A BUSINESS ATTORNEY'S VIEW OF ISSUES ESTATE PLANNERS AND PROBATE ATTORNEYS SHOULD SPOT

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1. GIFTS VS. PAYMENTS FOR SERVICES

1.1. A transfer for no consideration to a natural object of a client's bounty is usually a **gift**, subject to the gift tax regime.

1.2. A transfer to an employee or other service provider is usually **compensation** for services rendered, subject to the income tax regime.

1.3. Estate planners sometimes propose that a transfer of stock from the majority owner of an entity to a **long-time employee** can be a gift.

- ♦ If the employee is *not* a natural object of the owner's bounty, the transaction (a) is compensation for services, (b) is taxed under Section 83 (the transfer of property in connection with the performance of services) and (c) is not a gift.

  ⇒ So the annual exclusion does not apply.

- ♦ The value of the transferred stock is wage income to the employee when received, subject to deferral rules of Section 83.

  ⇒ The employment tax regime applies, including income tax withholding, FICA and Medicare taxes.

- ♦ The amount taken into income by the employee is deductible by the employer – even if the shares were provided by another shareholder and not by the corporation!

⇒ In that case, the transferor shareholder is treated as contributing the shares to the capital of the corporation and the corp is treated as transferring the shares to the employee. A complicated tax fiction that you do not want to apply to your clients.

1.4. It is possible to characterize a **transfer of property (for example, shares) to an employee-family member** as a Section 83 transfer and not as a gift, usually by extending the exact same deal to another, non-family employee.

- The converse is true: It is possible to characterize a transfer to an employee-family member as *gift* and *not* a Section 83 transfer, usually by *not* extending a similar deal to any non-family employees and by *not* requiring the employee-family member to pay anything for the shares.

1.5. **The Section 83 transfer has an advantage over the gift, because the gift has a carry-over basis, while the Section 83 property takes a market-value basis**.

1.6. If the corporation has sufficient taxable income, it can **cover the employee's income tax** on the Section 83 transfer, so that the employee ends up with the property with no tax, no out-of-pocket expense, and a basis in the shares equal to their fair market value on the transfer date.

- If the transaction is properly planned, the corporation will not have any negative cash flow because the taxes the corporation will save from its big deduction will equal the taxes it pays for the employee.

- The employee can pay something for the shares, or the shares can be subject to "golden handcuffs" to retain the employee's services for a period of time (such as three years) or until a particular milestone (such as going public or reaching $1M in sales) is achieved.

- These results are usually better than the results of an option to acquire shares. This arrangement is usually better for all

than an incentive stock option, unless the corporation's stock is publicly traded or the corporation plans to go public soon.

1.7. At the same time that shares or membership interests are transferred to an employee of a closely-held entity, the employee should sign a **buy-back agreement**, allowing the entity to buy its shares back when the employee ceases to be employed by the entity.

- ♦ Unless the entity has an ESOP, it will buy the shares back with after-tax dollars.

2. BUSINESS ENTITY ISSUES

2.1. **Don't let a client die with a sole proprietorship**.

- ♦ The named executor or successor trustee might balk at becoming:
  - ⇒ The employer of the proprietorship's employees (subject to employment law liability, including no-fault liability for the wrongful actions of employees),
  - ⇒ The owner of its inventory (subject to no-fault products liability), or
  - ⇒ The owner of its real estate (subject to no-fault environmental remediation obligations).
- ♦ The named executor or successor trustee will not be very happy about taking over a general partner interest in a general or limited partnership, either.

2.2. **Don't let the last individual founder of a family limited partnership owning real property die without converting the limited partnership into an LLC**.

- ♦ The general partners of a limited partnership have unlimited liability for claims against the partnership.

⇒ For real property owned by the limited partnership, the unlimited liabilities include the obligation to remediate the property's environmental problems.

⇒ If the parents owned the property and then contributed it to the family limited partnership, the parents had the personal clean-up obligation because they once held title to the property.

⇒ The children never held title to the property, so they have no personal clean-up obligation.

