

DON'T LET LIVING TRUSTS CAUSE PROBLEMS
FOR
OWNERS OF CLOSELY-HELD BUSINESSES

CALIFORNIA ASSOCIATION OF ATTORNEY-CPAS
and
TAX SECTION, CALIFORNIA STATE BAR

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September 23, 2009

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1. LIVING TRUSTS ARE USEFUL ESTATE PLANNING TOOLS

- 1.1 Living trusts avoid the publicity, delay, hassles and fees of probate proceedings
- 1.2 They are an elegant way to solve several estate tax problems.
- 1.3 Closely-held business interests held in living trusts avoid the necessity of a public, less-than-thorough valuation of the business in the probate proceeding.
- 1.4 A husband and wife who have just signed their living trust can walk out of their estate planner's office knowing that they have done well by their families.
 - ⇒ Unfortunately, they might not have done as well by the other shareholders.

2. THE FEUDING SPOUSES PROBLEM

Example. A, B, C and D each holds 25% of the outstanding shares of a California corporation, and the four of them are the directors.

While A and B vote together, they can stop any initiatives of C and D.

A puts A's shares into a living trust of which A and A's spouse Z are the trustees. The trust gives the trustees the power to vote shares held in trust, and says nothing more about voting.

After a few years, A and Z disagree about many things, including how the shares should be voted. At a shareholder's meeting, A votes to elect A as a director and Z votes to elect Z as a director. The corporate secretary splits the votes of A and Z.¹ A and Z would tie for the fourth board seat.

In a new shareholder vote to break the tie between A and Z, C and D might vote for Z, who would take the fourth board seat.² This would also disadvantage A and B. However, C and D probably would prefer their own nominee to Z, whose vote might be difficult to predict. If C and D voted for their nominee for the one open seat, they would prevail over A and B voting for A, and Z voting for Z. Now C and D are in control.

Or C and D, with Z's vote, could amend the bylaws as shareholders to provide for a fifth director, which C and D could elect if A and Z split their votes.

A and B are both disadvantaged and B asks "How could this happen?"

3. **BUY-SELL AGREEMENTS**

3.1 Shares are freely transferable. Unless the issuing corporation restricts this right in the terms of the shares or the shareholders restrict this right in a buy-sell agreement or shareholders agreement,

¹ Cal. Corp. Code § 704(3). The specific "split-the-vote" rule of Corporations Code Section 704 supersedes the general rule of Probate Code Section 15620 that co-trustees must act unanimously. *Edwards v. Edwards*, 61 Cal. App. 4th 599 (1998).

If the trust instrument required unanimous action by the trustees and a copy of the instrument was furnished to the corporate secretary, presumably the votes of A and Z would be ignored by the secretary.

² H. Marsh, Jr., R Finkle, L Sonsini, *MARSH'S CALIFORNIA CORPORATION LAW*, ch. 12 at fn. 20 (4th ed. 2004).

a shareholder is free to transfer shares to anyone, including a spouse or trustee.³

- 3.2 The first and best line of defense is a buy-sell agreement that addresses this issue.
- 3.3 The buy-sell agreement can (but need not) apply equally to all of the outstanding shares and all shareholders. Here is a provision that addresses the “feuding spouses” problem:

The parties intend that each Shareholder's Shares [“Shareholders” being defined by their names] shall retain their community or separate property character, which this Agreement is not intended to affect. The rights of a spouse of a Shareholder in the Shareholder's Shares shall be limited to the extent of any community property or other joint ownership interest, if any, that the spouse may have or acquire in the Shares. As between a Shareholder and the Shareholder's spouse, the Shareholder shall exercise the sole management and control of the Shares to the fullest extent permitted by law, even if the stock certificate representing the Shares bears the names of both the Shareholder and the Shareholder's spouse. To the extent permitted by law, the parties agree to waive the provisions of Section 704 of the Corporations Code so that only the vote of the Shareholder shall be respected, even if the Shares are registered to the Shareholder and someone else.

³ Cal. Corp. Code § 418(b).

