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TAX-FREE "F" REORGANIZATION ACHIEVES ASSET PROTECTION

One would be hard pressed to find any adult, especially a parent, to consider an "F" a good result under any circumstances. However, in the context of corporate taxation, qualifying for an "F" may be a very good thing indeed.

The Internal Revenue Code (the "Code") recognizes very few transactions that do not somehow result in a recognition of gain and assessment of tax, especially transactions that result in some form of corporate restructuring. A restructuring is generally involved in mergers, acquisitions or dispositions, and often results in recognition of taxes by an acquirer, a target, or their respective shareholders, as well as adjustments to asset or share tax bases, net operating losses, or other tax attributes.

A restructuring also may result in the termination of a business or entity, impacting a variety of contractual arrangements including, but not limited to, leases, licenses, financing commitments and employee welfare and benefit plan obligations. Although such arrangements may require consents, approvals or other actions regardless of the applicable tax considerations, the tax impact may be minimized or eliminated when a transaction is structured to qualify as a tax-free reorganization. One form of tax-free reorganization is recognized under Code Section 368(a)(1)(F), commonly referred to as an "F" reorganization.

An F reorganization is "a mere change in identity, form or place of organization of one corporation, however effected." Qualification as an F reorganization is often sought where a corporation changes its name, state of incorporation, or form, such as a change from a Massachusetts business trust to a corporation, or vice versa, conversion of a mutual savings and loan association into a stock savings and loan association, or conversion of a for-profit into a not-for-profit corporation. In addition, the IRS has recognized F reorganizations that included a change from a public to a private or limited liability company, accompanied by shareholder exchanges of stock certificates for registered shares or quotas.

F reorganizations that transform operating companies with valuable assets into operating subsidiaries without such valuable assets have been perhaps the most controversial. A typical scenario might be as follows: A corporation provides services and holds valuable assets, including the building from which the

services are provided, and related furniture and equipment. The shareholders desire to shield the corporation's assets from potential claims that might arise from their provision of services. They create a new corporate shell in which they own all of the shares, and then transfer their shares in the existing corporation to the shell, which becomes the parent through an F reorganization, including a transfer of the building, furniture, equipment and other assets to the parent. The reorganization creates a firewall between the assets and the liabilities that would be associated with any claims made in connection with services provided.

The transfer of assets from one entity to another solely to protect assets from claims of creditors may reflect a valid business purpose for the reorganization, a condition required to qualify for any type of tax free reorganization; however, it may also give rise to fraudulent transfer claims, particularly if there is any hint of a potential customer or client claim at the time of the reorganization. In the absence of customer or client concerns, an F reorganization may be a good way to protect business assets. If you desire any further information regarding F reorganizations, please contact us.

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ORAL SETTLEMENT AGREEMENTS MAY BE ENFORCEABLE

In *Brewer v. National Railroad Passenger Corporation*, Chester Brewer ("Brewer") filed suit to recover damages for personal injuries he sustained during his employment with Defendant, National Railroad Passenger Corporation ("National"). Brewer claimed National was negligent in failing to provide him with a safe place to work. Prior to trial, the case was dismissed with prejudice based upon a settlement agreement negotiated by the parties' counsel. The settlement agreement provided for a \$300,000 settlement payment to Brewer, in exchange for his resignation from National.

Brewer later claimed he did not agree to resign his position with National, and he refused to sign the settlement agreement. National responded by filing a motion in the trial court seeking to enforce the terms of the settlement agreement. Brewer argued the oral settlement agreement was unenforceable since he did not agree to the provision regarding his resignation. National argued an oral agreement is enforceable if there is an offer, an acceptance of the compromise, and a meeting of the minds as to the material terms of the agreement. Moreover, National claimed a mistake or misunderstanding by one party is not sufficient to compel rescission of the settlement agreement where both parties agreed to the material terms.

The Illinois Supreme Court found the settlement agreement was unenforceable. The Court noted while oral settlement agreements are generally enforceable in Illinois, where a settlement agreement is reached out of court, a party cannot be bound unless it can be shown they consented to all material terms of the agreement. In this case, Brewer's resignation was a material term that was not agreed upon by the parties.

This case demonstrates that oral settlement agreements are enforceable if a party can demonstrate that all material terms have been agreed upon. If you have any questions concerning an oral settlement agreement and its enforceability, please contact a member of the firm.

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**NAMING A TRUST THE BENEFICIARY OF AN IRA HAS BENEFITS,
BUT MUST BE DONE WITH CAREFUL PLANNING**

The benefits of an Individual Retirement Account (“IRA”) can be enormous. Those who have taken advantage of the tax deductible contributions and tax-free deferral afforded by the IRA laws have been richly rewarded with substantial balances in their IRAs. Because IRAs often represent a significant portion of one’s net worth, estate and tax planning for IRAs has become much more important, and individuals often seek to maximize the long-term benefits of IRAs while preserving the assets for their children and spouses.

