

March 2007

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Mark P. Altieri, Editor

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FIRM NEWS

by David L. Herzer

Combination with Buckingham, Lucal & McGookey

It is a great pleasure to announce that the law firm of Wickens, Herzer, Panza, Cook & Batista Co. has combined with the law firm of Buckingham, Lucal & McGookey, effective January 1, 2007.

Both groups of attorneys have long been familiar with the other, having sat across the table from each other on many occasions in the service of a variety of clients. It was in that quasi-adversarial role that both firms developed a strong and mutual respect for the legal expertise and professional integrity of each other. In addition to legal skills, the partners in each of the firms felt that there was also a superb meshing of personalities of the respective lawyers that would prove to be a major plus factor.

Following are the six attorneys of the Sandusky office who may be new to our Avon-based clients.

Daniel L. McGookey (admitted to the Ohio bar in 1979) has added his long-standing expertise as a business and commercial lawyer to our Business Organizations and Tax Department.

John D. Frankel (admitted to the Ohio bar in 1975) is also adding the same to our Business Organizations and Tax Department.

Duffield E. Milkie (admitted to the Ohio bar in 1991) has joined the Litigation Department where "Duff" will lend his years of practice as a commercial litigator to that Department.

Paul M. Koch (admitted to the Ohio bar in 2005) is a highly-regarded associate who will also join the Litigation Department.

John R. Ball (admitted to the Ohio bar in 1990) will add his expertise as an probate and estate planning lawyer to the Firm's Probate and Estate Planning Department.

Lastly, **Dean S. Lucal** (admitted to the Ohio bar in 1962) will also join the Probate and Estate Planning Department in an "Of-Counsel" capacity, thus lending his four plus decades of practice in the probate and estate planning areas to that Department.

The new Firm will continue to maintain the two offices in Sandusky and Avon under the name of Wickens, Herzer, Panza, Cook & Batista Co. The Sandusky office will be fully integrated with the Avon office through the use of our highly advanced technological infrastructure. This will add a distinct economy of scale to the Firm's practice and will provide more value-added capability to our clients. Two of the Avon-based practice areas, our outstanding Pension and Labor Law practices, will be fully available to our Sandusky-based clients.

These are just a few examples of the enhanced and cost efficient benefits that will accrue to our expanded client base. After all, it is the clients of the two historic firms that allowed us to grow and expand as professionals. That long standing loyalty will not be forgotten and will be reciprocated as we continue to bring our clients the finest legal services available in a courteous, timely and reasonably priced manner.

All of the attorneys and staff at Wickens, Herzer, Panza, Cook & Batista Co. wish you a most Happy New Year. Thank you once again for your continued support and providing us with the opportunity to serve you.

Wickens, Herzer, Panza, Cook & Batista Adds A New Shareholder

Wickens, Herzer, Panza, Cook & Batista Co. is pleased to announce that Todd Schrader has recently been elected as a shareholder and partner of the Firm, effective January 1, 2007. Todd joined the Firm in 2002 and practices in the Business Organizations & Tax and Real Estate Department.



Todd earned his Juris Doctor degree from Cleveland-Marshall College of Law where he was a member of the National Order of Barristers, Moot Court, and Board of Governors (Chairman). He holds a bachelor's degree in philosophy and public policy from Case Western Reserve University (Magna Cum Laude). He is also licensed with the Ohio Department of Insurance.

Todd is an active member with the Lorain County Bar Association and the North Coast Builders Industry Association (Secretary, Board of Directors, Ambassadors Committee Chair, Membership Committee and Build PAC), and the Smart Growth Education Foundation (Board of Trustees).

Todd and his family reside in North Royalton.

**Wickens, Herzer, Panza,
Cook & Batista Co. is pleased to
announce that Paul R. Phillips and
Thomas E. Stuckart III
have joined the Firm**



Mr. Phillips was admitted to the Ohio bar in 1989. He is a graduate of The State University of New York at Buffalo (B.A., 1985) and The University of Akron School of Law (J.D., 1989). He is a member of the Lorain County and Ohio State Bar Associations. He has joined the Litigation Department.



Mr. Stuckart was admitted to the Ohio bar in 2005. He is a graduate of Charleston Southern University (B.S., 2001) and Cleveland-Marshall College of Law (J.D., 2005). He is a member of the Lorain County and Ohio State Bar Associations. He has joined the Probate and Estate Planning Department.

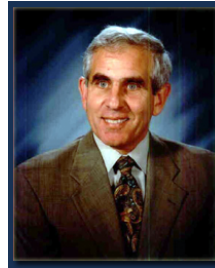
Avon Office Fax Number Update

Effective immediately, the Avon Office fax number has been changed to 440-930-8098. Please update your records accordingly.

Sandusky Office

Our Sandusky Office is located at 414 Wayne Street, Sandusky, Ohio 44870-2709; phone: 419-627-3100, fax: 419-627-3101.

Tom Pillari Honored as One of the Best



Our own Tom Pillari has again been honored by the prestigious Ohio Super Lawyers magazine. For the fourth year, Tom made the list of top 500 attorneys practicing in the state of Ohio. In coming to its decision, the magazine took special notice of the fact that Tom is a Fellow in the American College of Trust and Estate Council and is certified by the Ohio Supreme Court as a Specialist in Estate Planning, Probate and Trust practice. Congratulations Top-Attorney Pillari.

WHAT THE CLOSELY-HELD EMPLOYER NEEDS TO KNOW ABOUT THE NEW CODE SECTION 409A NONQUALIFIED DEFERRED COMPENSATION RULES

by Mark Altieri

Overview

In General. Most practitioners and business people are aware that a new and sweeping provision, Section 409A, was recently added to the Internal Revenue Code (unless otherwise noted, "Section" will refer to sections of the Internal Revenue Code). These new rules (we will call them the Section 409A Rules) potentially impact every "nonqualified" arrangement that defers the receipt of compensation income to a year later than that in which it was earned.

Generally, the Section 409A Rules are applicable to compensation deferred under a nonqualified deferred compensation arrangement (a DCA) after December 31, 2004. Since the advent of Section 409A in October of 2004 (the American Jobs Creation Act of 2004), the IRS and Treasury Department have provided clarifying notices and proposed regulations that will be elaborated on below.

