A TAX ATTORNEY'S TOOLBOX

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This outline should be viewed only as a summary of the law and not as a substitute for tax or legal consultation in a particular case. Your comments and questions are always welcome.

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1. S vs. C vs. LLC – Which is best?

- An LLC is usually best, if it can be used.
  - ⇨ C corps are subject to a double tax when the business is sold.
  - ⇨ If an S corp fails the eligibility requirements, it becomes a C corp.
  - ⇨ LLCs will never inadvertently become subject to the double tax
- However, LLCs don't go public, but corporations do.
- LLCs cannot conduct in California activities that require a license under the Business and Professions Code.
  - ⇨ Contractors can use LLCs, but shouldn't.[1]
- Incorporating is all about minimizing exposure to "strict" (or "no fault") liability and maximizing transferability. It has not been about saving taxes since 1986.
- A single-member LLC is the ideal *subsidiary*
  - ⇨ No consolidated return rules

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[1] See my bulletin *Choice of Entity Developments for California Engineers, Land Surveyors and Contractors* at http://www.staleylaw.com/images/Choice_update_2010_-_18522.pdf.

- ⇨ A QSub of an S corp can trigger tax when it ceases to be 100% owned by the S corp – a trap from which it is not possible to protect your client completely

- ⇨ Nonprofits should consider conducting in SMLLCs their most liability-prone activities that are *related* to their tax-exempt purposes – and holding their endowments in separate supporting organizations.[2]

  - ▪ For *profit-making businesses* that are *not* related to the their tax-exempt purposes, tax-exempt non-profits should using a C corporation subsidiary with different directors and officers. This avoids a threat to the tax-exempt status.

2. Stock buy-backs: Entity purchase vs. cross-purchase -- which is best for C and S corps?

- Entity purchase is more simple. Sometimes, that's most important.

- But entity purchase "wastes basis" for a C corporation.

  - ⇨ When the corporation buys out Shareholder 1, Shareholders 2 and 3 do not increase their tax basis in their shares.

  - ⇨ So when a share transaction happens *later*, S2 and S3 have less basis and more taxable gain.

  - ⇨ If instead S2 and S3 had bought the shares of S1, they would have more basis in their shares for the *later* transaction. Also, they could give the high-basis shares to their kids, who take a carry-over basis in the gifted shares.

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[2] See my bulletin *Charities Can Now Use Limited Liability Companies to Accept Dubious Assets* at http://www.staleylaw.com/images/SMLLCs_of_Charities_-_19728.pdf.

- The life insurance proceeds received by a C corporation (for example, to fund a buy-sell agreement) creates AMT. The receipt of the proceeds by individual shareholders doesn't trigger AMT.

- When the stock buy-back is funded by life insurance, cross purchase is also better for an S corp.

  ⇨ When the S corporation pays life insurance premiums, the shareholders tax basis in their shares is reduced.

  ⇨ The deceased shareholder's heirs get a basis step up to the FMV at the date of death (DOD).

  ⇨ Then they get a share of the stock basis increase from the receipt of the policy proceeds.

  ⇨ They sell for the DOD FMV – and have a capital loss that *they can't use*. But the *other* shareholders could have used the full basis increase from the S corp's receipt of the proceeds.

3. **Stock records – What you (and your assistant) must know**

- Who can vote to elect directors or amend the Articles of Incorporation? Who can make gifts of shares? Who gets dividends? Who gets a K-1? Who gets the proceeds from the sale of the business?

  ⇨ It's not a matter of reaching a consensus or what the Schedule k-1 or the Form 709 says –it's what the stock records say that counts.

  ⇨ Especially when a shareholder (or a former shareholder who still has a stock certificate) dies.

- When a legend is no longer needed (for example the shares are no longer pledged), issue a new certificate without the legend.

- Don’t sign the back of the certificate. Use a Stock Assignment Separate from Certificate. You don’t need a Wolcott form.

- The receipt-stub is very important. Always complete it, have the issuee sign it and immediately return it to the stock book.

