CHOICE OF ENTITY AND ESTATE PLANNING

-- Income Tax Issues --

FINANCIAL PLANNING ASSOCIATION OF VENTURA COUNTY

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

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1. PASS-THROUGH ENTITIES STILL RULE

1.1 **Bottom line**:

1.1(a) Sole proprietorships and general partner interests scare away executors and successor trustees.

1.1(b) Even with 15% federal income tax rates on dividends and long-term capital gain, pass-through entities have substantial income tax benefits compared to C corporations.[1]

1.1(c) The estate plan should not prevent the owners from getting these benefits.

1.2 **Key issues**:

1.2(a) A sale of assets by a C corporation still results in two taxes – at the corporate and shareholder levels.

1.2(b) The inside (corporate) tax rate is higher than the individual long-term capital gain rate, even if the individual shareholder is subject to the alternative minimum tax.

1.2(c) The basis in the entity is usually higher in a pass-through entity as compared to a C corp, so less tax is paid on a sale of assets *or a sale of stock*.

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[1] See outline on page 21 "Structuring Businesses for the 21st Century."

2. CHOICE OF ENTITY COMPARISON CHART

	Fed. taxes on sale of assets	**Inside tax rate**	**Outside tax rate**	**Liability protection**	**Eligibility issues**	**Can go public?**	**Can do tax-free reorg with a corp?**	**Creditor of owner gets**	**Hassle?**
C corp	TWO!	~40% CA + Fed	24% - 42%	Best	None, Can't be worse.	Yes	Yes	Stock	No
	BAD			GOOD		GOOD	GOOD	BAD	GOOD
S corp	1	1.5% CA	24% - 42%	Best	Monster issue. Defaults to C corp!	Yes (as a C corp)	Yes	Stock	Not much
	GOOD			GOOD	BAD	GOOD	GOOD	BAD	GOOD
LLC	1	CA gross receipts tax. PA and TX franchise tax	24% - 42%	Should be as good as a corp, but untested	None	No. Convert to C corp? Maybe.	No	Charging order and tax liability -- except for SMLLC, get assets	NO
	GOOD				GOOD	BAD	BAD	GOOD	GOOD
LLC taxed as S corp	1	1.5%	24% - 42%	Should be as good as a corp, but untested	Monster issue. Defaults to C corp! LLC increases the risk.	No. Convert to corp? Maybe.	Yes	Charging order and tax liability -- except for SMLLC, get assets	Yes, forever
	GOOD				BAD	BAD	GOOD	GOOD	BAD
LP	1	None	24% - 42%	Requires corp or LLC as GP, else bad for GP	None	No. Convert to C corp? Maybe.	No	Charging order and tax liability	Yes, forever
	GOOD				GOOD	BAD	BAD	GOOD	BAD

C corp – Taxes low until sale of business, then way too high.

S corp – Taxes high until sale of business, then low tax on sale. But eligibility concern creates constant threat of flipping to a C corp. Eligibility danger highest in estate or living trust!

LLC – Taxes high until sale of business, then high certainty of low tax. No eligibility concerns. Untested liability protection can be a concern. TX and PA taxes prevent LLCs from operating in those states. California gross receipts tax is a bogus issue if the business assets are rapidly appreciating in value. LLCs can't go public or do tax-free stock swaps. For businesses that have other exit strategies and can live with the unresolved liability concern, the LLC has a nice combination of features.[2]

LLC taxed as S corp – An attempt to get charging order protection for an S corp. Will confuse every adviser who deals with it. For a new entity, better to use an LLC. For an existing C corp, it is usually best to make the S election and skip the LLC.

LP – Not useful without an S corp or LLC as the GP. No good reason to use two entities when the LLC will do. The annoying California gross receipts tax on LLCs is just the cost of using an almost perfect entity and is seldom a good reason to reject the LLC.

3. THE POWER OF TAX-FREE DISTRIBUTIONS FROM PASS-THROUGH ENTITIES

The ability of a pass-through entity (I'm thinking of LLCs and S corps, but in Texas they'd be thinking of LPs instead of LLCs) to make tax-free distributions can be very useful in estate and succession planning.[3]

3.1 Example - Affiliated Group of C Corporations with a Closely-Held Parent Corp

3.1(a) Have the parent corp make an S corporation election.