Business newspapers, executive newsletters, journals and periodicals have been awash with summaries of the Section 409A Rules, but there is little in the literature that separates the many detailed rules that are more applicable to the publicly-traded employer from those of particular interest to the closely-held employer. The purpose of this article will be to explain in practical language what the Section 409A Rules mean to DCAs more likely to be maintained by the closely-held employer for its key employees and to highlight any necessary amendments.

Penalty for Noncompliance. Section 409A imposes a tax acceleration and a significant penalty to the extent that the DCA experiences a "plan failure" (described below) and the plan benefits to be paid in the future are not then subject to a "substantial risk of forfeiture" (an SROF). We will discuss what constitutes an SROF under Section 409A below, but for now we will note that a contractual requirement to render substantial future services before benefits vest will constitute an SROF. Upon a plan failure, absent an ongoing SROF, not only will all deferred compensation (plus income attributable

to it) be accelerated into income, but a 20% penalty tax will be imposed in that year.

Relevant Authority. We currently have a number of primary and secondary authority sources to help understand the breadth of Section 409A. The IRS has provided guidance in the form of IRS Notices. IRS Notice 2005 1 is the most helpful and relevant and was issued by the IRS in December 2004 to provide a much needed interpretation of Section 409A. In responding to comments from the public on Notice 2005 1, and to provide additional and new guidance, the Treasury Department issued proposed regulations on Section 409A in September 2005 (the Proposed Regulations). Final regulations are expected before the end of the year and are not expected to effect the issues elaborated on in this article (anticipate the final regulations to be virtually identical to the Proposed Regulations referenced herein).

The Intent of New Law. As we will see, the new law under Section 409A is generally applicable to DCAs maintained by closely held employers. However, the true abuse that Section 409A was intended to blunt occurred with more sophisticated DCAs, where manipulation as to the initial deferral decision and the timing of benefit payments was commonplace before 2005. For DCAs maintained by closely held employers that are traditional nonqualified deferred compensation plans, the new rules typically will not require substantial amendments. This is because the terms of these closely held plans may already largely follow the requirements laid out under the Section 409A Rules (that is, payments under the plans will not occur until a specified date, separation from service, death, or disability, and there is no mechanism under the plan to either accelerate or further defer payment of the scheduled deferred compensation). Still, the closely held DCA will need to conform its definition of these triggering events to those required under the Section 409A Rules. Additionally, as will be noted, the definition of what constitutes a DCA is extremely broad and goes well beyond traditional nonqualified deferred compensation arrangements to potentially ensnare employment, severance and bonus agreements. It is these latter agreements that are a potential trap for the closely-held employer, even among those somewhat well-versed on the Section 409A implication with regard to traditional nonqualified deferred compensation arrangements.

Relevant Timeframe for Section 409A Compliance.

Section 409A is generally applicable to income deferred after 2004. Notice 2005-1 originally required that amendments to DCAs to bring them into general conformity with Section 409A were to be made on or before December 31, 2005. The Proposed Regulations extended the amendment deadline to December 31, 2006. Lastly, recently issued Notice 2006-79 has extended the amendment deadline to December 31, 2007.

The Conceptually Difficult Multi-Pronged Analysis of Section 409A

What makes comprehension of Section 409A particularly difficult is the three-pronged nature of the necessary analysis. The first step is to determine that an arrangement to defer compensation is a DCA under Section 409A. Having determined that a deferral is a DCA, the second step is a determination as to whether the plan benefits are subject to an SROF. If not, the final determination is whether the DCA, at that time, inherently suffers from a "plan failure". The convergence of these three events invokes the income acceleration and penalties of Section 409A: amounts deferred under the DCA for the current taxable year and all preceding taxable years are includable in gross income and are subject to the additional penalty tax equal to 20% of the compensation required to be included in gross income. Interest is also added at the underpayment rate plus 1% from the year in which the amount was first deferred.

The First Prong: What is a DCA Under the New Law

Generally. A DCA under Section 409A may be an individualized arrangement (e.g., an employment agreement) or a more formal and broader plan (e.g., a nonqualified supplemental retirement plan in which all management-class employees participate). What Section 409A is generally looking for is an arrangement that provides for the deferral of the payment of compensation owed to a "service provider" (in which the service provider has a "legally binding" right to the deferred compensation) into a later year. Excluded from the definition of a DCA is a (i) "qualified" retirement plan (i.e., a tax qualified pension, profit-sharing, Section 401(k) plan, Section 403(b) tax deferred annuity, or a Section 457(b) eligible plan for state, government, or tax

exempt employees; or (ii) a bona fide vacation, sick leave, disability pay, or death benefit plan.

Except for these excluded plans and arrangements, any and all compensatory scenarios that defer income into a future year require scrutiny in order to determine if Section 409A is applicable.

According to Notice 2005-1 and the Proposed Regulations, the employee or independent contractor providing the services is referred to as the "service provider". For simplicity sake, we will refer to the service provider as the employee. The entity to whom the service provider is rendering services is referred to as the "service recipient". For simplicity sake, we will refer to the service recipient as the employer.

A Legally Binding Right to Deferred Compensation.

As noted above in the confusing general rule of what constitutes a Section 409A deferral, there is such a deferral only if the employee has a legally binding right to compensation that has been deferred into a future year. If the employer may unilaterally reduce or eliminate that right to compensation, there is no legally binding right. Notice 2005-1 notes, however, that if under the facts and circumstances of a particular case, the employer would be unlikely to reduce or eliminate the deferred compensation, the employee would be deemed to have a legally binding right to it. The Proposed Regulations take the legally binding right to compensation a step further by stating that the facts and circumstances indicate that the employer's discretion to reduce or eliminate compensation is available only upon occurrence of a condition, the employee is considered to have a legally binding right to the deferred compensation. The Proposed Regulations specifically state that even if the employee's right to the deferred compensation is subject to an SROF, he or she is deemed to have a legally binding right to it and there is a DCA under Section 409A.