⇒ When Mom and Dad die and Dutiful Daughter becomes the general partner of the family limited partnership holding that real property, *Dutiful Daughter becomes personally liable* to remediate that property – even if the assets of the limited partnership are not sufficient to pay for the remediation.

♦ In contrast, if Mom or Dad had *converted the limited partnership into a limited liability company*, and then Dutiful Daughter becomes the manager of the LLC, *she would not have personal liability* to remediate the property if the LLC's assets are not sufficient.

⇒ The conversion does not create a change in ownership for property tax purposes.

- In fact, the conversion is not a "transfer" for property tax purposes.

⇒ The LLC is the same partnership for federal tax purposes.

⇒ The LLC will be subject to the annual minimum tax (currently $800), the same as the LP.

- Unlike the LP, the LLC can also be subject to a gross receipts tax for years in which its California-source receipts exceed $250,000.

- ♦ It might be possible to do the conversion after the death of Mom and Dad and before anyone becomes a general partner of the limited partnership.

  ⇒ But that creates a situation in which there is no general partner for a time while the family organizes to understand and effect the conversion.

- ♦ An alternative is to create another general partner that is an S corporation or an LLC.

  ⇒ I discourage this because it is not really necessary to add another entity that will have its own complications, will owe at least minimum taxes and will require annual tax returns.

  ⇒ It is possible that the officers or managers of the GP entity will not sign documents correctly, possibly exposing themselves to unlimited personal liability as a general partner.

- ♦ A corollary: New "FLPs" should be LLCs, not LPs.

- ♦ A footnote: Existing California LPs organized before 2008 should have updated LPAs to reflect the Uniform Limited Partnership Act of 2008, which became effective for all California limited partnerships on 1-1-10.

  ⇒ The LPs that would be candidates to revise their LPA and not convert to an LLC might be those with a corporation or an LLC as the general partner, and with no individuals as general partners.

2.3. **If the owners expect to someday sell their business, and the business is now in a C corporation – Make the S corporation election**!

- ♦ There are not many good reasons to be a C corp for a "build-it-up-and-sell-it" type of business.

  ⇒ Inertia does not count as a "good reason."

⇒ The ideal time to make the election is at least 10 years before the business is sold. If that's not possible, the more time between the election and the sale, the better (to minimize the extra corporate-level built-in gain tax on appreciation that existed on the date of the S corporation election).

♦ For a Mom-and-Pop store or a service business that will not have much "goodwill" value to another owner, C corp status is OK.

2.4. Don't let non-licensed persons retain stock in a California professional corporation for too long after a licensed shareholder dies.

♦ Generally, the shares must be transferred from the non-licensed person within 6 months.

⇒ For dentists, it's 12 months.

⇒ Note: If while alive the licensed shareholder is disbarred or disqualified, it's 90 days.

♦ If the shares are held too long, the licensing agency can suspend or revoke the corporation's license to render professional services in California.

♦ These rules do not change the probate rules regarding the timing of distributions from the decedent's estate.

3. LIFETIME ENTITY HOUSEKEEPING CAN MAKE A HUGE DIFFERENCE

3.1. **Who owns the shares**?

♦ The stock certificates -- not the K-1s or the other schedules to the tax return – determine who holds how many shares.

♦ Do the stock records tell the story clearly?

♦ If not, this should be cleared up while the founders are alive.

- ♦ It will require declarations and, possibly, collecting stock assignments from people who sold their shares long ago.

- ♦ Gaps in the stock records can be a big problem if lost stock certificate number 4 turns up after Mom and Dad are gone, and they were the only ones who knew that the employee to whom number 4 was issued was actually bought out for cash in the second year of the business.

- ♦ There is no title insurance on the shares of a closely-held business. It's in the hands of the professionals involved.

3.2. After all the gifts and bequests, and transfers among trusts: Does the **number of shares outstanding** equal the total number of shares issued less the total number of shares redeemed?

- ♦ If not, something is wrong.

  - ⇒ Those who think they have a majority interest might not.

  - ⇒ It becomes necessary to trace all of the transactions in stock, ideally in a big worksheet, to find the problem.