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[2] Note that an LLC cannot conduct in California a business that requires a license issued under the California Business and Professions Code. See bulletin on page 21 "Limited Liability Companies - An Introduction."

[3] See outline on page 21 "Mistakes to Avoid During Succession - Ten Mistakes Families Should Avoid When Transferring a Business to the Next Generation."

3.1(b) Convert the subsidiaries into LLCs or qualified subchapter S subsidiaries ("Q-subs").

3.1(c) Distribute the profits earned after the S corporation election.

3.1(d) Use the cash to buy life insurance to pay estate tax on the value of the stock in the estate.

3.2 Example – Child Buys Mom's Stock

3.2(a) Have the corp make an S corporation election.

3.2(b) Child buys Mom's stock, pays with a promissory note at a market interest rate. Gets the future appreciation in the value of the shares out of Mom's estate.

3.2(c) S corp makes tax-free distributions to child, who uses the cash to make payments to Mom on the note. Avoids the disappearing basis and "complete redemption/attribution" problems that arise when the corp buys the parent's stock.

4. S CORP ELIGIBILITY ISSUES

If all of our clients had LLCs instead of corporations, we could forget about the S corp eligibility rules. But there are a lot of closely-held corporations out there, and they can't convert to LLCs without recognizing all of the inside and outside gain. So the S corporation election is the best they can do to avoid paying way too much tax on the sale of the business. That means we must fight the monster – the S corporation eligibility rules.

4.1 FLPs and IRAs can't hold S corporation shares

4.1(a) If any shares are held by a partnership, a multi-member LLC or an individual retirement account, the corporation cannot be an S corporation.

⇒ This means a family limited partnership cannot own S corporation shares.

⇒ A single-member LLC owned by an eligible S corporation shareholder *can* hold S corporation shares. But it's too dangerous, because if the LLC ceases to be disregarded for tax purposes, the S corporation will become a C corporation.

4.2 ESOPs, Qualified Plans and Charities can hold shares, but don't

4.2(a) Although an ESOP can hold S corporation shares, a shareholder cannot get Section 1042 non-recognition treatment on a sale to an S corp ESOP,[4] so most convert to a C corp before buying the shares.

⇒ The special contribution deduction limitations[5] and the deductible dividends rule[6] do not apply to S corp ESOPs.

4.2(b) Qualified plans and charities must pay unrelated business income tax on all of the income from the S corporation (including dividends, interest and rents that would be tax-free if received directly by the plan or charity).[7]

4.2(c) In addition, qualified plans and charities must pay unrelated business income tax on the gain on the *sale* of the S corporation stock![8]

4.3 Community property interests of nonresident aliens

4.3(a) If a nonresident alien has or acquires a current ownership (as opposed to survivorship) interest in shares, the corporation cannot be an S corporation.[9]

4.3(b) This is a particular concern with shareholder-employees in California, where the non-employee spouse can acquire a community property interest in separate property shares to

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4 I.R.C. § 1042(c)(1)(A).

5 I.R.C. § 404(a)(9)(C).

6 I.R.C. § 404(k)(1).

7 I.R.C. § 512(e)(1)(B)(i).

8 I.R.C. § 512(e)(1)(B)(ii).

9 Treas. Reg. § 1.1361-1(g)(1)(i).

the extent that the employee-spouse is under-compensated for his or her efforts on behalf of the corporation.

4.3(c) If a resident alien who owns S corporation shares becomes a nonresident alien, the corporation will become a C corporation.

Note: These are just two of several ways in which the S corporation status can be threatened *without any transfer of shares*.

4.4 Custodians

A custodian for the benefit of a minor is not treated as the shareholder for S corporation purposes.[10] The minor must be an eligible shareholder, but the custodian need not be eligible. The minor's parent or guardian must consent to the S election, and the consent of a custodian who is not the parent or legal guardian is not sufficient.[11]

4.5 Estates as shareholders

4.5(a) Estates can hold S corporation shares, without any limitation as to time.[12]

4.5(b) If the shares will be distributed from the estate to an ineligible trust, the ineligible trust has two years to dispose of the shares without terminating the S corporation status.[13]

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10 Treas. Reg. § 1.1361-1(e)(1).

11 Rev. Rul. 68-227, 1968-1 C.B. 381; Rev. Rul. 66-116, 1966-1 C.B. 198. *See, e.g.,* PLR 94-47-022, August 23, 1994 (inadvertent termination relief), 91-21-027, May 24, 1991 (same).