A Shareholder during his or her life may transfer Shares to a trust, but only if (1) the trust is established by the Shareholder for the benefit of such Shareholder or such Shareholder and the Shareholder's spouse, and (2) the Shareholder serves as sole trustee (or, if the Shareholder's spouse is a party to this Agreement, either the Shareholder serves as sole trustee or both the Shareholder and the Shareholder's spouse serve as the sole trustees) of the trust until the Shareholder's death or incapacity. Any Shares so transferred shall remain subject to all of the provisions and restrictions of this Agreement and the Shareholder, both individually and as trustee of the trust, shall continue to be considered a "Shareholder" for purposes of this Agreement. (If a spouse is a trustee, the spouse shall continue to be considered a spouse of a Shareholder and not a Shareholder with respect to the Shares held in the trust.)

- 3.4 California corporate law makes it very clear that voting agreements should be enforced.⁴
- 3.5 The existence of the buy-sell agreement and certain of its terms (regarding transfer restrictions and voting) should appear in a legend on the stock certificate.⁵

⁴ Cal. Corp. Code § 706. It is possible that electing "close corporation" status for corporate law purposes would increase somewhat the likelihood that the buy-sell agreement provisions would be enforced – such as the provisions protecting S corporation status. Cal. Corp. Code §§ 186, 300(b).

⁵ Cal. Corp. Code §§ 418, 705(f).

4. COMMUNITY PROPERTY LAW VS. CORPORATE LAW

4.1 Shareholders who get along reasonably well trust each other not to transfer shares in a way that will hurt the other shareholders.

⇒ But transferring to a living trust is so common and innocuous, no one worries about it.

4.2 The estate planner has as clients *the couple* in the estate planner's office, and is *not answerable* to the other shareholders.

⇒ However, many estate planners will encourage the owner of a closely-held business to enter into a buy-sell agreement with the other shareholders.

⇒ In fact, naming only one spouse as trustee will make the estate planner nervous. "They both have a community property interest in the shares now," the estate planner reasons. "Why not make them both trustees of their community property?"

4.3 Estate planners are familiar with Family Code Section 1100(d), which provides:

[A] spouse who is operating or managing a business or an interest in a business that is all or substantially all community personal property has the primary management and control of the business or interest. Primary management and control means that the managing spouse may act alone in all transactions but shall give prior written notice to the other spouse of any sale, lease, exchange, encumbrance, or other disposition of all or substantially all of the personal property used in the operation of the business ..., whether or not title to that property is held in the name of only one spouse.

4.4 However, Section 704(3) of the Corporations Code requires the corporate secretary to respect the vote of each spouse or trustee

named on the stock certificate, unless one of them provides the secretary with written notice why the secretary should not count the other's vote and documents the basis for the conclusion.

- 4.5 Because neither the Family Code provision nor the Corporations Code provision states that one supersedes the other, it is unlikely that the corporate secretary will be persuaded that the Family code provision allows the secretary to ignore Z's vote if Z is a shareholder of record.⁶

5. SHARES HELD BY INDIVIDUALS

- 5.1 In view of Corporations Code Section 704 and Family Code Section 1100, the best practice for titling shares not in trust is to use the name of the shareholder who is active in the business and nothing else.

- 5.2 Married shareholders can rely on the presumption that property acquired during marriage is community property. Cal. Fam. Code § 760.

⇒ Adding “, a married man” or “, a married woman” by itself indicates that someone (the transferor or the shareholder) intended the presumption to apply, but it does not add to the fact that the shareholder is married and the shares are not separate property.

⇒ If the non-active spouse wants to see his or her name on the certificate, my strong preference is to use “A, as the community property of A and Z, husband and wife.” This usually will satisfy Z, but it should not entitle Z to vote the

⁶ The 1998 *Edwards* case held that the specific provision of the Corporations Code superseded the more general provision of the Probate Code. See footnote 1. Using that approach, the specific provision of the Corporations Code would probably supersede the general provision of the Family Code.

shares, because it only indicates that Z has a community property interest in the shares.

- ⇒ In contrast, “A and Z” or “A and Z, husband and wife, as their community property” each makes Z a shareholder of record and probably permits Z to vote pursuant to Corporations Code Section 704, with the probable effect of superseding Family Code Section 1100(d).