  - ⇨ Were the shares an “ORIGINAL ISSUANCE” or were they transferred from another shareholder?

    - ▪ If transferred, show the old certificate number and the number of shares transferred.

  - ⇨ Show the date of the stock issuance or transfer.

  - ⇨ With this info and the cancelled certificates, anyone can create a share register to determine who owns what now.

- A stock purchase or redemption agreement is not enough. The seller must also sign the stock assignment separate from certificate. Otherwise, it is like selling a car without signing the pink slip. *There is no title insurance for stock ownership!*

4. **Living trusts and S corps – Threats to S corp status**

- A **living** trust that is a grantor trust (because it is revocable by the settlors) can hold S corporation shares.

- A **survivor’s** trust that is a grantor trust (because the survivor can revoke it) can hold shares of an S corp. But . . .

- A **QTIP** trust *cannot* hold S corporation shares, *unless* the *beneficiary* makes an election to treat the QTIP trust as a QSST.

  - ⇨ The QSST election must be made not more than 2 years after the S corporation stock is transferred to the QTIP trust. *Don’t wait that long.*

- The **credit shelter** trust *cannot* hold S corporation shares, *unless* the *trustee* makes an election to treat the trust as an ESBuT.

  ⇨ The ESBuT election must be made not more than 2 years after the S corporation stock is transferred to the trust. *Don't wait that long.*

- A child or grandchild who is a **nonresident alien** cannot hold S corporation shares and cannot be the current beneficiary of a QSST or ESBuT.

  ⇨ The trust instrument should give the trustee the power to allocate something else (even a promissory note from another trust) to this beneficiary, to preserve the S corporation status.

  ⇨ The trust instrument needs a general instruction to the trustee to preserve the S corporation status.

- A **foreign trust** can never hold S corporation stock.

- A **single-member LLC** owned by an eligible shareholder can hold S corporation stock – but it is too dangerous, so don't.

5. **Living trusts when there are multiple shareholders – what the trust should say**

- Shareholders know they must put up with each other

- The spouse who is involved in the company has a right to manage the shares and the other spouse does not have that right.

- S1 does not want the spouses of S2, S3 and S4 to be become voting shareholders, at least not while S2, S3 and S4 are alive. Only S1, S2, S3 and S4 are named on their stock certificates, not their spouses. They have no buy-sell agreement.

- The estate planning attorney sits down with S2 and Sp2. Both are clients. The shares are community property of S2 and Sp2.

  ⇨ The attorney prepares a trust for S2 and Sp2. S2 and Sp2 are co-trustees. They must act by unanimous consent.

  ⇨ The attorney tells S2 and Sp2 to put their shares in the trust. They do, in the names of S2 and Sp2, as co-trustees. *Sp2 just became a voting shareholder.*

  ⇨ S2 votes the shares one way and Sp2 votes the shares the other way. Their votes were not unanimous, so they don't count.

  ⇨ S1 and S2 are allies. By voting together they can keep S3 and S4 from taking control of the company. When S2's vote is cancelled, S3 and S4 take over the Board of Directors. S1's vote can't stop them.

- There are at least four ways to address this issue:

  ⇨ 4th Best – A **sentence in the trust instrument** saying that each trustee will vote the shares of the business in which he or she is involved and the other trustee will vote the same way. It is unlikely that the corporate secretary will be able to rely on this sentence to ignore the vote of one of the trustees.

  ⇨ 3d Best – The living trust includes a **special trust** of which only S2 is the trustee. S2 holds the community property shares in this special trust. Takes time to discuss and draft. Is revocable.

  ⇨ 2d Best – Sp2 give S2 a revocable **proxy** to vote the shares. Easy and quick to discuss and draft. But it's revocable.

- ⇨ Best – Address this in a **buy-sell agreement** that is also a voting agreement. Sp2's proxy becomes *irrevocable*. Takes time to discuss and draft.

6. **Professional corp vs. LLP – Which is best?**

- It's not even a close call. If the LLP is available, use it.