12 I.R.C. § 1361(b)(1)(B).

13 The former 60-day period in which an ineligible trust must dispose of its S corporation stock was extended to two years after the trust acquires the shares. Effective for taxable years beginning after December 31, 1996. 1996 Small Business Tax Act § 1303, amending I.R.C. § 1361(c)(2)(A)(ii) and (iii). California conforms. For administrative relief for late elections, see footnote 18 below at page 8.

4.6 **Living trusts (and their progeny) as shareholders**

4.6(a) If the shares were in the name of the employee-shareholder before the trust was created, consider creating in the trust a **special trust** to hold closely-held stock. The other shareholders will appreciate not having the non-employee spouse voting the shares.

⇒ Especially if the other shareholders are the parents who gave them shares and the parents are also your clients.

⇒ The buy-sell agreement can address this in the provisions that permit shares to be transferred to a living trust.

4.6(b) Allow the trustee to enter into buy-sell agreements and to take other actions to protect the S corporation status.

4.6(c) Grantor trusts can hold S corporation shares,[14] so the typical living trust qualifies *during the lifetime of the trustor*.

4.6(d) At the death of the first spouse:

⇒ If the survivor's trust created after the first death is a grantor trust, it qualifies as an S corporation shareholder.[15]

⇒ A QTIP trust will qualify as a QSST – but it must make a timely QSST election.[16]

4.6(e) At the death of the second spouse:

⇒ Consider whether an election under Section 645 is needed to treat the trust as part of the estate, thereby

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14 I.R.C. § 1361(c)(2)(A)(i). The grantor must be an eligible individual shareholder. *Id.*

15 Assuming the surviving spouse remains a U.S. citizen or resident alien.

16 *See* footnote 21 at page 9 regarding the election and footnote 13 at page 6 regarding relief for late elections.

qualifying as an S corporation shareholder. It will rarely be necessary.

4.7 Separate Trust Shares

Separate trust shares under Section 663(c) are treated as separate trusts for S corporation purposes.[17]

Drafting tip: Create separate trusts instead. OK to authorize commingling of assets.

4.8 QSSTs

If it meets the requirements of Section 1361(d) *and* makes a timely election, a QSST is treated as a grantor trust with respect to its S corporation stock. It must distribute all of its income annually to a single beneficiary, and if it distributes principal, it must be to that beneficiary and to no other. It cannot sprinkle or spray.

4.8(a) Limited Inadvertent Termination Relief for QSST Elections

If S status was lost solely because stock was transferred to a trust which would have been a QSST had the current income beneficiary so elected, the S election can be salvaged by a QSST election filed up to **two years** after the original due date.[18] This will save the corporation from the expense (including the user fee) of obtaining a ruling request for inadvertent termination relief.

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[17] I.R.C. § 1361(d) (flush language); Treas. Reg. § 1.1361-1(j)(3).

[18] Rev. Proc. 2003-43, 2003-23 I.R.B (also provides relief for late S corporation elections and late ESBuT elections). 998; *see also* I.R.C. §§ 1361(d)(2) (QSST election), 1362(f) (inadvertent termination relief authorized); Treas. Reg. §§ 1.1361-1(j)(6), 1.1362-6(b)(2)(iv) (QSST election procedure). The original due date is two years after the trust acquires the shares. I.R.C. § 1361(c)(2)(A)(ii).

Note: The Service receives more requests for inadvertent termination relief than any other type of S corporation ruling. Specific criteria and requirements have been developed. If you consider a ruling request, call the National Office to discuss the request before you submit it. The Service is considering issuing a revenue procedure that will grant automatic inadvertent termination relief in more situations.

4.8(b) When a QSST sells all of its S corporation stock, the sale proceeds are taxed to the trust (which will have the sale proceeds in most cases), and not to the grantor. [19] The installment method is available.

4.8(c) A trust that satisfies a legal obligation of the trustor to support the single income beneficiary cannot be a QSST because it benefits more than one person.[20] The **obligation of support** is determined under local law. The trust must preclude distributions that would satisfy an obligation of support.

Example – Parent creates trust that pays for prep schooling of parent's child. IRS says this benefits the parent *and* the child, so the trust can't be a QSST.