Example: Dave is a newly hired professional employee of PC, Inc. In addition to his regular salary and bonus compensation, PC provides Dave an additional fringe benefit in the form of a nonelective deferred compensation arrangement (contractual differences between elective and nonelective arrangements will be discussed below). However, Dave's right to the deferred

compensation is subject to an SROF that he maintain his status as a full time employee of PC for the next 10 years in order to vest the deferred compensation. Even though Dave is an at will employee and could be fired by PC at any time thus losing his deferred compensation, he is deemed to have a legally binding right to it. Therefore, the nonelective deferred compensation arrangement is a DCA under Section 409A. Absent application of the short-term deferral exception noted in the next paragraph, the DCA must be in writing and otherwise comply with the requirements of Section 409A.

A Major Exception to the Rules Just Noted.

The short-term deferral exception is a significant exception to the characterization of an arrangement as a DCA. Under the short-term exception, if deferred compensation is paid out in full within two and one-half months after the year of its vesting, the arrangement is deemed to never have constituted a Section 409A deferral. This would be relevant not only for annual bonuses determined on the basis of productivity for the year, but also with long-term deferrals where the payout occurs shortly after the SROF lapses.

Example: The executives of Hospital (a Section 501(c)(3) employer) participate in a nonqualified deferred compensation arrangement between them and the Hospital. Since the employer is a tax-exempt entity, the arrangement must conform to Section 457 in addition to Section 409A.¹ Because of the amounts of deferred compensation, the arrangement is structured as an "ineligible" Section 457(f) plan. Under such a plan, in order to avoid current income taxation under Section 457, the deferred benefits must be continually subject to an SROF. The plan provides that upon the executives obtaining age 62 while still in the full-time employ of Hospital, they will vest the deferred benefits which will be paid in a lump-sum within 60 days of vesting.

¹ The Section 409A Rules apply to nonqualified deferred compensation plans under Section 457(f) in addition to the requirements already applicable to such plans under Section 457(f).

Although the actual payments of the vesting deferred compensation may be delayed many years, the arrangement does not constitute a DCA under Section 409A since the complete payout will occur well within two and half months of the end of the vesting year (before the vesting date the deferred compensation had been continually subject to an SROF).

Separation Pay Arrangements. Under the general definition of what constitutes a DCA just noted, post-termination severance pay arrangements would generally constitute a DCA. The Proposed Regulations, however, have excepted certain severance pay arrangements from being ever defined as a DCA.²

There are two exceptions for severance pay arrangements that are of potential interest to the closely-held employer.³ The first of these two is applicable for severance arrangements payable in the event of an involuntarily termination of employment if the severance cannot be greater than two times the lesser of: (i) the employee's annual taxable compensation for the calendar year prior to the year of separation from service, or (ii) the compensation limitation under Code §401(a)(17) for qualified requirement plans (\$220,000 for 2006). All payments under this exception must be made no later than December 31 of the second calendar year following the year of separation of service.⁴

The second exception deals with so-called "window" programs. This is the only exception under the severance pay rules for voluntary, as opposed to involuntary, terminations. The Proposed Regulations require that the availability of the window program continue for only a limited period of time and, in no event, more than for one year. Additionally, window programs have to comply with the dollar limitations just noted in the prior exception. The trouble with window programs is that this exception is difficult to fashion on an individual or small group basis. The Proposed Regulations require that the window program be left open for less

² Proposed Reg. Section 1.409A-1(b)(9).

³ A third exception is for collectively bargained separation pay arrangements. Proposed Reg. Section 1.409A-1(b)(9)(ii).

⁴ Proposed Regulation Section 1.409A-1(b)(9)(iii).

than one year for employees who separate from service during that period under specified circumstances (for example, as a short-term early retirement incentive). If the employer establishes a pattern of repeatedly providing for similar separation pay in similar situations for substantially consecutive periods of time, the program would not be considered a window program.

If the severance pay arrangement fails to fit into either of these exceptions, and is not otherwise covered by the short-term deferral exception noted earlier, the severance pay arrangement constitutes a DCA and must comply with the Section 409A Rules. It is relevant, however, that such severance pay arrangements are treated as a separate class of DCA under Section 409A. That is, separation pay arrangements are treated as distinct from account balance DCAs (defined contribution DCAs), nonaccount balance DCAs (defined benefit DCAs), and other Section 409A DCA's (equity-based DCAs discussed in the next section). Generally, all plans in the same class are aggregated and treated as one plan. Thus, the separation pay arrangement that constitutes a DCA may provide a different amount and form of deferred compensation benefit than that payable to the employee on separation from service under other DCA's maintained for his or her benefit by the same employer.

Stock Options as DCAs. Notice 2005-1 and the Proposed Regulations clarify a prior area of confusion under the new law. An option to purchase stock that is a "nonstatutory stock option" may be deemed to be a DCA. More specifically, a nonstatutory stock option is one other than an incentive (qualified) stock option described in Code Section 422. Therefore, the typical stock option, being nonqualified, will constitute a nonstatutory stock option as defined under the new law.⁵ A nonstatutory stock option will further constitute a DCA subject to Section 409A if the amount required to purchase stock under the option is less than the fair market value of the underlying stock on the date the option is granted. The phrase "fair market value" refers to the true, objective fair market value of the underlying stock, not necessarily what the grantor and grantee of the option deem to be fair market value. Notice 2005-1 had requested "comments on appropriate techniques for valuation of stock

subject to options or stock appreciation rights where the value of such stock is not established by and in an established securities market, in order to ensure that such valuation reflects the actual fair market value of the stock". The Proposed Regulations look for a consistent and reasonable valuation method and add certainty in this analysis. Certain safe-harbors (e.g., independent appraisal at time of grant) are available. Certain widely-used valuation formulas, such as book-value formulas, that do not necessarily equate to true fair market value, are problematic.

Even in the case where the nonstatutory stock option is a DCA under the new law, the arrangement (like any DCA) may avoid a plan failure and the resulting tax acceleration and penalty. For example, as would frequently be the case with options involving closely-held stock, specifying an exact exercise date, or providing an exercise period that is not more than 2-1/2 months after the year in which the option vests will avoid Section 409A problems.

The Second Prong: is the DCA Subject to a Substantial Risk of Forfeiture?