6. SHARES HELD IN TRUST

6.1 A living trust instrument for a married couple should create a sub-trust to hold shares of or interests in a closely-held business.

- ⇒ It should make the spouse who is active in the business the only trustee of the subtrust.

6.2 This is especially true when the shares are separate property acquired by gift or inheritance.

6.3 Here is a sample provision (similar to a provision that would allow a shareholder of a professional corporation to vote the shares of that corporation):

A holds in his name shares of _____, Inc. and membership interests in _____ LLC, and might acquire interests in other companies in his name (all of which are referred to in this instrument as “the Companies”). With respect to shares of or interest in a Company, Trustors intend that only A shall exercise the powers set forth in [the Powers of Trustee provisions], so long as A serves as a Trustee of the trust. Title to such shares shall be held in the name of A, as Special Trustee. If A becomes unwilling or unable to act as Special Trustee, the successor Trustee provi-

sions of this trust instrument shall apply.

- 6.4 The trust probably should also have provisions allowing the trustee to retain an interest in a closely-held business (as opposed to diversifying the investment portfolio to minimize risk and volatility).
- 6.5 If the business entity is a corporation, the trust instrument should include provisions allowing the trustee to protect the valuable S corporation status.

7. PROXIES

- 7.1 A person entitled to vote shares can give another person a proxy to vote the shares.⁷
- 7.2 A spouse who is not active in the business but who is named on the stock certificate could give a proxy to the active spouse. In the “Feuding Spouses” example on page 1, Z could give to A a proxy to vote Z’s interest in the shares.
- 7.3 However, a proxy is generally not good for more than 11 months. Also, proxies can be revoked.
- 7.4 A proxy can be irrevocable when it designates as the voter:
 - ⇒ A person named in a shareholders agreement or voting trust; or
 - ⇒ A beneficiary of a trust with respect to shares held in the trust.⁸

⁷ Cal. Corp. Code § 705(a).

⁸ Cal. Corp. Code § 705(e)(5), (6).

- 7.5 Consequently, a buy-sell agreement or shareholders agreement could be irrevocable for the term it specified.
- 7.6 Also, the (trustee) spouse who is not involved in the business could give to the involved spouse (as beneficiary) a proxy that is irrevocable for a the term it specified.
- 7.7 A transferee of the shares who does not know of the irrevocable proxy can revoke it, unless “the existence of the proxy and its irrevocability appears, in the case of certificated securities, on the certificate representing the shares.”⁹

8. HIERARCHY OF METHODS

- 8.1 Addressing these issues with a subtrust or by keeping a non-active spouse’s name off the stock certificate is a temporary, partial solution. That horse is in the barn, but the barn door is still open.
- 8.2 In contrast, the buy-sell agreement or shareholders agreement can apply equally to all shares and all current and future shareholders.
- ⇒ The buy-sell agreement – with the appropriate legends on the stock certificates -- is the best way to address this issue.
 - ⇒ As a voting agreement, the buy-sell agreement eliminates the need for proxies.
- 8.3 The best time -- by far – to address this issue is while the shareholders still have their shares in their own names, and before they have created living trusts.
- 8.4 When a shareholders asks to transfer his or her shares into a living trust of which a spouse is a co-trustee, it is possible to ask the shareholder to amend his or her living trust to add a special trust.

⁹ Cal. Corp. Code §§ 418(b), 705(f).

- ⇒ However, there might be many reasons why they would prefer not to revisit their trust (examples: they might not want to revisit the expense and angst of the estate planning process, they might no longer agree on the dispositive provisions or successor trustees).

- ⇒ In that situation, an irrevocable proxy given by the non-involved spouse as a trustee of the living trust to the active spouse, as a beneficiary, might be the best interim step. The corporation could provide the proxies along with the stock assignment or new stock certificate.
 - Without a buy-sell agreement or shareholders agreement in place, the non-involved spouse would not be required to sign the proxy.

 - Of course, the involved spouse would not be required to sign the stock assignment, but the situation might not be that simple.