4.8(d) The regs include explicit rules for treating QTIP trusts as QSSTs.[21]

4.8(e) Trust-to-QSST distributions are allowed.[22]

4.8(f) If making the annual distributions from the QSST is a terrible idea, consider having the S corporation make redemptions instead of distributions. The QSST might not be required to distribute the "redemption" proceeds.

4.8(g) Until 1996, reviewing a living trust involved tracing all the possible ways that shares could end up in a non-grantor trust, and then requiring all those trusts to either be QSSTs or requiring the trustee(s) to distribute the principal to a CUTMA custodian. Sometimes neither alternative fulfilled the clients' wishes.

⇒ It is still important to instruct the trustee to segregate S corporation stock into separate trusts, to take actions necessary to preserve the S corporation status, and to

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[19] Treas. Reg. § 1.1361-1(j)(8).

[20] Treas. Reg. § 1.1361-1(j)(2)(ii)(B).

[21] Treas. Reg. § 1.1361-1(j)(4).

[22] PLR 94-44-022, August 3, 1994.

use promissory notes when necessary to equalize trusts that cannot hold S corporation stock.

⇒ If it becomes necessary to reform the trust to satisfy future S corporation laws, the court will look for language in the trust document that allows the court to find that the trustors would have wanted the court to reform the trust to preserve the S corporation status.

4.9 Electing Small Business Trusts ("ESBuTs")

S corporation shares can be held by sprinkling trusts and trusts with charitable beneficiaries.[23] The trust must make a timely election.

4.9(a) The current beneficiaries will be treated as the shareholders for purposes of counting shareholders towards the maximum number of shareholders for an S corporation. If there is no current beneficiary "for any period," the trust is treated as the shareholder.[24] The ESBuT pays its own income tax. So the beneficiaries do not need to see the K-1s from the corporation!

4.9(b) The trust does not qualify if any interest in the trust was "acquired by purchase." It must have as beneficiaries only individuals, estates and charities.[25] A QSST cannot also be a ESBuT, nor can a charitable remainder trust, charitable lead trust or other tax-exempt trust be an ESBuT.[26]

4.9(c) The portion of the ESBuT consisting of S corporation shares is treated as a separate trust for limited trust tax accounting purposes.[27] An effort is made to avoid double taxation of the

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23 I.R.C. §§ 641, 1361, 1366. California conforms.

24 I.R.C. § 1361(c)(2)(B)(v).

25 I.R.C. § 1361(e)(1)(A). Charities are defined by reference to Section 170(c)(2), (3), (4) and (5), rather than by reference to Sections 401(a) and 501(c)(3), as in the eligible shareholder provision. This means that a charitable remainder trust can be a beneficiary. However, a CRT cannot hold S corporation shares without terminating the S corporation status.

26 I.R.C. § 1361(e)(1)(B).

27 I.R.C. § 641(c)(1)(A), (d).

S corporation income (that is, at the beneficiary and trust levels). The regular Section 641 rules apply to the balance of the trust. An ESBuT has one EIN for both parts and files a single tax return.

4.9(d) ESBuT Tips:

⇒ Diverting a beneficiary's income to an ESBuT reduces the itemized deduction cut-back because it reduces the beneficiary's AGI.

⇒ Each human is counted only once toward the 100-shareholder (or 100-family, if the election is made) limit, even if he/she holds stock individually and is an ESBuT beneficiary.

⇒ The trustee makes the ESBuT election.[28] The consent of the beneficiaries is not required by the IRS, but the trustee might be well-advised to get it. If there is more than one trustee, look to state law to determine how many trustees need to consent. Of course, you can't go wrong with unanimous consent by all the trustees.

⇒ There may be a grantor portion of an ESBuT.[29] If so, there will be a grantor and a non-grantor portion of the S corporation portion of the trust.

4.9(e) If an ESBuT sells all of its S corporation stock and receives an installment obligation, the termination of ESBuT status (resulting from the disposition) is probably treated as a disposition of the obligation, preventing the trust from using the installment method to account for the gain.[30]

⇒ To avoid adverse tax consequences when an ESBuT terminates (*e.g.*, accelerating deferred installment

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28 I.R.C. § 1361(e)(3).

29 Treas. Reg. § 1.641(c)-1(b)(1), (c).

30 *See* Rev. Rul. 77-402, 1977-2 C.B. 222.

gain), consider creating a lightly capitalized S corporation to keep in the ESBuT and thereby retain its status.