3.3. It might make sense for the **estate planner** to prepare the stock assignments to transfer shares, and for the **corporate attorney** to prepare the new stock certificates.

- ♦ This way, two sets of eyes check the transaction.

- ♦ Remember: There is no title insurance for stock of a closely-held business.

3.4. **Non-pro-rata distributions** – Can threaten the S corporation status – by violating the "one class of stock" rule.

- ♦ They must be corrected ASAP.

- ♦ It is difficult from a corporate-law standpoint when the solution is to make "equalizing distributions" to people who

no longer hold shares, or who sold their shares to buyers who now claim the right to all distributions on those share.

- ♦ If the S corporation status terminates, the corporation generally must wait five years to make a new S corporation election.

  - ⇒ At that time, it might have substantially more "built-in gain."

  - ⇒ A new 10-year period will begin during which the built-in gain could trigger a double tax on the sale of assets held by the corporation when it makes its new S corporation election.

  - ⇒ In a nutshell: Terminating the S corporation election can be a tax disaster.

4. BUY-SELL AGREEMENTS

4.1. **If the entity has more than one shareholder, member or partner, it probably should have a buy-sell agreement**.

- ♦ Set a pricing method and payment terms for the interest of the spouse of a deceased owner.

  - ⇒ An owner while alive and healthy is in a much better position to negotiate than that owner's spouse will be after the owner's death – or after the owner gets terrible lab results.

  - ⇒ It is possible to consider life insurance, disability insurance and salary continuation during the elimination period for the disability. This is best done while all of the owners are healthy.

- ♦ If the marriage of an owner ends, give the entity and the owner-ex a right to buy the shares from the non-owner-ex.

4.2. **Protect the valuable S corporation status**.

- The S corporation status:

  - ⇒ Allows the business assets to be sold at much lower effective federal and California tax rates (25% vs. 55% in 2010);

  - ⇒ Allows the corporation to make tax-free cash distributions to the shareholders (and thus avoids the double tax that applies to profits earned by a C corporation and distributed to its shareholders as dividends);

  - ⇒ Avoids the penalty taxes for excess accumulated earnings;

  - ⇒ Avoids disallowed deductions for unreasonably high compensation of shareholders; and

  - ⇒ Is very fragile – a transfer of shares to an ineligible shareholder can terminate the election.

    - The buy-sell agreement can penalize the shareholder who terminates the S corporation election without the consent of a majority of the outstanding shares.

- Require the trustee of a QTIP trust holding S corporation shares to makes the QSST election to preserve the S corporation status.

- Require the trustee of a credit-shelter trust holding S corporation shares to makes the ESBuT election to preserve the S corporation status.

- If the trust might take a long time to resolve, require the successor trustee to make a Section 645 election to treat the trust as an estate for tax purposes.

⇒ An estate can hold S corporation shares without the need for any election.

5. A CROSS-PURCHASE OF STOCK IS BETTER THAN AN ENTITY PURCHASE -- ESPECIALLY FOR A FAMILY-OWNED BUSINESS

5.1. It's all about the tax basis and the *next* stock transactions.

- With a C corporation, the remaining shareholders lose substantial tax basis by an entity purchase. This is the "**disappearing basis**" problem.

  ⇒ That means they will pay more tax in a later sale of shares (or the liquidation of the corporation after it sells its assets).

- For an S corporation, there is ultimately no tax basis cost unless the S corp holds life insurance to fund the buy-out. In that case, the tax basis cost to the surviving shareholders is significant. There can be a short-term benefit to cross-purchase if the purchase price is paid with a note – at least until the note is paid in full.

- Note that the lost basis can haunt future generations who acquire their stock by gift (or as bequests from decedents who die in 2010), with carry-over bases from their donors.

5.2. **But** – a cross-purchase arrangement might be too complex for the owners' first buy-sell agreement. If so, an entity purchase arrangement is usually better than no buy-sell agreement at all.

- An entity purchase funded by life insurance requires compliance with the "employer-owned life insurance" rules of Section 101 to preserve the tax exclusion when the proceeds are received.