9. S CORPORATIONS AND LIVING TRUSTS

9.1 Most corporations are S corporations (approximately 60% based on federal tax returns filed for 2006).¹⁰

¹⁰ From 1980 to 2006, the portion of businesses operating as C corporation dropped from 17% to 6%. The portion operating as S corps increased from 4% to 13%. There are more S corporations than partnerships (including LLCs) (10%). Most businesses (72%) are sole proprietorships, but they account for only 5% of total business receipts. C corporations earn 65% of the receipts, with those C corporations with the largest C corps (more than \$10 million in receipts) earning 58% of all of the receipts of U.S. businesses. S corps earned 19% of national business receipts, and the largest earned 57% of that. Mark P. Keightley, Congressional Research Service, *Business Organizational Choices: Taxation and Responses to Legislative Changes*, August 6, 2009, Daily Tax Report (BNA) August 17, 2009 TaxCore/Congressional Documents/Reports.

- ⇒ When the *business assets are sold* in California, the *effective tax rate* on the gain recognized in a sale by a C corporation is 54%, versus 25% for an S corporation.¹¹
- ⇒ With an S corporation, *cash not needed for the business* can be distributed to the shareholders without a second level of tax (effective tax rate: 41%). There would be a double tax if the cash was distributed by a C corporation (effective tax rate: 54%).
- ⇒ The highest tax rates for individuals and C corporations are very close, so there is no longer a short-term tax cost of S corporation status.

9.2 But C corporation status is the *default*.¹² To be an S corporation, the corporation must meet *eligibility requirements* and a proper *election* must be made.¹³ The election will *terminate* if the corporation ceases to meet the eligibility requirements.¹⁴

9.3 A corporation that is an S corporation for federal purposes is also an S corporation for *California tax purposes*. When the federal election terminates, the California election terminates also.¹⁵

¹¹ Calculations: $100\% - ((1 - (8.84\% \text{ California corporate tax rate} \times (100\% - 35\% \text{ federal corporate rate}) + 35\% \text{ federal corporate rate}) \times (100\% - 9.3\% \text{ California individual rate}) \times (100\% - 15\% \text{ federal individual rate on net long-term capital gain})) = 54.32\%$ vs. $9.3\% \text{ California individual rate} + 15\% \text{ federal individual rate on net long-term capital gain} = 24.3\%$.

¹² I.R.C. § 1361(a)(1).

¹³ I.R.C. §§ 1361(b), 1362(a), (b).

¹⁴ I.R.C. § 1362(d)(2).

¹⁵ It does not matter whether the corporation is incorporated in California or qualified to do business in California. There is longer the possibility of being an

9.4 *Estates* can hold S corporation shares, without any limitation as to time.¹⁶

9.5 If the shares will be distributed from the estate to an ineligible *testamentary trust*, the ineligible trust has *two years* after it *acquires the shares* to dispose of the shares without terminating the S corporation status.¹⁷

⇒ *Grantor trusts* can hold S corporation shares,¹⁸ so the typical living trust qualifies during the lifetime of the trustor and for *two years after death*.¹⁹

9.6 At the death of the first spouse:

⇒ And *administrative* can hold S corporation shares for two years after the date of death.²⁰

⇒ If the *survivor's trust* created after the first death is a grantor trust, it qualifies as an S corporation shareholder.²¹

S corporation for federal tax purposes and a C corporation for California tax purposes, or vice versa. Cal. Rev. & Tax. Code § 23801(a), (b), (e).

¹⁶ I.R.C. § 1361(b)(1)(B).

¹⁷ The former 60-day periods in which an ineligible trust must dispose of its S corporation stock was extended to two years, effective for taxable years beginning after December 31, 1996. Small Business Tax Act § 1303, amending I.R.C. § 1361(c)(2)(A)(ii) and (iii). Treas. Reg. § 1.1361-1(h)(1)(iv) (testamentary trusts).

¹⁸ I.R.C. § 1361(c)(2)(A)(i). The grantor must be an eligible individual shareholder. I.R.C. § 1361(c)(2)(B)(i).

¹⁹ I.R.C. § 1361(c)(2)(A)(ii).

²⁰ Treas. Reg. § 1.1361-1(h)(1)(ii).