For a variety of reasons, people with significant net worth incorporate trusts as part of their estate plan. Trusts have many benefits, including protection of assets from creditors, or spendthrift heirs from their own bad habits, and maximization of available tax benefits. IRA owners can also use trusts to obtain those benefits. However, the complicated rules regarding IRA distributions require very careful planning. While the IRS recently issued final regulations related to IRA distributions, not only are the IRS regulations complicated, but the IRS’s own interpretations of its regulations are often contradictory.

If a person does not have sufficient assets aside from his or her IRA to fund a credit shelter trust and/or marital trust, then IRA assets must be used in order to minimize the effect of estate taxes. In order to qualify an IRA trust for the marital deduction, *all* income from the marital trust must be payable to the surviving spouse. However, the amount of income received by the marital trust is not necessarily the same – in fact, probably never – as the amount paid to the trust as the required minimum distribution from the IRA. Thus, in order to preserve the marital deduction, care must be taken to provide that all income of the IRA will be distributed to the marital trust so that it can be paid out to the surviving spouse.

To permit the longest payout from an IRA, an individual should establish a separate trust (sometimes referred to as a “conduit” trust or “look-through” trust) for each of his or her intended beneficiaries during his or her lifetime. This trust is separate and apart from any trust the grantor has established in his or her living trust. If the trust fails to identify a beneficiary, the IRA payout cannot be stretched out. Thus, when naming trusts to be the recipient of IRA benefits, it is imperative that the IRA beneficiary designation be clear that the IRA is to be distributed to the separate trust established for each beneficiary. In this way, each beneficiary will be permitted to receive distributions from the IRA over the beneficiary’s lifetime. Failure to create separate trusts will result in the IRA being distributed over the life of the oldest beneficiary.

The alternative to having the entire amount of each year’s IRA distribution paid out to the beneficiary is to have the distributions accumulate within the trust. This prevents the beneficiary from squandering the principal of the trust, but it comes at a cost: the tax brackets for trust income taxes are compressed, so a trust pays the highest tax rate beginning at income of approximately \$10,000.

Planning for IRA distributions, particularly when the IRA owner desires to use trusts in order to provide long-term payouts, is complicated and requires careful planning. Please do not hesitate to telephone us if you have any questions regarding estate planning and your IRA.

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WHAT KIND OF DAMAGES ARE AVAILABLE IN A BREACH OF CONTRACT ACTION?

A damage limitation provision in a contract which was the subject matter of a litigation filed by the International Truck and Engine Corporation (“International”) against the Ford Motor Company (“Ford”) raises the question of the type of damages recoverable in a breach of contract action. The provision provided as follows:

. . . neither Party shall be liable for any consequential, incidental or special (including multiple or punitive) damages of the other Party arising out of the performance of this Agreement.

Ordinarily, when awarding damages for a breach of contract, the court awards damages which will put the non-breaching party in the position it would have been in had the contract been properly performed. Such damages are commonly known as “benefit-of-the-bargain” damages and can include costs incurred in remedying the breach (also known as “incidental damages”), out-of-pocket costs incurred in performance prior to the breach, and lost profits and other damages suffered by the non-breaching party which were anticipated by the parties at the time the contract was entered into (also known as “consequential and/or special damages”). Such damages, however, are not the only type of damages recoverable for a breach of contract.

Another type of damages that may be recovered in a breach of contract action are restitution damages. These damages arise when the non-breaching party has conferred a benefit on the other party by, for example, making a partial payment or providing services under the contract. Restitution damages are an award of damages in an amount necessary to disgorge the benefit received by the breaching party.

The final types of damages recoverable for a breach of contract are punitive damages and/or statutory damages. Punitive damages are only recoverable if the breaching conduct is considered tortious, such as fraud or conversion. Similarly, statutory damages – which sometimes provide a damage award be doubled or tripled (also known as “multiple or treble damages”) – are recoverable if the breaching conduct violates a statute prohibiting such conduct, such as a consumer fraud statute.

Given the types of damages that are recoverable in a breach of contract action, the damage limitation provision contained in the contract between International and Ford would limit the damages recoverable in the event of a breach of contract action to the non-breaching party’s out-of-pocket costs incurred as a result of the breach. All other damages, including restitution damages, would appear to be contractually precluded. Such a damage limitation provision is not unusual when parties are trying to define and negotiate a limit to the amount and types of damages recoverable in the event of a breach of contract.

If you have a question about the damages recoverable in a breach of contract action or contractual provisions that limit such recovery, please call a member of the firm.