  - ⇨ The LLP can be used in California by attorneys, accountants, architects, land surveyors and civil engineers (until 12-31-15 for the last three). None of them can use LLCs in California.

  - ⇨ The LLP provides to the partners protection from partnership liabilities, but for tax purposes it is a partnership.

    - ▪ The LLP does not protect partners from their own negligence or other wrongful acts.

  - ⇨ A group of attorneys, accountants, architects, land surveyors or civil engineers practicing as general partners *should immediately* become an LLP – unless they cannot get the E&O insurance required for an LLP.

- The **professional corp** is best for a sole practitioner who is concerned that liabilities from actions of the practitioner's *employees* will trigger liabilities that exceed insurance coverage.

  - ⇨ The **sole practitioner** without employees should not incorporate.

  - ⇨ If a practitioner with a PC joins an LLP, the PC might need to become the partner. Otherwise, the practitioner might have a deemed taxable distribution of goodwill and receivables from the PC, possibly triggering extra income taxes.

7. **S corp distributions –Things you need to know (to avoid piercing the corporate veil and to protect the S corporation status)**

- The Board of Directors should approve in advance each and every dividend -- even tax-free S corporation distributions that the shareholders will use to pay their estimated income tax on the S corporation income.

- The distributions should *not* be declared or paid more frequently than quarterly (or paid biweekly as a substitute for payroll).

- Before each distribution, the board should determine that the distribution will not drive the corporation into negative retained earnings. That would violate Chapter 5 of the Corporations Code and allow creditors to get the $ back from the shareholders -- or from the directors who approved the illegal distribution.

  - ⇨ If the distribution would create negative retained earnings, there is an alternate test. The assets must exceed the liabilities immediately after the distribution. The assets can be valued at GAAP values or at appraised values. This allows assets to be contributed at the same time as the distribution is made (even though the contribution would increase paid-in capital and not retained earnings, which might be negative after the contribution).

  - ⇨ This is usually not a problem for S corps when the CPA is careful to avoid distributing (taxable) C corporation earnings.

  - ⇨ This *is* usually a concern when **redeeming shares**, especially from thinly capitalized S corporations.

    - ▪ It can also be a problem in a tax-free spin-off, when the Distributing corporation distributes shares of the Controlled corporation to the shareholders of Distributing.

    - The test is sometimes applied when the payment is made and sometimes when the distribution is declared.

- Dividends should be expressed in terms of *dollars per share*. A *record date* (which must not precede the board meeting) and a *payment date* (which can be "ASAP") should be set.

  ⇨ If shares change hands on January 1, 2013, the S corporation cannot on March 15, 2013 distribute to the shareholders as of December 31, 2012 the exact right amount to pay their 2012 taxes on the S corporation income.

    - The IRS says this is OK in the one-class-of-stock regulations. But corporate law does not allow it.

    - The buyer and seller of the shares can agree to direct the corporation to pay the March, 2013 dividend to the seller, in which case it probably would be treated as paid from the corporation to the buyer and then from the buyer to the seller as additional purchase price.

8. Dissolving an S corp after a sale or a death – the right way and the wrong way

- At the death of an S corporation shareholder, the heir's outside basis in their shares will adjust to the DOD FMV, but the inside basis in the assets will not change.

- If the heirs sell the inside assets and dissolve the S corporation there will be inside gain on the sale of the assets. The inside gain will flow to the shareholder/heirs. Their basis in their shares will increase – above the FMV of the shares.

  ⇨ If the corp does *not* distribute the sale proceeds in the year of the sale, the shareholders *will pay tax on the inside gain* from the sale of the inside assets. When the corporation

later liquidates and distributes the sale proceeds, the shareholders will have an *outside capital loss*. They will *not* be able to carry the outside capital loss back to offset the inside capital gain. *Ouch!*

⇨ If the corp *does* distribute the sale proceeds in the year of the sale, the shareholders *will have inside gain* from the sale of the inside assets. When the corporation liquidates and distributes the sale proceeds in the same year, the shareholders will have *outside capital loss*. They can use the outside capital loss to *offset* the inside capital gain. *No tax on the sale. No tax on the distribution of the sale proceeds. Everything is beautiful.*

- If, instead of selling the inside assets, the corporation distributes them to shareholders, there cannot be a capital loss problem, because the inside gain and the outside capital loss are generated by the same event – the distribution of the assets.