- ⇒ A *QTIP trust* will qualify as a QSST – but it must make a timely QSST election.²²
- ⇒ A *credit shelter trust* will often qualify as an electing small business trust or ESBuT – but it also must make a timely ESBuT election.²³

9.7 No more than 100 families can hold shares of an S corporation.²⁴ Avoiding exceeding the *100-family limit* is now less important as S corporation shares move through the second and third generations.

- ⇒ Holding the shares in ESBuTs is the best way to avoid exceeding this limit.
- ⇒ The necessity of getting shareholder and spousal consents to changes to the buy-sell agreements makes them inferior to trusts.
- ⇒ The trust can specifically address the 100-family limit.
 - The trust needs a mechanism to change as the S corporation rules change over time.

²¹ Assuming the surviving spouse remains a U.S. citizen or resident alien. Treas Reg. §1.1361-1(h)(3)(A). Regarding grantor trusts as S corporation shareholders, see Treas. Reg. § 1.1361-1(h)(1).

²² Treas. Reg. § 1.1361-1(j)(4). See Section 9.10 at page 14 below.

²³ I.R.C. § 1361(c)(2)(A)(v), (e).

²⁴ I.R.C. § 1361(b)(a)(A), (c)(1).

9.8 *Custodians (just to be thorough)*

- ⇒ A custodian for the benefit of a minor is not treated as the shareholder for the purpose of counting S corporation shareholders and the other eligibility rules.²⁵
- ⇒ The minor must be an eligible shareholder, but the custodian need not be eligible.
- ⇒ When the S corporation election is made, 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.²⁶

9.9 *Separate Trust Shares*

- ⇒ Separate trust shares under IRC Section 663(c) are treated as separate trusts for S corporation purposes.²⁷

9.10 *Qualified Subchapter S Trusts ("QSSTs")*

- ⇒ If it meets the requirements of IRC Section 1361(d) and makes a timely election, a QSST is treated as a grantor trust with respect to its S corporation stock.²⁸

²⁵ Treas. Reg. §1.1361-1(e)(1).

²⁶ 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).

²⁷ I.R.C. § 1361(d)(3) (flush language); Treas. Reg. § 1.1361-1(j)(3).

²⁸ I.R.C. § 1361(d)(1).

- ⇒ 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.²⁹
- ⇒ It cannot “sprinkle” or “spray.”

9.11 *Electing Small Business Trusts (“ESBuTs”)*

- ⇒ Since the 1996 Small Business Tax Act, S corporation shares have been permitted to be held by sprinkling trusts and trusts with “contingent” charitable beneficiaries.³⁰
- ⇒ The ESBuT is treated as a separate trust for trust tax accounting.³¹
- ⇒ The ESBuT provisions of the Internal Revenue Code reflect an effort to avoid double taxation of the S corporation income (that is, at the shareholder and trust levels).

9.12 *Grantor Retained Annuity Trusts (“GRATs”)*

- ⇒ As a grantor trust, the GRAT is eligible to hold S corporation shares³² – and a GRAT is an ideal way to capture a third discount (a time value of money discount added to those for lack of control and lack of marketability) for S corporation shares.

²⁹ I.R.C. § 1361(d)(3)(A).

³⁰ I.R.C. § 1361(a)(1), (b)(1)(B), (c)(2)(A)(v), (e).

³¹ I.R.C. § 641(d).

³² See PLR 94-15-012, January 13, 1994.

9.13 *Defective Grantor Trusts*

- ⇒ Although the Service has expressed concerns about defective grantor trusts, there is no question that they are grantor trusts. As such, they are entitled to hold S corporation shares. The defective grantor trust holding stock of a very profitable S corporation is a powerful estate planning technique.

9.14 *Crummey Trusts*

- ⇒ In theory part of a Crummey trust is 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.

9.15 *Voting Trust*

- ⇒ Ignored for S corporation purposes.³³

9.16 *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 an ESBuT, if at all.