Substantial Risk of Forfeiture

Having established that the arrangement is a DCA, the second step in the analysis is to determine if the DCA is subject to an SROF. The Section 409A Rules state that the right of the employee to deferred compensation is subject to a substantial risk of forfeiture if the compensation is conditioned on the future performance of substantial services by any individual. This is the same definition of an SROF as is found in Section 83(c)(1) on transfers of property in connection with the performance of services. However, Section 409A authorizes the Treasury Department to issue regulations disregarding an SROF in cases where necessary to carry out the purposes of the Section 409A. Following that lead, Treasury noted in the Proposed Regulations that certain arrangements that could possibly constitute an SROF under the Section 83 regulations (for example, noncompete agreements) would not constitute an SROF for purposes of Section 409A.

Thus, an SROF for Section 409A purposes must be real and substantial. The Proposed Regulations also scrutinize the substantiality of an SROF if the employee owns a significant amount of his or

⁵ Proposed Regulation Section 1.409A-1(b)(5); Notice 2005-1, Q and A-4(d).

her employer. The criteria in the Notice and Proposed Regulations focus on the employee's effective control and dominion over the employer, thus making any purported SROF less likely to be exercised by the employer. Therefore, in the case of a closely-held DCA that is providing a DCA benefit to a controlling shareholder-employee, it should be presumed that any nominal SROF would be ineffective and proceed with the drafting of the DCA in a manner that would preclude a plan failure during its entire existence.

The Third Prong: at the Time the DCA is Not Subject to a Substantial Risk of Forfeiture is there a Plan Failure?

General Plan Failure Rules

Early Distribution. Plan failures under the new rules can take a variety of forms. The first would result from the possibility of an improper early distribution under the DCA. An improper early distribution possibility is present if the plan could pay any benefits prior to: (1) the date of the employee's separation from service during life; (2) the employee's death; (3) the employee's disability; (4) the time specified in the plan for payout; (5) the time of a change in the ownership or effective control of the employer; or (6) the occurrence of an unforeseen emergency. Note that only points (1) and (2) are predicated on the employee's termination of employment. Points (3)-(6) are addressed in the Proposed Regulations in a way that presumes DCA payout irrespective of the employee's actual term of employment.

Separation from service requires permanent cessation of employment. Significant post-termination consulting would preclude a separation from service and leaves of absence do not generally constitute separation from service. Thus, payouts that occur on "retirement" defined as mere term of employment may require amendment (the employee could retire as a common-law employee yet continue to render substantial post-retirement consulting services as an independent contractor).

The DCA may also provide for deferred compensation to be paid to an in-service employee at a time and in a manner specified at the time of deferral. The rules under this scenario are flexible despite the statutory statement on specificity. The specified time and fixed schedule of payments need be objectively determinable as

to the amount and tax year of payment. For example, a DCA that provides that deferred compensation will be made in three annual payments on December 31 following an initial public offering of the employer would satisfy the requirements that the DCA provide for payments at specified times pursuant to a fixed schedule.

To the extent that an unamended pre-Section 409A DCA allows for a payout irrespective of the employee's separation from service on change in control of the entity, it is likely that the change in control definition will have to be modified by amendment to comply with the rather unique Section 409A definition of change in control.⁶

Similarly, if a disability payout will occur irrespective of separation from service, the required definition under Section 409A will be needed. A disability is defined under Section 409A as a mental or physical impairment qualified for Social Security disability payments, or a disability that is expected to last for more than a year and (1) one that prevents the employee from engaging in substantial gainful activity, or (2) for which the employee is receiving disability income benefits under an employer disability plan for at least three months.⁷

An unforeseen emergency is a severe financial hardship to the participating employee resulting from an illness or accident to the participant, the participant's spouse, or a dependent of the participant not compensated or reimbursed through insurance or otherwise. An unforeseen emergency also includes a loss of the participant's property due to casualty or a similar extraordinary and unforeseeable circumstance.⁸

The legislative history notes that the DCA could allow participants different forms of payment (as long as objectively ascertainable) for different permissible distribution events. The DCA could provide, for example, that the employee would receive a lump-sum distribution upon a Section 409A defined disability, but receive an annuity stream upon separation from service.⁹ Thus, a DCA benefit payout on separation from service for any reason must provide the same payout

⁶ Section 409A(a)(2)(A)(v).

⁷ Section 409A(a)(2)(A)(ii).

⁸ Section 409A(a)(2)(A)(vi).

⁹ House Report 108-755 at 733.

amount at the same time regardless of whether separation from service is due to retirement or disability or change in control. If, however, the parties want to provide a different benefit on disability or change in control, or if the employer wants to provide a DCA payout on disability or change in control irrespective of separation from service, the plan would have to segregate that benefit from the separation from service scenario with the triggering event conforming to the Section 409A definitions of those terms.

Lastly, it was fairly common pre-Section 409A that a deferred compensation agreement would give the employer a unilateral right to change the form of deferred compensation payments. For example, the employer, in its sole discretion, might have had a right to make a discounted lump-sum payment in lieu of monthly payments to be made for 20 years. Such a provision post-Section 409A would violate the requirement that the amount and time of DCA payments be objectively determinable at the time of deferral.

Subsequent deferral. A plan failure also includes an ability to again defer payments due to be made under the terms of the DCA. The plan may permit subsequent elections to delay or change the form of payments if the new election cannot take effect until at least 12 months after it is made. Also, an election to further defer a distribution due to be made after the participant's separation from service, upon a predetermined date or schedule or upon a change in ownership of the employer, must defer the delayed payment for at least an additional five years.¹⁰

Initial deferral election for Elective DCAs. Another major category of plan failure relates to the initial deferral election for elective DCAs (in which the deferral decision is initiated by the employee). Let's first distinguish elective from nonelective DCAs.

There are two broad structural categories of DCAs: elective and nonelective. An elective DCA is one under which the employee opts to receive less salary and/or bonus compensation than he or she would otherwise currently receive and to defer receipt of the reduced amount to a future tax year. The point here is that the initiative behind the deferral comes from the employee. Because the employee is initiating the deferral of compensation that he or she would otherwise shortly earn and receive, it would be

inappropriate to impose an SROF on the deferred compensation. Therefore, an elective deferral would normally be fully vested from its inception.

Nonelective deferred compensation is a different scenario. It is not unusual for employers to provide a deferred compensation benefit as a fringe benefit to key employees. It does not result in a reduction in their salary and bonus compensation otherwise payable. Rather, the nonelective arrangement is typically in the nature of an add-on benefit. This is the so-called "velvet handcuff" mechanism for retaining key employees, and usually incorporates within the arrangement an SROF requiring a number of years of service before the benefits become nonforfeitable.

