Contra Costa County Bar Association

2023 MCLE SPECTACULAR

Refresh & Reimagine

CCCBA Estate Planning & Probate and Business Law Sections proudly present…

SUCCESSION: BUSINESS ENTITIES, LITIGATION, AND ADMINISTRATION AFTER DEATH OF AN OWNER

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AGENDA

1. Introductions

2. Entities Review

3. Succession Planning

4. Litigation and Administration Hypotheticals

5. Q&A

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PROGRAM MATERIALS

SUCCESSION: BUSINESS ENTITIES, LITIGATION, AND ADMINISTRATION AFTER DEATH OF AN OWNER

PART I. OWNERSHIP AND ENTITY CHARACTERISTICS

- SOLE PROPRIETORSHIP
  - Single person management.
  - Single person ownership.
  - Schedule C tax reporting.
  - No limited liability.
  - FBN/DBA registration.

- GENERAL PARTNERSHIP
  - Default form of doing business for at least two owners.
  - **Management** - All owners.
  - Partnership pass-through tax reporting.
  - No limited liability - joint and several liability for all partnership obligations.
  - Statement of partnership authority with the Secretary of State.
  - Partnership Agreement.

- LIMITED PARTNERSHIP / LIMITED LIABILITY PARTNERSHIP
  - **Management** – General Partners vs. Limited Partners.
  - Pass-through taxation.
    - No self-employment tax of partner income unless they actively participate in management.
  - Limited liability for LPs.
  - Certificate of Limited Partnership / Application to Register for LLP.
  - Partnership Agreement.

- LIMITED LIABILITY COMPANY
  - Generally the entity of choice for new businesses.
  - **Management** – Can designate managers, or member-management
  - Pass-through taxation.
  - Limited liability for members.
  - Articles of Organization.
  - Operating Agreement.

- CORPORATION
  - **Types** – General stock, close, professional, nonprofit.

    - Different Secretary of State initial filings for each.
  - **Management** – board of directors and officers.
  - **Ownership** – share classes, ownership restrictions, single shareholder
  - **Taxation** –
    - C-Corp taxed for accumulated earnings.
    - Election for S-Corp – no self-employment taxes on shareholder dividends (but rather only on reasonable salary paid to shareholder employees).
  - Articles of Incorporation / Bylaws / Shareholder and Board Resolutions

- REAL PROPERTY TITLE OWNERSHIP
  - **Joint Tenancy**
    - Four unities – time, title, interest, and possession
    - Any party can sever the joint tenancy
    - Cannot now create a joint tenancy with an inter vivos trust.
  - **Tenancy In Common**
    - Management – owners can designate managers
    - Proportionate tax reporting - IRC 761 election to not annually submit partnership tax returns

PART II. BUSINESS OWNER WITH NO ESTATE PLAN

- POTENTIAL ISSUES
  - Probate Administration
    - **Costs** - The personal representative and the attorney are entitled to compensation for ordinary services based on a percentage of the estate. Prob C §§10800, 10810.
      - Examples: $1,000,000 gross estate = $23,000 in attorney's fees and $23,000 for the personal representative.
        $2,000,000 gross estate = $33,000 in attorney's fees and $33,000 for the personal representative.
      - Personal representative and/or the attorney may also petition for additional fees for extraordinary services. Prob C §§10801, 10811. Fees for extraordinary services are based on time and difficulty of service and are awarded only in the court's discretion.
    - **Delay** -
      - Required Notices
        - Must locate all heirs to provide notice. Prob C §§ 8110, 1201
        - Must give notice to creditors. Unsecured creditors can have up to 1 year to file a claim. CCP §366.2