- It's a good idea to file Form 966 to tell the IRS that the next distributions will be liquidating distributions, taxed as a deemed sale of the shares.

9. When to use a holding company – and what kind of entities to use

- Successful Business-1 is in Entity-1. Founder has a new idea for a business (Business-2), or appreciated real estate, or art, or a jet -- or all of the above.

⇨ If it all stays in Entity-1, then a claim arising from the conduct of Business-2 can be satisfied with the assets of Business-1. Or the equity in the real estate. Or the art or jet.

⇨ A claim against Business-1 can be satisfied with the assets of Business-2.

- If Business-2 is moved to a subsidiary (Entity-2) of Entity-1, then a claim arising in Business-2 cannot be satisfied with the assets of Business-1. But ... a claim against Business-1 can be satisfied with the stock of Entity-2, which owns Business-2.

- If a holding company (HC) is created, it would own the stock of Entity-1, which would retain Business-1. HC would create Entities -2, -3 and -4, as necessary. All of the stock of each entity would be owned by HC. HC would not engage in any other activity. Entity-2 would own Business-2. Entity-3 would own the real estate. Entity-4 would own the art, etc.

  - ⇨ A claim against Business-1 could be satisfied with the assets of Entity-1 but not any other entity. A claim against Business-2 could be satisfied with the assets of Entity-2 but not any other entity.

  - ⇨ There would be no claims against HC because it would not do anything but hold interests in the other entities.

  - ⇨ The holding company structure can be created without triggering any income or property tax.

- If Entity-1 is an LLC, all of the entities can be LLCs. If Entity-1 is a corporation, then HC is an S corporation, Entity-1 should be a QSub and the other subsidiaries can be LLCs. Consider converting the QSub to a SMLLC.

10. Using S corps to avoid both personal holding company ("PHC") penalties and excess passive receipts penalties

- When a closely-held C corporation holds mostly passive investments, it is subject to a penalty tax that forces the directors to declare dividends. This makes the PHC income subject to the double tax.

- When an S corporation that still has undistributed C corporation earnings has more than 25% passive receipts, it can be subject

to a penalty tax. After three consecutive years of excess passive receipts, the S corporation election is terminated and the corporation becomes a C corporation again.

⇨ The excess passive receipts rule was intended to prevent PHCs from simply electing S corporation status to avoid the PHC penalty tax.

- To avoid the excess passive receipts tax, the S corporation invests in publicly traded LLCs or LPs that distribute natural gas. They have razor-thin gross margins, so each investment dollar buys lots of receipts and not much profit.

  ⇨ Because they are partnerships for tax purposes, the active nature of the receipts flows through to the S corporation.

  ⇨ The S corporation can effectively buy enough active receipts to keep the passive receipts from its own operations below 25% of its total receipts (which will include the active receipts from its share of the gas distribution business.)

  ⇨ So a C corporation with a PHC problem should make the S corporation election and use its cash to manage its passive receipts. No double tax. Not penalty tax. No excess passive receipts problems.

11. Sell stock/buy assets – why?

- Why **sellers** want to **sell stock**, not assets:

  ⇨ Sellers don't need the entity when they sell the business. So they prefer to sell the entity with the business inside it.

  ⇨ When sellers sell assets, some of the capital gain is recharacterized as ordinary income, which is taxed at a higher rate.

- ⇨ When a C corporation sells assets, all of the gain is subject to the double tax. The overall tax rate can be 63%

- ⇨ When an S corporation or an LLC sells assets the effective rate is generally 33% to 39%, but the seller must dispose of the "wrapper" – the corporation or LLC.

