RETURN OF THE CALIFORNIA ESTATE TAX

If you did not receive your 2011 California state income tax refund, you are not alone. Some 48,000 refunds were not collected in 2012, totaling over $14 million in value, including one check for $35,000 that was returned as undeliverable.

One way to avoid problems receiving your state tax refund is to provide the Franchise Tax Board with your banking information for direct deposit. Over 6 million taxpayers took advantage of direct deposit to receive their refunds in 2012. Another option is to update your taxpayer information directly with the FTB every time you move.

If you think you or a family member may be due a refund, you can check the Franchise Tax Board website at https://listmanager.ftb.ca.gov/t/141240/153909/1474/3/, or follow this link to Check Your Refund Status.

### RETURN OF THE CALIFORNIA ESTATE TAX

California may begin collecting estate tax revenue again in 2013. The state last collected estate taxes in 2005 because its tax (a "pick-up" tax) only collects the amount permitted as a deduction on a federal estate tax return. When the Economic Growth and Tax Reconciliation Act of 2001 ("EGTRA") phased out this deduction, California lost its estate tax revenue.

In 2013, EGTRA is scheduled to expire and the laws to revert back to what it was in 2001. That means California should start collecting estate taxes again.

This tax should not cause a significant expense for estates of decedents dying in California. This is because the total tax to be collected will remain the same - the federal share will simply be reduced by the amount the state collects. However, estates will need to prepare and file a second tax return, this one with the State of California, which will cause some expense.

Governor Brown's budget is counting on California collecting a lot of revenue this way over the next few years. The budget projects revenue of $290 million in 2013-2014, $725 million in 2014-2015, and $1.2 billion in 2015-16. Legislative analysts are not as certain these taxes will be collected, as Congress continues talks regarding the Fiscal Cliff and possibly setting the federal estate tax exemption permanently at $3.5 million (with no mention of deduction for state taxes). California does not have an inheritance tax and cannot collect one without passing an amendment to the state Constitution.

## Legislative Update: Living in Interesting Times

The ancient Chinese curse, "May you live in interesting times," has new meaning to us as we continue to live through times of uncertainty in the estate planning arena. The uncertain economic recovery has forced older business owners to postpone the sale or transfer of their business, and has caused seniors to reconsider gifting as their own future financial needs become less clear. Uncertainty about tax rates and deductions has resulted in some people postponing setting up or amending estate plans, while others feel compelled to make large gifts before 2013, some taking risks they might not otherwise have considered in hopes that, in the end, they have made the "right" gamble.

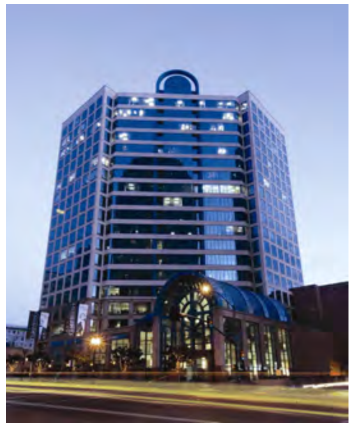
The results of the November elections have not made the country's economic future clearer. The Senate is now more firmly in the hands of Democrats, while the House of Representatives remains in Republican hands (although with a smaller majority). President Obama remains in the White House, but is reportedly making changes to his cabinet. While both parties have publically urged reconciliation to avoid the fiscal cliff, finger pointing began within a week of the election, and recent developments make an agreement in 2012 less certain (although not impossible).

Proposals and counter proposals were made by the White House and House Speaker John Boehner in December, with each taking a hard line and accusing the other of not presenting a workable solution to the budget, tax and spending problems. While the parties appear to have moved closer to a compromise, none was reached in time for Congress to write and vote on the bill before breaking for the winter recess on December 21st. Unless Congress returns to session in late December, no solutions will be reached before the fiscal cliff.

Current proposals include extending the alternative minimum tax patch permanently, increasing taxes only on taxpayers with AGI over $400,000 (Obama) or over $1 million (Boehner), extending the debt ceiling for the next 3 years (Obama). The White House has refused to discuss spending cuts, which will likely result in the sequestration cuts being imposed on January 1st.

We will be keeping an eye on Washington and will update you on any developments in our next edition of this Newsletter.

*If you would like to receive further information regarding the topics in this or past newsletter, or if you would like to let us know any issues or topics you would like to see addressed in future newsletters, please contact us at (619) 239-7777 or newsletter@mmpph.com.*



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