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WARM UP TO THE IDEA OF AN ESTATE FREEZE

Many of our clients are faced with a dilemma: how best to plan for a rapidly appreciating asset in an uncertain estate tax environment. Given that any significant estate tax reform is unlikely until after the 2008 elections, clients want to avoid possible estate tax on future appreciation but are reluctant to make significant gifts lest they pay a gift tax that later turns out to be unnecessary. Owners of an appreciating business or appreciating real estate want to avoid estate tax yet continue to receive the income from the asset for the near term. This article will review a recapitalization freeze, one of the three common methods for accomplishing an estate freeze. Other estate freeze methods employ family limited partnership or a sale of assets to a trust created for the benefit of the grantor's descendants.

The strategy requires a recapitalization of an existing corporation to create two classes of stock – common and preferred. Both classes of stock are voting. The preferred shares generally have a cumulative preferred dividend; the dividend is established by reference to interest rates at the time of the recapitalization. The preferred shares, by definition, do not share in the appreciation of the value of the company's assets. After creation of the two classes of shares, the owner makes a gift either in trust or outright of the common shares; he retains the preferred shares. Because the preferred shares are voting shares, the owner retains the right to vote the shares and thereby retain control of the corporation. Because the common shares represent the appreciation in the value of the company, the owner will avoid estate tax on any appreciation in the value of the shares after the date of the gift.

Consider this illustration. Smith is the owner of tool and die company, Smithco. He started the business 30 years ago with an investment of only \$5,000. Because there is high demand for US tool and die services, Smith believes his company may be worth at least \$1 million. He also believes that the future appreciation of his company will be significant. Smith's son and daughter work in the business and have expressed an interest in continuing the business after Smith retires. Smith has saved sufficient monies during his lifetime so that he will have a taxable estate. He also desires to leave the business to his children in such a way that estate taxes will not require them to sell the business to pay the estate taxes.

After consulting with his advisors, Smith decides to accomplish an estate freeze. Smith first exchanges his common shares of Smithco for 500 preferred shares of a new company, NewSmith. (This exchange is structured as a tax-free reorganization.) The preferred shares are voting shares, which ensures Smith will continue to have operating control of the business. The preferred shares may also be sold back to Smithco at any time for \$2,000 per share, thus giving Smith the opportunity to cash out at any time. The preferred shares further provide for a cumulative preferred dividend. Smith's son and daughter each purchase 100 common shares in NewSmith. If, five years after the reorganization, the value of NewSmith has increased to \$1,500,000, the value of Smith's preferred shares will still be \$1 million, and the children's common shares will be worth \$500,000. By having the foresight to transfer the future appreciation value of NewSmith to his children, Smith will avoid any estate tax on the \$500,000 of value attributable to the common shares.

If you have a business or real estate asset that has the potential to appreciate rapidly, please contact us to discuss whether an estate freeze may be appropriate for you.

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PERSONAL USE OF A COMPANY VEHICLE IS FRAUGUT WITH DANGER

Derrick Lewis (“Lewis”) was an employee of Roseville Toyota (“Roseville”). During his lunch break, Lewis asked Roseville’s vehicle key attendant if he could use a Roseville vehicle for a personal errand. The attendant gave Lewis keys to a vehicle but told him to return the vehicle after the errand or the attendant would get in trouble. While on the errand, Lewis struck the rear-end of a car stopped at a stoplight. The driver and passenger of the car filed suit against Lewis and Roseville for their personal injuries and damages resulting from the accident. Is Roseville liable for Lewis’ accident, and what can employers do to shield themselves from such liability?

During trial, Roseville produced a copy of the employee handbook it gave to Lewis which provided “[u]nauthorized use of Company property, vehicles, tools, equipment, or facilities is prohibited. Personal use of the postage meter, photocopy machines and telephones is not allowed.” Roseville management also testified that Lewis had been told on several occasions that it was a strict policy of Roseville that no employee is permitted to use property of Roseville for his or her own personal use. While Lewis acknowledged the policy, he believed he had obtained Roseville’s authorization to use the vehicle. Therefore, Lewis believed his use of the vehicle was authorized.

After trial, the jury found Lewis was negligent, his negligence was a substantial factor in causing harm to Plaintiffs, and while Lewis was not acting within the scope of his employment, Roseville had given Lewis permission, by words or conduct, to use its vehicle at the time of the accident. Thus, the jury found Roseville liable for \$277,662 in damages. Roseville appealed.

In upholding the jury’s award, the Appellate Court noted that Roseville’s restriction of its employees’ use of its vehicles to solely business purposes was not reflected in its employee handbook, which merely stated unauthorized vehicle use was prohibited. In addition, there was sufficient evidence that Roseville failed to monitor or supervise the use of its vehicles for business purposes only, thereby suggesting a tacit permission for employees to use the vehicles for purposes other than business purposes. Accordingly, the Appellate Court found it was not improper for the jury to conclude that Roseville had given Lewis permission to use the vehicle.

