

Hot Tax Planning Tips and Strategies

June 8, 2005

National Bank of California
Sherman Oaks

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This presentation 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.

Topics

- 1. Choice of Entity**
- 2. Preserving Net Operating Losses**
- 3. Liquidation Traps**
- 4. S Corp Tips**
- 5. C Corp Tip**
- 6. Selling a Business**
- 7. Incentive Compensation**
- 8. Nonprofit Organizations**

Choice of Entity

Choice of Entity

Situation: Existing corp (C or S) has operating business and other appreciated assets (maybe real estate, art, a second or third business) in the corporation.

Concern: A claim against the operating business can be satisfied with the other valuable assets.

Tip: Create a holding company structure to isolate the operating business from the valuable assets.

Old Structure

Shareholders

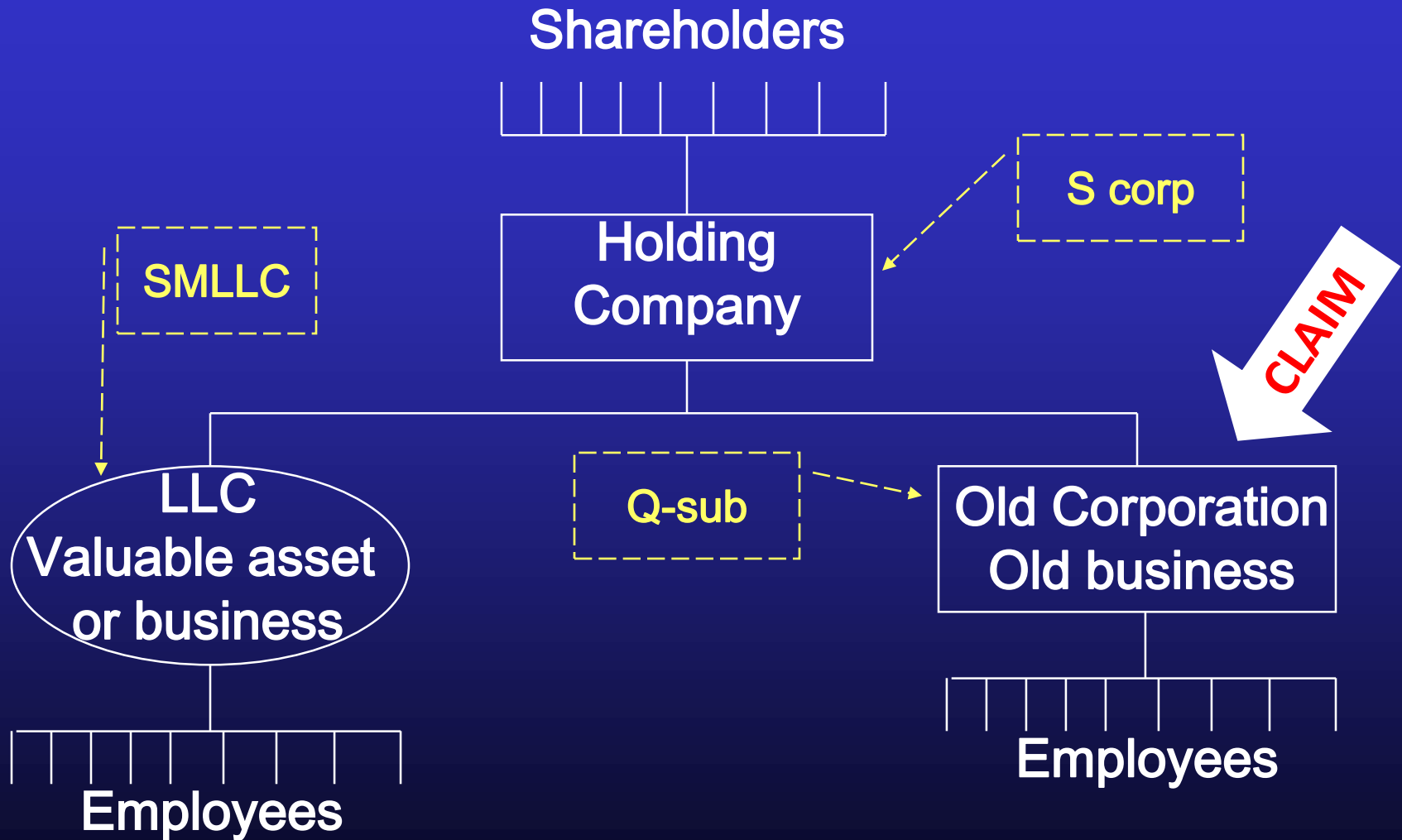


Other Asset
or business



Employees

New structure



Choice of Entity

Situation: It's time to create a subsidiary of an S corp.