Elective deferrals must specify the time and form of payment on deferral. Additionally, Section 409A requires that a participant's elective deferral is effective only if it is made before the tax year in which the deferred compensation will be earned (e.g., a salary reduction agreement entered into on or before December 31, 2006, to defer 10% of compensation that would otherwise be earned and payable in the 2007 calendar year). If the electively deferred compensation is based on performance criteria or services performed over a period of at least 12 months (e.g., bonus compensation based on a fiscal year net profit increase), the election must be made no later than six months before the end of the measurement period. With regard to a new participant (for example, a new officer hired mid-year), the election must be made within 30 days after the date the new participant becomes eligible to participate in the DCA and initiate deferrals for the remainder of that year. A deferral election as to future compensation that remains in place unless the employee changes the election (an evergreen election) is generally permissible.

A nonelective DCA does not have to contend with the specific timing rules just noted, but the underlying contract must be entered into before the deferred compensation is earned and the amounts and timing of the deferred compensation payout must be objectively determinable.

Funding arrangements. Long before the advent of Section 409A, formally funding a nonqualified deferred compensation obligation accelerated the taxable event to the participating employee. To the extent that the participant had a vested, nonforfeitable interest in any trusteed or escrowed money (a "secular" trust) to be used to

¹⁰ Section 409A(a)(4)(C).

satisfy DCA payments, taxation on the deferred compensation was, and is, accelerated under Section 83.

An important and frequently used device to somewhat enhance the likelihood that deferred compensation will be paid without accelerating the taxable event is through "informal" funding of the obligation in a rabbi trust. In a rabbi trust, the employer contributes money to a trust to satisfy the deferred compensation obligations. Yet that wealth remains subject to the employer's general and secured creditors in the event of legal insolvency or bankruptcy. Because of this contingency in a rabbi trust, the IRS has long acknowledged that employee taxation is not accelerated.¹¹

The new law does not change this result except in the rarest situations. Under the Section 409A Rules, employee taxation through the use of a rabbi trust is accelerated only if the trust is an off shore trust (thus providing a practical impediment to employer creditors reaching the trust assets) or if it is a "springing" arrangement under which a pre-existing rabbi trust would contractually flip to secular trust status (or would be first funded) upon a negative change in the employer's financial health short of legal insolvency or bankruptcy.¹²

CONCLUSION

It is incumbent upon the closely-held employer to scrutinize any arrangement (regardless of how labeled) for deferrals of income beyond the year in which earned by the benefited employee. To the extent that such deferrals are not specifically excepted from the Section 409A Rules (short-term deferrals, welfare benefit plans, certain involuntary severance pay arrangements), it is likely that such arrangements are subject to Section 409A. Hopefully, few amendments will be required before 2008 to address the Section 409A issues in the traditional nonqualified deferred compensation arrangement. The adviser must additionally explore for such deferrals in other contractual arrangements to assure that deferred bonuses, rights to purchase equity in the employer, severance pay and other deferrals are contractually accounted for under Section 409A.

¹¹ Rev. Proc. 92-64, 1992-2 C.B. 422.

¹² Section 409A(b).

NEW SUPERFUND REGULATIONS EFFECTIVE NOVEMBER 1, 2006

by Marsha L. Collett

The Comprehensive Environmental Response, Compensation and Recovery Act ("CERCLA"), more commonly known as the "Superfund Act", imposes responsibility for clean-up of hazardous substances upon owners of contaminated real estate. An owner may be held responsible for costs of clean-up even if the owner had *nothing* to do with causing the contamination, and even if the owner does not know about the contamination.

An important defense to an owner's liability under CERCLA is known as the "innocent landowner" defense. An owner who can establish that he is an "innocent landowner" will not be held responsible for clean-up.

Under CERCLA, an "innocent landowner" is a person who undertook "all appropriate inquiries" upon acquisition of real estate to determine if it was contaminated. The meaning of the term "all appropriate inquiries" has evolved over the last several years. Recently, a procedure known as the ASTM E1527-00 Standard for Phase I Environmental Site Assessments was followed by those seeking to become "innocent landowners".¹³

Under a 2002 Congressional mandate, however, new regulations recently were enacted by the United States Environmental Protection Agency ("EPA") that define "all appropriate inquiries".¹⁴ Now, in order to qualify for the "innocent landowner" defense, an owner, prior to acquisition of property, must undertake "all appropriate inquiries" into prior ownership and uses of the property in accordance with the new regulations,¹⁵ which became effective November 1, 2006.

¹³ The term "ASTM" means American Society for Testing and Materials.

¹⁴ There is a revised standard, ASTM E1527-05, that is consistent with the final EPA regulations regarding "all appropriate inquiries".

¹⁵ Owners receiving grants under EPA's Brownfields grant program, designed to allow development of contaminated locations, must conduct characterizations and assessments in compliance with the new "all appropriate inquiries" regulations.

The final regulations require that a report be prepared documenting results of the owner's "all appropriate inquiries". The regulations do not specify the structure, format or length of the report. However, it must be prepared by a "qualified professional". A "qualified professional" is an individual who, in the eyes of the EPA, possesses specific information, training and experience necessary to spot conditions indicative of potential releases of hazardous substances. Specifically, a "qualified professional" must have a state-issued certification or license and three years of relevant full-time work experience or a baccalaureate degree or higher in science or engineering and five years of relevant full-time work experience or ten years of relevant full-time work experience. Relevant experience means participation in environmental analyses, investigations and remediation.

In the report, the "qualified professional" must make two declarations: first, that he is a "qualified professional"; and second, that "all appropriate inquiries" were carried out in accordance with the requirements of the final regulations.

The regulations require that, as part of his "all appropriate inquiries", the "qualified professional" must interview persons, such as current and past facility managers, past owners, operators or occupants of real estate, and employees of the same to inquire about current and past uses of the real estate. The "qualified professional" also is required to review all commonly known and reasonably ascertainable information about the real estate. A review of government records, and information obtained (if reasonable to do so) from newspapers, local governmental officials, community organizations and websites should be reviewed.