- If the entity is a C corporation, the life insurance proceeds received by the corporation will be subject to the alternative minimum tax (AMT).

5.3. **For now, it's also about applying basis to the sale and using the installment method**.

- ♦ If Dad and Daughter hold most of the outstanding shares, and the corporation buys out Dad, the redemption will be a "bad" Section 302 redemption and will be treated as a Section 301 "regular dividend" to Dad.

  - ⇒ This is because Daughter's shares are attributed to Dad, so Dad has not reduced his interest in the corporation for Section 302 income tax purposes – even though he no longer has any shares or any rights as a shareholder!

  - ⇒ As a consequence, Dad cannot apply his basis in the shares to reduce his income.

  - ⇒ Also, Dad cannot use the installment method to report his income, since the redemption is not treated as a sale for tax purposes.

    - Even if Dad takes back a promissory note from the corporation, he will recognize all of the "dividend" income in the buy-out year.

  - ⇒ Finally, the tax rate on dividends will apply, not the tax rate on long-term capital gain.

    - Those federal rates are both 15% in 2010, but they are likely to change, with the rate on dividends likely becoming higher than the rate on long-term capital gain.

- ♦ It is possible to avoid the attribution rules.

  - ⇒ The best way is to have Daughter buy as much of Dad's shares as she can afford to buy with a down payment and a note – a cross-purchase.

    - If the corporation is an S corporation or becomes one, Daughter can probably buy all of

Dad's shares, because the corporation can make tax-free distributions to her of its S corporation profits, and she can use those funds to pay down the note.

- If the corporation is a C corporation and must stay a C corporation, then the amounts that the corporation buys will have dividend treatment and the amounts that Daughter buys will have long-term capital gain treatment.

  ◊ A combination of a cross-purchase of some shares and an entity-purchase of others at the same time is called a *Zenz* transaction after the case of *Zenz v. Quinlivan*, in which both sales were held to generate capital gain if they result in a "complete termination of interest" for Section 302 purposes, after applying the attribution rules.

- Dad won't recognize loss on the sale to Daughter. She will keep the deferred loss and recognize it (if she or her advisors remember) when she disposes of her shares.

⇒ The other way is to "turn off" the attribution rules.

- This has high transaction costs and is fraught with uncertainty – Dad must keep his statute of limitations open on the transaction for 10 years.

- It is much easier to recast the transaction as a sale to Daughter and to make an S corporation election, if necessary.

6. AVOID INTRA- AND INTER-FAMILY CONFLICTS AFTER A FOUNDER OF THE BUSINESS CEASES TO BE INVOLVED

6.1. **When the parents transfer ownership interests in an entity to more than one child, they should include a "pressure relief valve."** This is usually a buy-sell agreement – which can also protect the S corporation status.

- **Call Option** - Consider giving the children involved in the business options to buy the business interests of the other children at the death of the founder.

  ⇒ This way, those involved in the business would not have to share management decisions with those who are not involved.

  ⇒ Those who are not involved will not always be demanding dividends and obsessing about the salary and perks of the children in the business.

  ⇒ The purchase price would be the appraised value.

  ⇒ Payment terms could be specified in the option.

  ⇒ The buyers could obtain life insurance to fund the purchase.

- **Put Option** - Consider giving the children *not* involved in the business options to *require* their siblings involved in the business (or the business entity) to buy the business interests of the non-involved sibs at the death of the founder.

  ⇒ This gives the non-involved sibs an exit if they feel that holding the interest in the business is not a good investment.

- **Shoot-Out** – For two children who will become 50-50 shareholders, each involved in the business, allow either child (Child 1) to name a price, and the other (Child 2) has only two choices at that point: to sell to Child 1 at that price or to buy the entire interest of Child 1 at that price.

After Child 1 names a price, they will no longer be in business together.

⇒ The payment terms can be spelled out in the agreement.

6.2. **Family Business Advisor –** This is not the first family business in history, even though it often feels like it from inside the business. There are very good family business advisors and institutes. Use them.