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

9.17 *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

9.18 *Late Elections*

- ⇒ The IRS has published procedures to permit late elections.³⁵

9.19 *Role of the Buy-Sell Agreement*

- ⇒ The buy-sell agreement for an S corporation should penalize a shareholder who terminates the S corporation status without the consent of the holders of a majority of the shares (who could vote for a voluntary termination of S corporation status).
- ⇒ If an election (such as a QSST or ESBuT election) is not made by the last day to make it, the buy-sell agreement should treat that day as the day on which the S corporation bought the shares from the trustee.
- ⇒ The buy-sell agreement can also give the board authority to make elections that would otherwise require the consent of all shareholders (such as closing the year for tax purposes, if a transferee also agrees to close the year).

10. **THE SUCCESSOR TRUSTEE AND THE SOLE PROPRIETORSHIP**

- 10.1 It is one thing to take over the personal finances of the decedent. It is another thing to become the employer of the decedent's em-

³⁴ Treas. Reg. 1.1361-1(h)(2).

³⁵ Rev. Proc. 97-48, 1997-2 C.B. 521; Rev Proc. 2003-43, 2003-1 C.B. 998; Rev. Proc. 2007-62, 2007-41 I.R.B. 786.

employees, the owner/operator of the decedent's business, and to take title to the decedent's products or real property. Many named successor trustees would decline to serve in this situation.

- ⇒ Employer, sellers of products and real property owners can have liability without fault. They can also be liable for their negligent actions or omissions to act. These possible claims can be covered to some extent by liability insurance, but it will take the successor trustee time to find and review all the insurance policies.
- ⇒ The problem is worse if the decedent did not have a living trust, because it takes time to appoint an executor. While that is happening, the business has no owner.

10.2 To address this concern, the sole proprietor should transfer the business to an LLC or corporation.

- ⇒ A single-member LLC that is disregarded for tax purposes will be the smallest change for the proprietor.
- ⇒ A disregarded single-member LLC is treated for tax purposes as a sole proprietorship, which how the proprietor reported before the change.
- ⇒ The successor trustee will become the owner of the membership interest, and will have the right to name the manager of the LLC. However, the successor trustee will not become the manager without affirmative action by the successor.
- ⇒ The successor trustee never becomes the employer, never takes title to the products or real property, is never the owner or operator of the business. The LLC becomes the employer, takes title, and owns and operates the business. The manager can have liability for negligent or otherwise wrongful acts or omissions, and the LLC shares that liability.

ty. But the member is not generally liable for claims against the LLC.

⇒ A corporation (probably an S corporation) can be used if the business is not allowed to operate as an LLC in California (because it is licensed under the Business and Professions Code).

10.3 To a lesser extent, these concerns apply to general partners in *general* and *limited partnerships*.

⇒ The partners of those entities should consider *converting* them into LLCs or LLPs, to provide liability protection for the general partners.³⁶

11. PUT THE SHARES IN THE TRUST!

11.1 A final note – The living trust can avoid probate only for those assets that the owners *put into* the living trust during their lifetimes.

11.2 A corporate attorney who handles a stock certificate for even a moderately wealthy client should *ask the client* if the client has a living trust.

⇒ If so, the shares probably should be *transferred to* the living trust.

⇒ The estate planner who wrote the trust can confirm this and can provide the *exact wording for title* to the shares.

⇒ If the client does not have a living trust and has not recently considered his or her estate plan, the corporate attorney should advise the client to *sit down with an estate planner*.

³⁶ See my *Structuring Businesses* outlines available on the “Events” page at www.staley.com.

11.3 Most principals of successful closely-held businesses should have a living trust, especially if they are *married* and/or *have children*.

- ⇒ The trust for a married shareholder should have a special subtrust to hold shares of the business, to avoid problems among the shareholders.
- ⇒ If there are other owners of the business, they should have a buy-sell agreement to assure that spouses do not change the balance of power among the shareholders.
- ⇒ If the business is a corporation, the trust should have special provisions to protect its current or possible S corporation status.
- ⇒ Should the trust should allow the trustee to keep the family business in the trust without diversifying?
- ⇒ If a *sole proprietor* has a business that could continue after the proprietor dies, the proprietor should transfer the business to a LLC or corporation. A single-member LLC is the smallest change.

[End of outline.]