4.10 **GRATs**

As a grantor trust, the GRAT is eligible to hold S corporation shares[31] – and a GRAT is an ideal way to capture a third discount (added to lack of control and lack of marketability) for S corporation shares.

4.11 **Defective grantor trusts**

Although the Service has some odd ideas about defective grantor trusts, there is no question that they are grantor trusts. As grantor trusts they are entitled to hold S corporation shares.

4.12 **Crummey trusts**

Part of a Crummey trust should be a grantor trust with respect to the beneficiaries, and the S corporation stock could be allocated to that part of the trust. The better approach is to be very conservative with the S corporation status, and to avoid S corporation stock in Crummey trusts.

4.13 **Section 678 trust**

A trust of which a person other than the grantor is treated as the owner may also own S corporation shares.[32]

4.14 **Voting trust**

Ignored for S corporation purposes.[33]

4.15 **Bypass or credit shelter trust**

Usually does not qualify as a QSST because it does not require current distributions to a single beneficiary. So must qualify as a ESBuT, if at all, with appropriate election.

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31 *See* PLR 94-15-012, January 13, 1994.

32 I.R.C. § 1361(c)(2)(A)(i).

33 I.R.C. § 1361(c)(2)(A)(iv); Treas. Reg. § 1.1361-1(h)(1)(v).

4.16 **Foreign Trust**

Does *not* qualify as an S corporation shareholder, even if the beneficiaries are eligible or the trust would otherwise be a QSST, voting trust or ESBuT.[34]

4.17 **Number of shareholders**

4.17(a) The maximum number of shareholders for an S corporation is now 100 families (as long an election is filed to count families rather than shareholders).

4.17(b) As S corporation shares move through the second and third generations, it used to become a challenge to avoiding exceeding the limit. A buy-sell agreement and close-corporation status were the best ways to avoid exceeding the limit – or to get inadvertent termination relief if the limit is accidentally exceeded![35] Now this eligibility rule is so generous that it is less important.

5. BUY-SELL AGREEMENTS FOR S CORPORATIONS

5.1 **Eligibility Protection**

A buy-sell agreement is the best way to protect the fragile S corporation status. The agreement can address transfers to ineligible shareholders as well as non-transfer problems: allocations among trusts as trustors die and beneficiaries reach target ages and change from resident alien to nonresident alien tax status.

Eligibility protection can be enhanced by electing close corporation status for corporate law purposes. The puts more teeth in the various restrictions.

The agreement can address whether the corporation will be required to make distributions to enable the shareholders to pay their taxes on the S corporation income. This issue also arises when the

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[34] Treas. Reg. § 1.13611-1(h)(2)().

[35] The Service is empowered to validate **bad and late S corporation elections** and instructed to apply this power liberally. Effective for elections made for taxable years beginning after December 31, 1982. I.R.C. § 1362(b) and (f). California has conformed, with relief available back to 1996.

agreement provides for sales of stock paid for by promissory notes that are secured by pledges of the purchased shares; in that case, the pledge should allow the buyer to retain distributions to pay taxes.[36]

5.2 Redemptions before and after death

5.2(a) Because a shareholder's basis in his or her S corporation shares is affected by the corporation's income, loss and distributions (as well as the shareholder's capital contributions and capitalized expenses associated with the shares and the corporation's excludable income and non-deductible expenses),[37] S corporation stock basis is much more volatile than C corporation stock basis.

5.2(b) The carry-over basis rule for gifts might not be a big problem if the gift is stock of an S corporation that has substantial undistributed income. In effect, the parents can pay the tax on the income, give the shares to the children, and permit the children to take the tax-free distributions. (For S corporations without C corporation e&p, the play is in the stock basis. For S corporations with undistributed C corporation e&p, the key rule is that the "accumulated adjustments account" is maintained at the corporate level,[38] so a shareholder can lose or give up his or her right to receive tax-free distributions.

5.2(c) When a shareholder dies, there will be a basis adjustment in his or her shares under Section 1014.

5.2(d) A redemption or sale *before* death will result in gain if Section 302 sale-or-exchange treatment applies, and might be partly tax-free and partly taxable if Sections 301 and 1368 apply. So for appreciated stock, a "bad" 302 redemption is

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[36] See outline on page 21 "Buy-Sell Agreements for Closely-Held Businesses – An Overview."