Choice: Use a Q-sub or an SMLLC?

Tip: Use a SMLLC if there is no licensing problem.

Why: When the Q-sub terminates it can trigger gain recognition for some (357(c)) or all (failed Section 351) of its assets.

And it defaults to a C corp.

Choice of Entity

Situation: It's time to organize an entity for a business that could grow rapidly and have a public offering.

Choice: Use a corporation or an LLC?

Tip: Use a corporation, first S, then C when it ceases to qualify as an S.

LLCs are cool, but ...

Choice of Entity

Why use a corp for an IPO candidate?

- LLCs don't go public, corps do
 - The conversion of the LLC to the corp is an opportunity for haggling, holdouts and litigation
- LLC can't have ISO plans
- LLCs can't do tax-free stock swaps

Choice of Entity

Situation: Client wants to loan money to an LLC, or to enter into a contract with an LLC. The LLC looks like it has substantial assets to back its promises.

Issue: Are all the assets of the LLC available to satisfy your client's claim against the LLC?

Choice of Entity

Series LLC

Tip: Not if it's a "series" LLC. If so, each "series" is like a separate SMLLC within the master LLC.

How to tell? Get the articles of organization or certificate of formation.

Tip: If it's a California LLC, it's not a series LLC.

Preserving Net Operating Losses

NOLs

Situation: Parent Corp has pumped cash into its subsidiary but Sub's business failed. Sub is indebted to Parent for more than Sub's assets are worth. Sub has lots of unexpired NOLs.

Issue: How to dispose of Sub?

Intuitive: Merge Sub into Parent.

Not so fast....

NOLs

How to dispose of an insolvent Sub with NOLs?

- The Sub \Rightarrow Parent merger is a failed Section 332 liquidation.
 - The NOLs won't survive.
- Better: Merge Parent into Sub and re-name Sub with Parent's name.
 - This is a good Type A reorg.
 - The NOLs will survive.

Liquidation Traps

Liquidations

Situation: Business is sold, cash is on hand, debts are collected.

Issue: Distribute all the cash to the several shareholders?

Intuitive: Sure. Wasn't that why we were in business?

Not so fast....

Liquidations

To distribute or not to distribute?

- It might be best to hold some cash in the corp to satisfy lurking claims or tax audits.
 - Distributed cash creates capital gain.
 - A payback to the corp or paying claims against the corp creates ... capital loss.
 - You don't want your clients to have a capital loss they can't carry back.

Liquidations

Situation: OK, so we'll hold some cash.

Issue: Keep the corp alive holding the reserve cash or ... create a liquidating trust or LLC, transfer the cash to the liquidating trust/LLC?

Intuitive: We're trying to eliminate entities here, not create new ones.

Well ...

Liquidations

How to hold the cash reserve

- The sooner the corp dissolves, the sooner it starts the special statute of limitations (4 years for a CA corp).
- A claimant can tap any shareholder to satisfy a judgment against the dissolved corp.
- A liquidating trust has classification issues that LLCs no longer have, so ...

... an LLC is often the best way to hold the reserve.

Liquidations

Note the competing concerns:

- The corp should dissolve to start the special statute of limitations (4 years for a CA corp).
 - So, dissolve sooner.
- But ... a claim paid after dissolution will be a capital loss
 - So, dissolve later.
- Each case requires a balancing of these competing concerns.

S Corp Tips

S corps

Situation: S corp is subject to the “excess passive receipts” penalty tax. (Or maybe it’s a personal holding company that wishes it could be an S corp.)

Issue: How to pump up active receipts to over 75% of all receipts to beat the excess passive receipts penalties (penalty tax and loss of S status)?

S corps

Beating the Passive Receipts Penalties

- The S corp buys interests in publicly-traded gas distribution LPs or LLCs.
 - The active receipts flow through partnership and the S corp and retain their active character for purposes of the excess passive receipts test.
 - The LP/LLCs' margins are thin, so a dollar buys a little bit of earnings but a lot of active receipts.

S corps

Situation: S corp is subject to excess passive receipts penalty tax. (Or maybe it's a personal holding company that wishes it could be an S corp.)

Tip:

1. Distribute the C corp e&p at the current low federal income tax rates.
2. No C corp e&p = No S corp penalty tax

S corps

Situation: Sole shareholder of S corp dies. Heir wants to *sell* asset to an unrelated buyer.

The S corp's asset would create long-term capital gain when sold. S corp has zero basis in asset.