6.3. **Don't let your clients die with general partner interests or as tenants in common in rental real estate** – Dad and two longtime buddies owns investment property as tenants in common or in a general partnership. That works well while they are all alive and competent. When the heirs take over, it becomes a mess.

- ♦ All the heirs need to sign off on every lease and to approve every repair. They each have unlimited liability, too.
- ♦ Best alternative: Convert it to an LLC with one class of interest for each family, each class electing one manager, who act by majority.
- ♦ Distant second best: Transfer the tenancy in common interests to a general partnership, if necessary, and then each partner assigns his general partner interest to a separate LLC to hold his family's interest – if they will all do it. The LLCs provide the liability protection and the representative management.
- ♦ Consider property tax issues when planning these transactions.

7. PRACTICAL PROBLEMS CREATED BY FUNDING A FOUNDATION FROM THE ESTATE

7.1. **How will the successor directors or trustees be determined**?

- ♦ If the foundation is a corporation, who elects or designates the directors if Mom and Dad go at the same time? Should

the foundation have one member who is the successor trustee of Mom and Dad's living trust, and who can elect new directors? Do Mom and Dad want more control over that situation?

- ♦ If the foundation is a trust, the trust instrument can name the successor trustees. What if they turn out to be bad seeds or uninterested in the foundation? Should the trust have a mechanism to put the foundation in other hands?

7.2. **What will the successor directors or trustees do with the foundation assets?**

- ♦ If they are family who are not interested in the task of running the foundation, the money might not be used well.

- ♦ Or the family members might mis-use the foundation money and get themselves into trouble with the IRS and the Attorney General.

- ♦ If the successor managers of the foundation are diligent and interested, they will want to know how the foundation's founders wanted them to make grants.

  - ⇒ If the foundation was barely funded during the lives of the founders, and receives substantial assets from the estate, the founders will not have set an example of how they selected worthy grantees.

  - ⇒ Better to make substantial, income-tax deductible contributions to the foundation during life, and to name the successors-to-be to the board of directors or as advisors while the founders are alive. The successors-to-be can participate with the founders in the process of selecting grantees.

  - ⇒ The founders could also hire a consultant to write down the desires of the founders for the use of the foundation assets.

- ♦ Failing that, the founders should reconsider the role of the foundation in their estate plan.

- ♦ These concerns apply also to testamentary charitable lead trusts.

8. TRUSTS HOLDING STOCK OF CLOSELY-HELD BUSINESSES

8.1. **If only one spouse is involved in a business, create a "subtrust" to hold the stock or interests in that business**. The involved spouse would be the sole trustee of that subtrust, which would be subject to the trust's other successor trustee provisions.

- ♦ Otherwise, if the spouses, as co-trustees, disagree on how to vote on an issue, they can cancel each other's vote.

- ♦ A buy-sell, shareholders or voting agreement can give the involved spouse the right to vote the shares, even if the shares are held in the names of both spouses.

  - ⇒ It's best to handle this *both* in the trust and in a buy-sell agreement. If the trust is revoked (for example, by the disgruntled spouse who is not in the business), the agreement can remain in effect. If the agreement should terminate for any reason, the trust will remain in effect.

8.2. Also use the "subtrust" concept when one spouse is licensed and holds an interest in a licensed entity, such as a professional corporation or an LLP.

9. HOLDING S CORPORATION STOCK IN TRUST

9.1. **The trust must be eligible to hold S corporation stock as of the second that the shares are acquired**.

- ♦ Grantor trust (with grantor who is a U.S. citizen or a resident alien)

- ♦ Section 645 election in effect to treat trust as estate

- ♦ QSST election made and trust qualifies as a QSST (with beneficiary who is a U.S. citizen or a resident alien)

- ♦ ESBuT election made and trust qualifies as an ESBuT (with potential current beneficiaries each of whom is a U.S. citizen or a resident alien)

- ♦ Each election has a time deadline, but the IRS offers reasonable procedures to make late elections.

9.2. **The trustee should be instructed and empowered to act to preserve the S corporation election**.

- ♦ The trustee should not transfer S corporation shares to any person, entity or trust that is not eligible to hold S corporation shares.