[37] I.R.C. § 1367.

[38] I.R.C. § 1368.

best, and an outright sale (or a "good" Section 302 redemption) is to be avoided.

5.2(e) A redemption or sale *after* death will not result in gain if Section 302 or 303 sale-or-exchange treatment applies, and might be partly tax-free and partly taxable if Sections 301 and 1368 apply. So when the stock basis equals the value, a "good" 302 or 303 redemption or a taxable sale is usually best.

5.3 **Cross-purchase vs. redemption agreements; life insurance proceeds**

Bottom line: Do a cross-purchase to avoid the "disappearing basis" problem, even in an S corporation.[39]

Bottom line: Have the shareholders hold the insurance on each others' lives to avoid the "disappearing basis" problem, even in an S corporation. How to avoid the jillion policies problem? "Live with it" is the best answer. "Use a partnership" is the distant second best, but no one has resolved all the theoretical and mechanical problems raised by the partnership.

6. ORGANIZATIONAL ISSUES FOR TRUSTEES AND EXECUTORS

6.1 Get the money

6.1(a) The nature of a pass-through entity is that the owners (that is, the shareholders, partners or members) pay tax on the entity's income.

6.1(b) The entity has no obligation to give the owners cash to pay their taxes.

6.1(c) So, as soon as possible (when signing the S corporation election or the operating agreement for an limited liability company) get an agreement from the entity that it will, to the extent it is able, make quarterly cash distributions in amounts sufficient to pay the owner's estimated state and federal tax obligations resulting from the ownership interest.

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[39] See on page 21 the outline "Buy-Sell Agreements for Closely-Held Businesses – An Overview" and "Buy-Sell Agreement Checklist."

6.2 **Avoid unnecessary liabilities**

6.2(a) Consider employer and other no-fault liabilities that could arise by accepting the role of successor trustee or executor.

6.2(b) Avoid becoming a sole proprietorship or a general partner. Liability could arise from acts of employees, partners or from products liability.

6.2(c) Consider whether liability would arise from holding real property in the estate.

7. SOME COOL USES OF A SINGLE-MEMBER LLC

7.1 **Sole proprietorship**

7.1(a) During the sole proprietor's life, transfer the business to a single-member LLC. This will be disregarded for tax purposes, so the taxation won't change much.

7.1(b) The single-member LLC will file no federal tax return. It will file a short California tax return to report the minimum tax and the gross receipts tax.[40] Otherwise, its reporting will continue on the owner's Form 1040 Schedule C.

7.2 **Clients holds real property or general partner interests**

7.2(a) Create a single-member LLC to hold the real property or GP interests.

7.2(b) This will minimize the risk to the executor or successor trustrustee.

7.3 **Client has a FLP that's really a limited partnership**

7.3(a) Dad and Mom held the property in their names before they put it into the FLP. If there was environmental liability, they already had it before they created the FLP. So when they became the general partners of the FLP, they did not increase their exposure.

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[40] FTB Form 568.

7.3(b) If dutiful daughter steps in as the general partner of the FLP, she takes new liability exposure that she did not have as a limited partner.

⇒ She would organize an LLC to become the general partner, with the consent of the other partners. She would manage the limited partnership in her role as manager of the LLC. This is an adequate, but very awkward solution.

7.3(c) From a liability standpoint, the best solution might be to merge the FLP into a new LLC before Dad and Mom both die. It should be possible to do so without triggering a change of ownership for California property tax purposes. The LLC would be treated as the same partnership for federal income tax purposes, with the same EIN.

7.3(d) As manager of the LLC, dutiful daughter does not take on more no-fault liability. The LLC's assets are at risk, but hers are not.[41]

7.4 Donating real property to a charity

7.4(a) Client wants to donate real property to a charity. Charity says "Thanks, but ... please donate it to our single-member LLC." Client wants the transferee on the deed to be the charity, to assure his deduction.

7.4(b) Solution: Client transfers property to single-member LLC, then transfers to charity the interest in the LLC.

7.5 Husband + wife = 1 member

7.5(a) The IRS will allow a husband and wife in a community property state to treat as a single-member LLC one in which the husband and wife are both members.[42]

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41 Of course, she cannot escape liability for her own wrongful acts as manager of the LLC.