Information obtained and included in the report must include current and past uses of the real estate, current and past uses of hazardous substances, waste management activities, engineering controls, institutional controls, and information about nearby real estate. Environmental clean-up liens must be searched and reported upon. The "qualified professional" also must examine historical sources, such as aerial photographs, fire insurance maps, building department records, chain of title documents and land use records regarding the property. It is up to the "qualified professional" to decide how far back in the records that he should examine.

In the report, the "qualified professional" must identify data gaps that remain after the conduct of all required investigations. In the report, he must identify the source of information consulted to address data gaps and comment on the significance of the data gaps with regard to his ability to identify conditions indicative of contamination. For example, if the "qualified professional" cannot obtain access to the real estate, he must document efforts to gain access, as well as his use of other sources of information to determine the existence of potential contamination. He also must express an opinion about the significance of his failure to conduct an on-site visual inspection.

In conducting the review of the real estate, the "qualified professional" must consider the relationship between the purchase price and fair market value of the real estate if it were not contaminated, and consult with the prospective owner as to whether or not the difference in purchase price and fair market value is due to the actual or potential presence of contamination. If the prospective owner does not comment upon this information, the "qualified professional", in the report, must treat the lack of information as a data gap and comment on whether the data gap may impact his ability to identify conditions indicative of environmental contamination.

Regarding the use of prior environmental assessments in preparation of the report, outdated or possibly stale information may not be relied upon by an owner seeking to qualify as an "innocent landowner". In general, information in a prior Phase 1 environmental assessment report may be used if the investigation was completed less than 180 days prior to the date that the owner acquires the real estate.

"All appropriate inquiries" must be conducted within one (1) year prior to the acquisition of his property. However, certain components of such inquiries must be conducted or updated within 180 days prior to acquisition of the real estate. These components include interviews with past and present owners, operators and occupants, searches for reported environmental clean-up liens, reviews of state and local governmental records, visual inspections of the property, as well as the declaration of the "qualified professional".

To summarize, if a potential owner of real estate wants to attempt to qualify as an "innocent landowner" under the new "all appropriate inquiries" regulations, it is imperative that he

retain a "qualified professional" and thoroughly check the professional's credentials and experience. The report prepared by the "qualified professional" also must contain all information required by the EPA regulations.

ROTH IRA CONVERSION UNDER THE TAX INCREASE PREVENTION AND RECONCILIATION ACT

by Richard A. Naegele

The Tax Increase Prevention and Reconciliation Act of 2005 ("TIPRA") amends Internal Revenue Code §408A to eliminate the requirement that a taxpayer's gross income not exceed \$100,000.00 in order to be eligible to convert a non-Roth IRA into a Roth IRA. This change is effective for tax years beginning after December 31, 2009. Additionally, TIPRA amends Internal Revenue Code §408A to provide a two-year ratable income option for taxpayers who elect Roth IRA conversions in 2010. Under this rule, the amount of the conversion that must be included in gross income is recognized in two equal installments in 2011 and 2012. Taxpayers who are subject to this two-year ratable income rule would incur no taxation in the year of conversion (i.e. 2010). A taxpayer may elect not to have the two-year ratable income rule apply and include the entire taxable amount in income in 2010.

Contributions to a traditional IRA may or may not be deductible. The extent to which contributions to a traditional IRA are deductible depends on (1) whether or not the individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan and (2) the taxpayer's adjusted gross income ("AGI"). An individual may deduct his or her contributions to a traditional IRA if neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan. If an individual is an active participant in an employer-sponsored retirement plan, the deduction is phased out for taxpayers with AGI over certain levels. In 2006, for single tax filers with an employer-sponsored retirement plan, an IRA contribution is fully-tax deductible if AGI is below \$50,000.00. It is then pro-rated between \$50,000.00 and \$60,000.00. If AGI is over \$60,000.00 for an individual and the individual participates in an employer-sponsored retirement plan there is no tax deduction. For married couples, the same rules apply except the deduction is phased out between \$75,000.00 and \$80,000.00 (and increased to \$80,000.00 to

\$100,000.00 in 2007). If an individual is not an active participant but the individual is married to an active participant, the deduction for an IRA for such individual is phased out for AGI between \$150,000 and \$160,000. To the extent an individual does not or cannot make deductible contributions, the individual may make non-deductible contributions to a traditional IRA, subject to the maximum contribution limits.

A stand alone nondeductible IRA — or an IRA that has been funded with both deductible and nondeductible contributions — may be converted to a Roth IRA. Only the portion of the IRA in excess of the individual's nondeductible contribution is included in income as a result of such conversion.

The IRA deductible contribution limit for 2005 through 2007 is \$4,000.00 and is \$5,000.00 for 2008. Additionally, in 2006 and 2007, individuals 50 or older may make an additional catch-up contribution of \$1,000.00 for each year.

GIFTS OF RETIREMENT PLAN ASSETS TO CHARITY – NEW OPPORTUNITIES UNDER THE PENSION PROTECTION ACT OF 2006

by Rennie C. Rutman

On August 17, 2006 President Bush signed the Pension Protection Act of 2006. One section of this Act encourages taxpayers to make charitable gifts directly from their IRAs by providing donors with a host of tax advantages.

I. The Pension and Protection Act of 2006

One provision of the Act, effective immediately, provides an exclusion from gross income for otherwise taxable IRA distributions of up to \$100,000 from traditional IRAs for "*qualified charitable distributions*" made during 2006 and 2007 by plan owners who are at least 70-1/2 years old on the date of the gift. In addition, the qualified charitable distributions will apply towards any required minimum distribution.

II. Qualified Charitable Distributions, Defined

Qualified charitable distributions may be made from traditional IRAs and Roth IRAs, but not from 401(k)s, 403(b)s, SEP-IRAs or SIMPLE IRAs. The gift must be made no earlier than the

day on which the plan owner attains age 70-1/2. The transfer must be made directly from the plan custodian; the transfer cannot be made from the plan owner. Distributions to charitable organizations which are commonly thought of as "public charities" (e.g. the American Cancer Society, the Red Cross) qualify but distributions to private foundations generally do not qualify. Finally, the charitable contribution must be one which would otherwise satisfy all requirements for deductibility, including the requirement that the gift be adequately substantiated, but excluding the requirement (discussed below) prohibiting current deductions for contributions in excess of 50% of the taxpayer's contribution base.