- ♦ If the general trust instructions would require the trustee to transfer shares to a person, entity or trust not eligible to hold S corporation shares, special rules should kick in to instruct the trustee to transfer other property of equal value instead, and/or to give a promissory note from a trust or trusts holding S corporation shares to the person, entity or trust that cannot hold S corporation shares.

- ♦ Allow the trustee to enter into agreements to preserve the S corporation status.

- ♦ Instruct the trustee to make the elections (such as the QSST and ESBuT elections) necessary to preserve the S corporation status.

- ♦ Allow the trustee to consult with experts about preserving the S corporation status and to provide legal opinions if required by agreements that protect the S corporation status.

10. THE TAX PLANNING OPPORTUNITY PRESENTED BY THE DEATH OF AN S CORPORATION'S SOLE SHAREHOLDER (OR THE SOLE SHAREHOLDER'S SPOUSE)

10.1. An S corp's capital assets and Section 1231 assets can be sold with **no tax liability** immediately after the death of the sole shareholder, even though there is no "inside basis step up." (This opportunity requires a Section 1014 basis step-up at death, so it would not apply to decedents dying in 2010.)

- ♦ This is because there is a date-of-death basis adjustment to the shares (except for decedents dying in 2010), followed by a basis adjustment when the assets are sold (which generates "inside" capital gain). The total basis becomes twice the value of the shares if all of the assets are sold.

- ♦ When the sale price is distributed in liquidation of the S corporation, there is a deemed "sale" of the shares and "outside" capital loss results. The "outside" capital loss offsets the "inside" capital gain.

- ♦ The *distribution* must happen *in the same year as the sale*, otherwise the capital loss will not offset the capital gain – there is no capital loss carry-back.

10.2. This always works for the **distribution of capital assets** or Section 1231 property by an S corp, as opposed to a sale.

- ♦ There is no timing issue because the capital gain and the offsetting capital loss are triggered by the same event – the distribution.

10.3. Key **lifetime planning** for this:

- ♦ Make no gifts of the S corp shares (which would have a carry-over basis, not a date-of-death basis, in the hands of the recipient).

11. SELL LOSS ASSETS DURING LIFETIME TO AVOID A BASIS STEP-*DOWN* WITH NO INCOME TAX BENEFIT

11.1. This does not apply to decedents dying in 2010 (whose assets will not have a basis adjustment) or to those who do not plan to sell appreciated assets.

11.2. **Use the losses to offset gain from the sale of appreciated assets**.

- ♦ The sale of Section 1231 assets (used in a trade or business) will generate ordinary loss.
- ♦ Capital loss carries forward but not back.
- ♦ Only a small amount of capital loss can offset ordinary income.

[End of outline.]

ADDITIONAL INFORMATION

To receive more information about these issues, please check the box(es) below, provide your address (or business card) and return this page to Bill Staley -- or FAX it to Susan Rognlie at (818) 936-2990.

1. ☐ **Buy-Sell Agreements for Owners of Closely-Held Businesses** *

2. ☐ **Buy-Sell Agreements: Life Insurance Issues** *

3. ☐ **C2S: S Corporation Elections for Existing C Corporations** *

4. ☐ **Choice of Business Entity: Structuring for the Recovery** *

5. ☐ **Dissolving Business Entities and Corporate Housekeeping** *

6. ☐ **Large Charitable Contributions - Private Foundations, Charitable Lead Trusts and Community Foundations** *

7. ☐ **Limited Liability Companies: An Introduction** *

8. ☐ **S Corporations – The Nuts and Bolts** *

9. ☐ **S Corporation News Flash: The Wait to Avoid the Federal Built-In Gains Tax Was Shortened from Ten ~~to Seven~~ to Five Years -- But Only for Sales in ~~2009 and 2010~~ 2011** *

10. ☐ **Succession Plans to Move a Business to the Next Generation** *

11. ☐ **Tax Rates for 2010 and 2011 under Current Tax Laws** *

12. ☐ **Year-End Stock Sale Issues – For professionals dealing with stock certificates of closely-held businesses** *

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