How can other employers shield themselves from such liability? If possible, employers should require employees to use their own vehicle and pay them a car allowance for such use. If employees must use a company vehicle, in addition to having and enforcing a policy prohibiting personal use, employer should make it a condition of employment that employees provide proof of insurance coverage for the employee’s use of a company owned vehicle.

If you have a question about a company policy regarding vehicle use, please telephone a member of the firm.

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PROCEDURES TO LOCATE RETIREMENT PLAN PARTICIPANTS

Peter Semler of Better Business Planning, Inc. reminds us that although employers are required to take all reasonable means to locate missing benefit plan participants, many find it next to impossible to do so. This creates concern that they are not satisfying IRS requirements, and subjecting themselves to potential civil an/or criminal sanctions, including personal liability for any losses suffered by a participant and fines ranging in the hundreds of dollars per day per participant for continuing failures to distribute required disclosures. For such employers, the IRS Letter Forwarding Program (the “Program”) provides relief.

The Program is available to individuals, companies and federal agencies. It may be especially useful to plan sponsors or administrators who are attempting to locate missing participants.

For requests that involve fewer than 50 missing participants, the IRS Disclosure Office can forward letters from plan administrators to missing individuals if the administrator provides the following information:

STEP 1: Prepare a cover letter directed to the IRS Disclosure Office for the local area where the requester is located. This cover letter should: (1) state why IRS assistance is being sought; (2) list the name, social security number, and last known address for each participant; and (3) include the name and address of the person or organization to whom the IRS should send an acknowledgment letter, limited only to acknowledgment of receipt of the sender’s correspondence and an indication of whether or not the matter has been accepted into the letter forwarding program. Inclusion of the correct social security number is mandatory since the IRS will not attempt to locate any individual without this information.

STEP 2: With your cover letter, include a letter (three pages or less) directed to the individual(s) who cannot be located. This letter should: (1) advise the recipient of the reason for the letter; (2) include instructions regarding what the recipient should do to contact the sender if he or she decides to respond; (3) make it clear a response to the sender’s letter is completely voluntary on the part of the recipient; and (4) include the following disclaimer statement, “In accordance with current policy, the IRS has agreed to forward this letter because we do not have your current address. The IRS has not disclosed your address or any other tax information and has no involvement in the matter aside from forwarding this letter. Your response to this letter is completely voluntary.”

Upon receipt of a valid request, the IRS Disclosure Office will search its records under the social security number provided and, if an address is found, forward the letter using an IRS envelope. If an address cannot be found or the letter is returned by the Postal Service as undeliverable, the letter will be destroyed. The requester will not be notified of the letter destruction since the law does not allow the IRS to provide the sender of such letter with the results of its efforts.

For requests involving less than 50 recipients there is no charge. Each request should be sent to the attention of the Disclosure Officer at the IRS district office nearest the requester regardless of where the recipient last resided.

Requests involving 50 or more participants are processed separately for a charge. Charges may be obtained from the IRS Disclosure Office in Washington, DC at 202-622-3324. The mailing address for this service is:

Internal Revenue IRS
Director, Office of Governmental Liaison & Disclosure
CL:GLD, Room 1603
ATTN: Disclosure Officer
1111 Constitution Ave., NW
Washington, DC 20224

Response time will depend upon the overall workload of the IRS Disclosure Officer.

Use of the National Registry is an alternative to the options given above. The Registry is a website where plan sponsors, plan administrator, custodians, or other plan service providers can register the names of missing plan participants who have unclaimed retirement funds. Individuals who think they may have old 401(k) accounts simply enter in their social security number and the database is searched for any nationwide matches. If there are any matches, the person is shown who the employer(s) is that has retirement money and is asked to provide your current contact information so the employer may contact them and make arrangements for distribution.

Thanks to Pete for providing this useful guidance.

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From *The Lawyer Joke Book*:

Cara Prewitt was pleading her case. She had been retained by a farmer to prosecute a railway company for running over twenty-four hogs.

She wanted to impress the jury with the magnitude of the injury and said, "Twenty-four hogs, ladies and gentlemen! Twenty-four! Twice the number there are in the jury box."

Kate Smith, a young lawyer, was trying her first case before Justice Blom. She had evidently memorized her entire argument and had proceeded for ten minutes with her oratorical effort when the judge banged his gavel down and decided the case in her favor. Despite this, the young lawyer would not stop. It seemed as though she had attained such momentum that she could not be interrupted.

Finally, Justice Blom leaned forward and said, in his politest tone, "Counselor, notwithstanding your arguments, the court has decided this case in your favor."

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