Tip: Sell the asset *and distribute the sale proceeds in the same year*. There will be no net capital gain on the sale or distribution.

S corps

Zero tax *sale* of S corp asset

- Heir gets a basis step-up in stock to FMV – to \$100.
- S corp sells asset for \$100 cash to unrelated person or entity
 - Inside gain of \$100 flows through to heir.
 - ☆ Heir's stock basis jumps from \$100 to *\$200*.
- *Same year:* Heir receives cash distribution in liquidation of S corp.
 - Amount realized on distribution = \$100 cash
 - Basis in stock = *\$200*
 - ☺ *\$100 outside capital loss on distribution*
offsets *\$100 inside capital gain on sale*.
- There might be depreciation recapture or other inside ordinary income from the sale that would not be offset by the outside capital loss.

S corps

Botched “zero” tax sale of S corp asset

- Heir gets a basis step-up in stock to FMV – to \$100.
- S corp sells asset.
 - Inside gain of \$100 flows through to heir.
 - Heir pays tax on capital gain.
 - Heir’s stock basis jumps from \$100 to \$200.
- *Next year:* Heir receives cash in liquidation of S corp.
 - Amount realized on distribution = \$100 cash
 - Basis in stock = \$200
 - ★ \$100 *outside capital loss on distribution.*
 - ☹ No offset or carry back!

S corps

Unfortunate *distribution* of S corp asset

- Heir gets a basis step-up in stock to FMV – to \$100,000.
- S corp distributes asset to heir/shareholder.
 - Inside gain of \$100,000 flows through to heir – as ordinary income because the heir is “related” to the corporation as a shareholder.
 - ☹ Heir owes tax on ordinary income – but no cash is generated by the distribution.
 - Heir’s stock basis jumps from \$100,000 to \$200,000.
 - ☹ Receiving the distribution generates a capital loss to heir/shareholder of \$100,000 -- but it cannot offset more than \$3,000 of ordinary income per year.
 - ☹ The unused capital loss can be carried forward.

S corps

Situation: S corp issues new shares – or S corp shareholder sells shares.

Problem:

- Get the *old* shareholders enough cash to pay their tax on their S corp income -- without over-paying the *new* shareholder.
- Key rule - Must distribute the same number of dollars per share to all shareholders under corporate law -- and to avoid a one-class-of-stock problem.

S corps

Share transfers and distributions to pay tax

Tip: Make a distribution to clean out the undistributed S corp profit *before* the stock transaction. Maybe loan it back, if needed.

Or take solace in the high stock basis of the old shareholders. For the old shareholders, the high basis provides:

- *An immediate* benefit to the shareholder who sold stock.
- *A deferred* benefit when the corp issues new shares.

S corps

Situation: C corp (OldCo) wants to make a mid-year S corp election.

Tip:

1. Organize a new corp, make the S corp election for NewCo. (Best if NewCo already exists.)
2. Contribute all outstanding OldCo stock to NewCo and make a Q-sub election for OldCo.
3. Establish a business purpose for NewCo, maybe by creating another subsidiary.

S corps

Situation: Parent is reluctant to continue giving children S corp stock now that Parent is approaching 50% ownership. Parent wants to retain control.

Tip:

1. Convert each outstanding share to one voting and nine non-voting shares.
2. Parent continues giving non-voting shares.
3. Parent retains control with voting shares.

C Corp Tip

C corps

Situation: C corp is exposed to accumulated earnings penalty tax as a result of high retained earnings and liquid assets not needed for working capital.

Tip:

1. Distribute the C corp e&p at the current low federal income tax rates.

Selling a Business

Sale of a business

Situation: The buyer wants to buy assets.

Issue: Do we really have to pay sales tax on all the equipment and vehicles?

Tip: Drop these assets into a SMLLC (before the LOI is signed), sell the LLC interest.

- The buyer (and seller) treat it as an asset sale for income tax purposes.
- The buyer should keep the SMLLC in place and lease the assets to the entity that runs the business.

Sale of a business

Situation: Seller wants to sell a business to an existing shareholder.

Issue: Who should buy seller's stock?

Intuitive: Corp buys because corp is where the cash accumulates. Other shareholder has no cash to buy.

Well ...

Sale of a business

Who buys Seller's stock?

- If C corp buys, remaining shareholder has the “disappearing basis” problem.
 - His basis in his shares does not increase
- If shareholder buys, his basis in his shares increases.
 - S corp election may solve disappearing basis problem, or allow remaining shareholder to buy and get cash from corp as distributions.