III. Effect of Pre-Act Inclusion in Gross Income and Post-Act Exclusion

In general, with certain restrictions, taxpayers can make deductible and nondeductible contributions to their traditional IRAs. Contributions to Roth IRAs are nondeductible.¹⁶ Assuming that the contributions to an IRA are deductible when made, then they are wholly includible in income when withdrawn. If the contributions (or a part of them) are nondeductible when made, then the nondeductible portion is not includible in income when withdrawn.

A. Background and Summary

Under pre-Act law (and under post-Act law for non-qualified charitable distributions), a distribution from a retirement plan or a traditional IRA is *included* in a taxpayer's gross income. Assuming the distributed amount is then gifted to charity, the taxpayer may receive an income tax deduction for that gifted amount. However, due to

¹⁶ In the case of withdrawal from a Roth IRA that is "not qualified", there is hierarchy that is utilized in order to determine the portion of the distribution which is deemed to be attributable to earnings, contributions and distributions. Specifically, the following are deemed distributed as part of the withdrawal, in the following order: (1) regular Roth IRA contributions; (2) taxable conversion contribution – which refer to conversion of amounts in a traditional IRA to a Roth IRA; (3) non taxable conversion contribution; and (4) earnings. In determining the amount of taxable distributions from a Roth IRA, all Roth IRA distributions in the same taxable year are treated as a single distribution, all regular Roth IRA contributions for a year are treated as a single contribution, and all conversion contributions during the year are treated as a single contribution.

certain restrictions in the Internal Revenue Code discussed below, the amount of the gift is not, as a practical matter, always truly *deductible* in that it may not be one which will reduce the taxpayer's total tax liability. However, under the Act, if the gift is a qualified charitable distribution, it is wholly excludible from gross income (up to \$100,000 per taxpayer per year) irrespective of the restrictions alluded to above.

In addition, under pre-Act law (and under post-Act law for non-qualified charitable distributions) the increase in the taxpayer's reportable gross income by the amount of the IRA distribution to the plan owner may engender several potentially negative tax consequences that may not be offset by the deduction even if the gift is currently deductible. However, since the Act *excludes* the qualified charitable distribution from the computation of the taxpayer's gross income, those negative tax consequences are avoided as first listed and further detailed below:

1. No Requirement of Itemization — taxpayers who do not itemize their deductions may make a qualified charitable distribution.
2. State Income Tax Benefits — Ohio does not provide a state income tax charitable deduction for a gift to charity, but by excluding the IRA distribution amount from adjusted gross income (the Ohio income tax base), Ohio residents will now, in effect, receive a state law charitable deduction for the qualified charitable distribution.
3. No Interference with Other Income Sensitive Tax Benefits - the qualified charitable distribution will not interfere with the taxpayer's ability to take other income sensitive deductions or qualify for lower tax rates for certain types of income, such as Social Security benefits.

1. Itemization

Under pre-Act law (and under post-Act law for non qualified distributions), the charitable deduction is only available for those who itemize their deductions. Thus, even if all of the requirements for deductibility are met (e.g. substantiation, appropriate recipient organization, etc.), if the standard deduction is higher than the combined total of all itemized deductions, the taxpayer receives no tax savings due to the gift

for charity. Senior citizens, who likely have no home mortgage financing interest (a major itemized deduction for younger taxpayers), generally elect the standard deduction in lieu of itemization. Thus, the inclusion in gross income of the distribution from the IRA triggers income tax with no corresponding deduction.

Under the Act, a qualified charitable distribution is excluded from gross income and thus no itemization is required in order to offset the distribution. A taxpayer who makes a qualified charitable distribution may take her standard deduction and still effectively receive a deduction for the qualified charitable distribution.

2. Denial of State Income Tax Deduction

The State of Ohio does not provide a state income tax deduction for charitable contributions. Thus, if a taxpayer receives an IRA distribution and then gifts the amount distributed to charity, the initial inclusion in gross income of the distribution amount increases his state income tax base and the resulting tax liability and there is no deduction available. Therefore, Ohio residents ultimately pay state income tax on amounts gifted to charity.

Under the Act, a qualified charitable distribution is entirely excluded from gross income and thus does not affect the tax base of Ohio residents. This effectively creates a state law charitable deduction for the qualified charitable distribution.

3. Interference with Other Deductions and Exemptions and Favorable Tax rates

In addition to the "50% Limitation" discussed below, there is a host of restrictions relevant to most itemized deductions, including, but not limited to charitable deductions, which causes the deductions to be phased out for taxpayers whose total income exceeds certain amounts. Thus, if the distribution from the IRA is deemed to be included in the taxpayer's income (as it is under pre-Act law and is under post-Act law for non-qualified distributions), the taxpayer may have to sacrifice other deductions and exemptions and credits which may be phased out or eliminated due to his increased gross income.

Similarly, due to the exclusion of the distribution from gross income, provisions of the Internal Revenue Code which require that certain other

items of income be taxed at higher rates if total gross income exceeds certain levels are not triggered. The most significant example to those age 70-1/2 is the rule on the taxation of Social Security benefits which requires that when a taxpayer's income exceeds a certain amount, his benefits become taxable.

IV. Two Other Critical Changes – Disregard for Purposes of the 50% Limitation and Favorable Treatment of Non-Deductible Contributions

A. The "50% Limitation"

In addition to the exclusion of a qualified charitable distribution from gross income, the Act eliminates a restriction, often referred to as the "50% Limitation", relevant to the deductibility of qualified charitable distributions, and this change favorably impacts the deductibility of even non-qualified charitable distributions.

Specifically, the amount of a charitable deduction available to a taxpayer for her donation to public charities is currently "limited" in that it may not exceed 50 percent of the taxpayer's contribution base. A taxpayer's contribution base is her adjusted gross income for the year computed without regard to any net operating loss carrybacks to the taxable year.

Under the Act, a qualified charitable distribution does not factor into the equation when determining if the total amount gifted by the taxpayer for the taxable year exceeds 50% of the taxpayer's contribution base.

Under the Act, the only limitation on the excludable amount of the qualified charitable distribution is that it not exceed \$100,000 per taxpayer per year. The taxpayer's contribution base is irrelevant. The effect of the elimination of this restriction is two-fold.