42 See outline on page 21 "Disregarded Entities: Single-Member Limited Liability Companies and Qualified Subchapter S Subsidiaries."

7.5(b) Best practice: avoid doing this. Name just one member in the operating agreement for a single-member LLC that you intend to be disregarded for tax purposes. And state your intention in the operating agreement. (And have an operating agreement.)

7.5(c) If the wife is the only named member of the LLC, her husband's community property interest in her membership interest will not prevent the LLC from being disregarded for tax purposes.

8. BASIS ISSUES

8.1 Effect of carryover basis for gifts

8.1(a) All else being equal, choose for gifts assets with a basis close to the value. This avoids passing to the next generation an income tax gain waiting to be realized. Retaining the assets with low bases relative to their value gets the most out of the Section 1014 basis step-up at death.

8.1(b) Generally, interests in pass-through entities will be closer to the value of the interest than shares of C corporations.

8.2 Dynamic basis in pass-through entity interest

8.2(a) A shareholder's basis in C corporation stock does not change unless the shareholder makes a capital contribution or incurs cost to defend title to the shares.

8.2(b) In contrast, a shareholder's basis in S corporation stock is dynamic. In addition to capital contributions and title defense costs, profits increase basis in the shares. Distributions and losses decrease basis. Similar rules apply to interests in LLCs and partnerships.

8.2(c) The bottom line is that an owner of a successful business will probably have a higher income tax basis in a pass-through entity than in a C corporation.

8.3 Preserving the identity of blocks of high-basis stock

8.3(a) When a shareholder buys out another shareholder, he should preserve the identity of the high-basis block of shares.

8.3(b) The shareholder can use the high-basis shares to make gifts, which will have a carryover basis, and retain the lower basis shares, which will receive a basis step-up at the shareholder's death.

8.4 **Make gifts of S stock *before* declaring a dividend**

8.4(a) Declare and pay the dividend *after* the gift.

8.4(b) The effect is to discount the cash gift by the discount that applies to the shares.

8.5 **As an exit vehicle, tax-free stock swaps avoid gain recognition**

8.5(a) An 85-year-old client should avoid a taxable disposition of his shares. Better to do a tax-free stock swap with the "buyer" and take a low, carry-over basis in the buyer's shares.

8.5(b) The buyer shares will get a basis step up when the client dies, and no income tax will be paid for the privilege.

8.5(c) *Note:* An LLC or partnership cannot do a tax-free stock swap.

9. CHOICE OF ENTITY FOR A PRIVATE FOUNDATION

9.1 **Nonprofit corporation vs. trust**

There's no clear winner here.

9.1(a) The California nonprofit corporation law beautifully sets forth the duties of the directors and the mechanics of corporate governance.[43]

9.1(b) With a trust, it is easier to name successors to the founders.

9.1(c) A California nonprofit corp must invest with a view to preserving principal, an out-of-date standard.

9.1(d) Trustees of California trusts use the prudent investor rule and modern portfolio theory.

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[43] See outline on page 21 "Nonprofit Organizations, Private Foundations and the Charitable Contribution Deduction."

9.1(e) The IRS does not seem to prefer one form to the other.

9.2 California nonprofit corporation or Delaware nonstock corporation?

9.2(a) A California nonprofit public benefit corporation cannot have more than 49% of the directors (or their relatives) compensated by the corporation.

9.2(b) This rule does not apply Delaware nonstock corporations doing business in California.

9.2(c) It is not a prohibited transaction to pay compensation to a disqualified person as long as the compensation is not excessive.

9.2(d) However, it usually is not a good idea to pay a family member for service to the family foundation, and can lead to problems with the Attorney General.

[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.

[ ] **"Buy-Sell Agreement Checklist"***

[ ] **"Buy-Sell Agreements for Closely-Held Businesses – An Overview"***

[ ] **"Buy-Sell Agreements for Closely-Held Businesses: Insurance Funding for C and S Corporations"***

[ ] **"Disregarded Entities: Single-Member Limited Liability Companies and Qualified Subchapter S Subsidiaries"***

[ ] **"Limited Liability Companies - An Introduction"***

[ ] **"Nonprofit Organizations, Private Foundations and the Charitable Contribution Deduction"***

[ ] **"Mistakes to Avoid During Succession - Ten Mistakes Families Should Avoid When Transferring a Business to the Next Generation"***

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