Sale of a business

Consider an ESOP Purchase

- If ESOP gets at least 30% of shares, the seller can avoid gain on the sale.
 - Use sale proceeds to buy securities of U.S. companies.
 - Carryover basis in those securities
 - Get a stepped up basis at death.
 - Take margin loans during life.
- Problem: ESOP is an unfunded pension plan.
- Also, only for C corps.

Sale of a business

Consider an ESOP Purchase

- When an ESOP borrows to buy out the shareholder, the principal payments effectively become deductible.
 - The company makes deductible contributions to the ESOP.
 - The ESOP uses the \$ to pay the interest and principal on the loan.
- Problem: For the “real” shareholders, the basis still “disappears.”

Sale of a business

Situation: *Seller* wants to sell stock of S corp. *Buyer* wants to buy assets for the basis boost.

Tip: Seller sells stock, makes Section 338(h)(10) election.

- Buyer gets basis boost
- Seller has one level of tax – the inside tax.
 - Seller might have built-in gains tax or depreciation recapture from “asset sale”
- No sales tax. www.staley.com

Sale of a business

Situation: Seller and Buyer use an earn-out or contingency payment.

Issue: Should buyer take the \$ now, and refund it if necessary, or get the \$ only if the wind eventually blows his way?

Intuitive: Take the \$ now.

Not a bad idea, but there are tax issues...

Sale of a business

Earn-out or contingency payment

- Taking the \$ now will create LT capital *gain*.
 - Giving it back will create LT capital *loss*, with *no carry back*. Not pretty.
- Receiving the \$ later will defer tax using the installment method.
 - Only the amount received will be taxed.
 - The goal is to “almost” receive it.

Sale of a business

Situation: The only assets in the S corp are passive assets like rental real property, but they are subject to the built-in gains tax.

Issue: Is there a way to sell the assets and dissolve the S corp without paying the BIG tax?

Maybe ...

Sale of a business

Beating the BIG tax – First try

1. Don't make any gifts of shares, and
2. Wait until the *later* of:
 - The end of the ten-year BIG period,
and
 - The shareholders' death (to get the basis step up).
3. Then sell the assets – no tax at all.

Sale of a business

Beating the BIG tax – Second try

- S corp creates a charitable remainder trust
- S corp donates asset to CRT
- CRT pays S corp an annuity for a fixed term of years.
- S corp dissolves.
- CRT pays annuity to shareholder.

Incentive Compensation

Incentive Compensation

Situation: Employer wants to provide incentive to employee and to use golden handcuffs.

Issue: Use a stock option or restricted stock?

Tip: The employee is best served with restricted stock.

- LT cap gain holding period starts.
- Employee gets basis in shares.
- Employee must make 83(b) election.

Incentive Compensation

Situation: When employee makes the 83(b) election, the employee will have surprise income (and wage withholding) and the employer will have a surprise deduction.

Issue: How to eliminate both surprises?

Tip: Profitable employer gives employee the cash to pay tax on the surprise income, plus the tax on the bonus.

The employer has a deduction for the stock transfer and for the cash bonus.

Incentive Compensation

Cover the employee's surprise tax

Value of stock	<\$10,000>
+ Cash bonus	<\$ 6,700>
	<hr/>
= Total deduction	<\$16,700>
X Tax rate of employer	40%
= Value of deduction	\$ 6,700
Net cost to employer	\$ -0-

Incentive Compensation

Situation: Employer wants to issue stock options. The company is not an IPO candidate.

Issue: Use ISOs or NQSOs?

Tip: Use NQSOs

- The employees are unlikely to exercise and hold stock that is not publicly traded.
- To get the benefit of the ISO, they must exercise and hold for 1 year from the exercise date (and 2 years from the grant date).
 - They won't.

Incentive Compensation

Situation: Employee exercises ISO when the stock price is miles above the exercise price.

To get ISO treatment, employee must hold the shares for 1 year from exercise, 2 years from date of grant.

Tip: In *December* employee should consider selling the shares, or at least enough shares to pay the AMT tax on the spread. Even though this is a “disqualifying disposition.”

April is too late to cure an AMT problem.

- Sometimes share prices drop.

Incentive Compensation

Situation: LLC wants to give an employee a piece of the action.

Issue: Use “stock option” or “restricted stock”?

Tip: Use “profit interests” to allow the employee to participate in the sale of the business.

Use special allocations and special distributions to provide a capital interest.

- Allocate profit to bring employee to target ownership %.
- Use distributions to pay the tax.

Incentive Compensation

LLC Employee gets a piece of the action

- For employee to get the capital interest, LLC must have profits.
- Avoids surprise employee tax and employer deduction is Section 83.
- But ...
...employee becomes a partner and moves from wage withholding/FICA regime to estimated tax, self-employment tax regime.