First, this permits a greater tax benefit for a gift of IRA assets than might have been available under pre-Act law for those with more modest contribution bases/adjusted gross incomes. For

example¹⁷, if a taxpayer had a contribution base of \$20,000 and then received an IRA distribution of \$90,000, her contribution base would be \$110,000. If she made a donation of the entire \$90,000 IRA distribution, under pre-Act law only \$55,000 would be deductible this year, since the deduction is limited to 50% of the taxpayer's contribution base. Under the Act, if the \$90,000 distribution is a qualified distribution, it is effectively entirely "deductible" this year in that the distribution is not included in income in the first place and, therefore, need not be washed out with a corresponding deduction.

Second, the inapplicability of the restriction to a qualified charitable distribution permits taxpayers to receive a deduction for non-qualified gifts in an amount up to 50% of their contribution base. In other words, under pre-Act law a gift of non-IRA assets of an amount equal to 50% of the taxpayer's contribution base *plus* any additional gift of IRA assets would effectively render the IRA gift non-deductible.

For example, assume that a taxpayer age 71, has a single traditional IRA with \$100,000 comprised solely of deductible contributions. Assume that he donates the entire IRA to the American Cancer Society, and he also donates another \$25,000 from a non-retirement account to the same organization. Assume that he itemizes his deductions. Also assume his contribution base (aka his adjusted gross income) is \$70,000 not including the \$100,000 IRA distribution. Under the pre-Act law, his \$125,000 contribution could be deducted only up to 50% of his contribution base, or up to \$85,000 (which is 50% of \$70,000 adjusted gross income + \$100,000 of the increase in his adjusted gross income due to the IRA distribution). The balance would not be deductible this year. Under the new law, the \$25,000 donation from non-IRA assets is entirely deductible under the "50% of contribution base (adjusted gross income) limitation" since it is less than 50% of his \$70,000 contribution base or \$35,000. The additional \$100,000 *qualified charitable distribution* is not factored into the analysis as it is excluded from gross income. Thus, under the pre-Act law, a total gift of

¹⁷ This example and those which follow cannot identify and address all variables which may be relevant in a particular circumstance. These examples are intended as general illustrations, only. There are many factors and variables not mentioned in this Article and the examples which may alter the effect a qualified charitable distribution may have on a taxpayer's overall tax liability.

\$125,000 generated only a \$85,000 tax deduction in the current year; under the new law, it generated what amounts to a full \$125,000 deduction.

B. Favorable Treatment for Non-Deductible Contributions

In addition, the Act provides favorable treatment for those account holders with deductible and non deductible components of traditional IRAs.

Under pre-Act law (and under post-Act law for non-qualified distributions) when a distribution is taken from a traditional IRA which is comprised of deductible and non-deductible contributions, a portion of each distribution is nontaxable until the total amount of nondeductible contributions has been received. In general, the amount of a distribution that is nontaxable is determined by multiplying the amount of the distribution by the ratio of the remaining nondeductible contributions to the account balance. In making the calculation, all traditional IRAs of an individual are treated as a single IRA, and all distributions during any taxable year are treated as a single distribution. Thus, part of each distribution will be both taxable and non-taxable. Under the new law, a qualified charitable distribution from an IRA is treated as being distributed from "taxable income first", so that the taxpayer can effectively cause the non-deductible (and thus non-taxable) portion of his account to remain available for later distributions.

For example, assume that a taxpayer has a single traditional IRA with a balance of \$100,000, consisting of \$30,000 of nondeductible contributions and \$70,000 of deductible contributions. He distributes \$70,000 to the Salvation Army. Under pre-Act law, a portion of that distribution would be treated as a non-taxable return of non deductible contributions. The nontaxable portion of the distribution would be \$21,000, determined by multiplying the amount of the distribution (\$70,000) by the ratio of the nondeductible contributions to the account balance (\$30,000/\$100,000). Accordingly, under present law, \$49,000 of the distribution (\$70,000 minus \$21,000) would be includible in his income.

Under the new law, the distribution is treated as consisting of income first, up to the total amount that would be includible in gross income (but for the Act), or \$70,000. Accordingly, under this provision, the entire \$70,000 distributed to the

charitable organization is accounted for first and is a qualified charitable distribution. Thus, none of it is includible in the taxpayer's gross income. In addition, for purposes of determining the tax treatment of later distributions from the IRA, the \$30,000 remaining in the IRA is treated as comprised solely of nondeductible contributions that will not be taxed when withdrawn.

In addition, all IRAs are aggregated when determining how much of the gifted IRA is deemed to consist of taxable income. Thus, for example, if an IRA owner has two separate IRAs, each worth \$100,000 and each consisting of \$50,000 of deductible contributions and \$50,000 of non-deductible contributions, the taxpayer can make a qualified charitable distribution of either one of the IRAs and the entire distributed IRA is deemed to cannibalize the taxpayer's deductible contributions. Thus, assuming that there is no subsequent increase in the amount of income inside the remaining IRA, the taxpayer could take a distribution of that entire IRA and all amounts distributed would be non-taxable to him.

V. Conclusion

The Pension Protection Act of 2006 eliminates several of the negative tax effects engendered by gifts of retirement plan assets to charity and provides an opportunity for taxpayers to increase their total tax-effective gifts. Coupled with the provisions which provide tax favorable treatment of otherwise non-deductible contributions to retirement plans, the Act could provide substantial tax savings to charitable minded taxpayers. However, unless additional legislation extends the incentive, it will be a brief window of opportunity for gifts made from January 1, 2006 through December 31, 2007.

RESIDENTIAL RENTAL PROPERTY — RECENTLY ENACTED LAW

by Todd A. Schrader

Effective September 28, 2006, the State of Ohio adopted new legislation that requires residential rental property owners to file certain information with the local county auditor (in the county where the residential rental property is located), which information must be supplied relating to the residential rental of properties, including mobile home parks.

The information to be registered includes the property address, permanent parcel number, the

year in which the property was built and the owner's name, address and telephone number. The owner is then required to update the information within ten days after any change. Failure to comply with the new law is a minor misdemeanor.

In some cases, a residential rental property form required by Ohio law may be downloaded directly from the local auditor's website or you may call the county auditor's office where the residential rental property is located.

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