  - ▪ If an S corporation sells assets subject to the "built-in gain tax," the effective rate of tax can be higher than 63%.

- Why **buyers** want to **buy assets**, not stock:

  - ⇨ Buyers want to get a new tax basis in the business assets, so that they can amortize the goodwill and start deducting depreciation from the current value (not the seller's historic depreciated value) of the hard assets.

    - ▪ If the seller is an S corporation, a Section 338(h)(10) election can achieve this in a stock sale.

  - ⇨ Buyers want a fresh start, with a brand new entity. They do not want the claims that might arise from pre-sale operation of the entity. They want to tailor the tax elections to their needs, not the seller's.

  - ⇨ Buying target stock and making a QSub election (or doing a Section 332 liquidation of the target/sub) makes the ("outside") basis of the stock disappear. The ("inside") asset basis survives.

12. How to avoid sales tax in an asset sale

- When a seller sells "*tangible* personal property not held for resale," sales tax applies.

- ⇨ When a business is sold in an asset sale, sales tax generally applies to furniture, equipment and vehicles. Some businesses have a lot of equipment.

  - ▪ Sales tax generally does not apply to a business that only sells services and never sells inventory. (This is the "occasional sale" exemption.)

- Shares of stock and LLC interests are *intangible* personal property that are not subject to sales tax.

- Concept: When the business is being groomed for sale, the seller puts the furniture, equipment and vehicles into an LLC.

  - ⇨ If the buyer demands that the seller sell assets, the seller sells receivables, inventory, goodwill – and the LLC interest. The seller does not sell any *tangible* personal property except inventory, which is *held for resale*.

  - ⇨ No sales tax applies.

    - ▪ A "step transaction"? Probably not *if* the LLC is set up and the assets are transferred to it *before* the letter of intent is signed or the buyer otherwise commits to the sale.

  - ⇨ If the seller can get a stock sale, no sales tax applies because the stock is *intangible* personal property.

FOR ADDITIONAL INFORMATION:

1. **S vs. C vs. LLC – Which is best?**

   Choice of Business Entity: Structuring Businesses for the Recovery*

   Limited Liability Companies: An Introduction*

2. **Stock buy-backs: Entity purchase vs. cross-purchase -- which is best for C and S corps?**

   Insured Buy-Sell Agreements: Tax Issues for S and C Corporations *

3. **Stock records – What you (and your assistant) must know**

   Dissolving Business Entities and Corporate Housekeeping*

   Year-End stock Sale Issues*

4. **Living trusts and S corps – Threats to S corp status**

   Choice of Business Entity and Estate Planning*

   Don't Let Living Trust Cause Problems for Owners of Closely-Held Businesses*

5. **Living trusts when there are multiple shareholders – what the trust should say**

   Don't Let Living Trust Cause Problems for Owners of Closely-Held Businesses *

6. **Professional corp vs. LLP – Which is best?**

   Choice of Business Entity: Structuring Businesses for the Recovery*

   LLPS - Registered Limited Liability Partnerships for Accountants, Architects and Attorneys*

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* Available on www.staleylaw.com.

7. **S corp distributions – Two more things that you need to know (to avoid piercing the corporate veil and to protect the S corporation status)**

   S Corporation Distributions: How to Make 'Em and How to Fix 'Em*

8. **Dissolving an S corp after a sale or a death – the right way and the wrong way**

   Dissolving Business Entities and Corporate Housekeeping*

9. **When to use a holding company – and what kind of entities to use**

   Choice of Business Entity: Structuring Businesses for the Recovery*

   Disregarded Entities: Working with Single-Member Limited Liability Companies and Qualified Subchapter S Subsidiaries*

10. **Using S corps to avoid both personal holding company ("PHC") penalties and excess passive receipts penalties**

    Hot Tax Planning Tips and Strategies*

11. **Sell stock/buy assets – why?**

    Selling a Business - Practical, Tax and Legal Issues*

12. **How to avoid sales tax in an asset sale**

    Hot Tax Planning Tips and Strategies*

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