Nonprofit Organizations

Nonprofits

Situation: Donor offers real property to charity, which is concerned about environmental liabilities.

Tip: Donor transfers property to a new SMLLC, transfers interest to charity.

SMLLC inherits liability, not charity.

No tax when charity sells property.

Nonprofits

Situation: Nonprofit school holds an endowment and operates several charitable but risky activities.

Concern: A claim against the risky activity could be satisfied with the endowment assets.

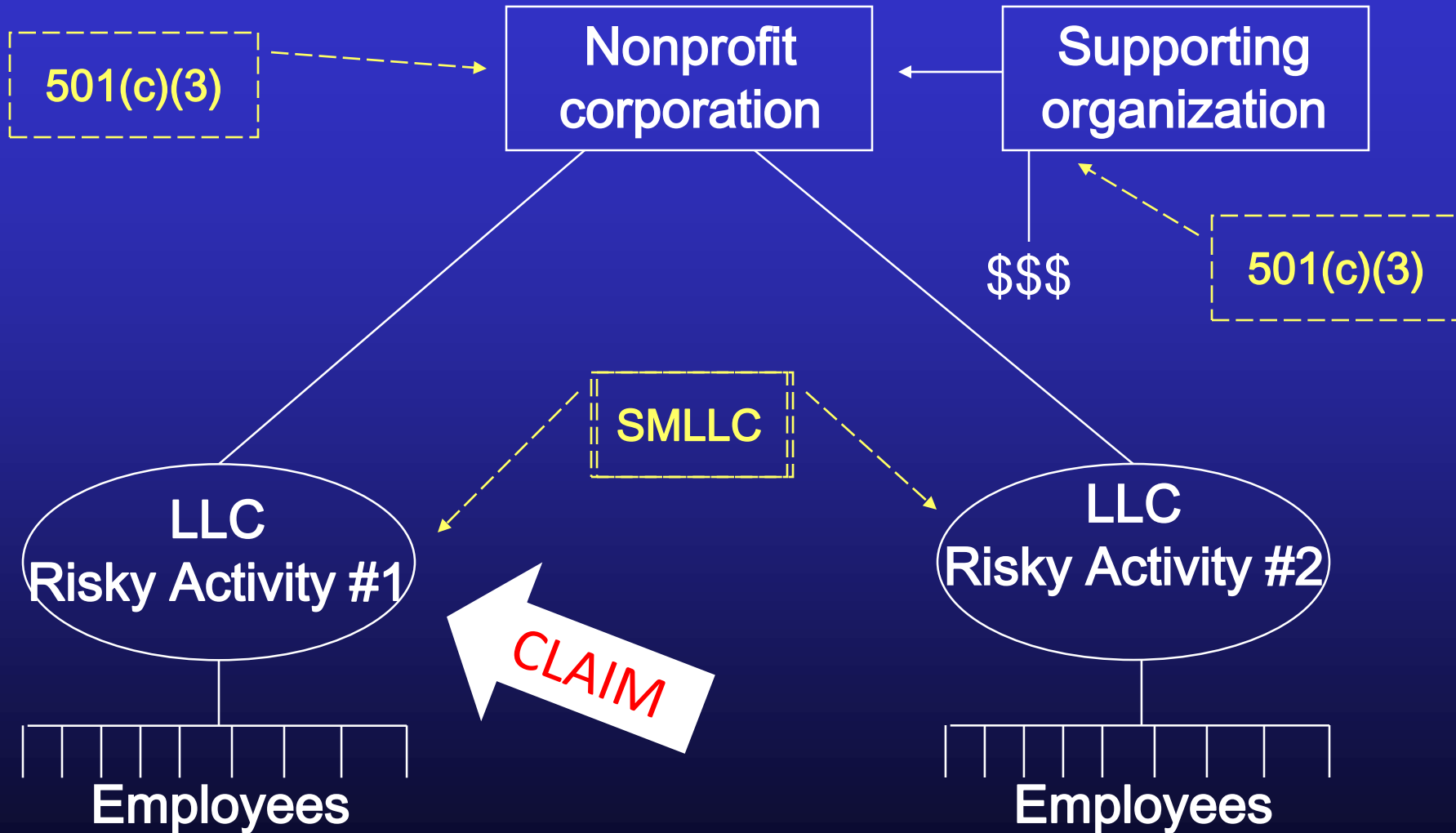
Tip: Create a holding company structure to isolate the risky activities from the endowment.

Sound familiar?

Old Structure



New structure



Thank you.

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