            - Typical probate in California from beginning to end takes longer than 12 months because of access to the Court.
        - **Public**
            - Publication of notice of petition to administer estate must be made in accordance with Prob C §§8120–8125.
            - Court documents are available to the public.
    - <u>Conflicts with Business Partners</u>
        - **Valuation issues**
            - What is the value of the decedent's interest in the business and how will it be determined?
            - Who is eligible to purchase the decedent's interest in the business?
        - **Management issues**
            - If the decedent managed the business, who will take over operations?
            - Who votes on behalf of the decedent?
        - **Knowledge**
            - Does the decedent hold institutional knowledge that is critical to the success of the business?
            - Will employees and/or third parties lose confidence in business after the death of the decedent?
        - **Partition/Dissolution**
            - Partition of Real Property Act or Uniform Partition of Heirs Property Act for tenant-in-common property ownership
    - <u>Liquidity Issues</u>
        - **Estate tax** - The estate tax rate is 40%. IRC §2001. The estate (and gift) tax credit in 2023 is $12,920,000 per individual ($25,840,000 collectively per married couple). IRC §2010. The estate tax is due within 9 months of the date of the decedent's death. You may request an extension of time for payment by filing IRS Form 4768. You may also elect under IRC section 6166 to pay in installments or under IRC section 6163 to postpone the part of the tax attributable to a reversionary or remainder interest. California does not currently assess a state estate tax.
        - **Loan acceleration** – Will the death of the decedent cause the bank to accelerate any business loans? Personal guarantee by the decedent?
    - <u>Consequential Tax Elections</u>
        - **Partnerships (IRC §754 Election)** – The "inside" basis of the decedent's share of partnership assets is increased or decreased to equal the "outside" basis of that partner's partnership interest. IRC §§754, 734, 743, 755.

- **Corporations** – Do we anticipate a stock sale or asset sale following the death of the decedent?
- **S-Corp Shareholder Limitations** – Only estates (for no longer than 2 years); grantor trusts; Qualified Subchapter S Trusts (QSST); or Electing Small Business Trusts (ESBT) can hold shares in an S-corporations.
- **1031 Exchange** – Will your choice of entity limit your estate or your partners from executing a 1031 exchange?

o <u>Property taxes</u>

- **Proposition 19** - Became operative on February 16, 2021. Limits current taxable value plus $1,000,000 (as biennially adjusted) for Primary Residence. Eliminates exclusion for other real property other than the principal residence. Cal. R&T §63.2.
    - Will the death of the decedent result in a change in ownership?
    - Will the death of the decedent result in a change in control?

PART II. RECOMMENDATIONS

➢ Methods for Avoiding Probate Administration

o <u>Establish Your Revocable Estate Plan</u>

- **Trust** – Removes assets from Probate estate; Appoints Successor Trustee
- **Durable Power of Attorney** – Appoints attonery-in-fact to manage financial assets that otherwise would be subject to conservatorship of estate.
- **Will** – Facilitates an expedited Probate administration (Heggstad Petition)
- **Joint Tenancy or Life Estates** – Title ownership automatically passes upon recording of affidavit of death.
- **Transfer on Death Deeds** – Disfavored because of issues with predeceased beneficiaries, minor beneficiaries, creditor protection, and inability to obtain title insurance or sell the property after the death.

➢ Methods for Avoiding Disruption of the Business

o <u>Buy-Sell Agreement</u> – Execute a separate agreement to address several issues following the death of a partner, including but not limited to:

- Setting a process for valuing the decedent's interest in the business;
- Creating a market for the decedent's interest in the business;
- Developing a strategy for tax elections (to ensure timely filings);
- Illustrating stability to third-parties for future viability of business;
- Attempt to fix estate tax value for estate tax planning purposes.

- Operating Agreement – Include provisions in your Operating Agreement or Bylaws nominating successor managers/Directors to avoid delay in management decisions.
  - **Coordinate Management**: Include provisions in Operating Agreement or Bylaws with estate planning documents. For example, consider nominating a Trustee for the business interest and a separate Trustee for all other trust assets.
- Co-Tenancy Agreement (for real property) - Provide for management, income, expenses, waivers of rights to partition, buyout procedures, qualifications for transferees and future co-owners
  - **Memorandum of Agreement** – recorded against title to protect against transferee (or bona fide purchaser) who has no other actual or constructive notice of agreement or restrictions that "run with the land" – take title subject to the agreement.
- Succession Planning – Identify a successor to the decedent. Work with the successor to develop a transition plan. For example, how will clients or customers be notified of new ownership?
  - **Anticipate Family Conflict** – Are there competing interests in the family? If so, address these conflicts before death to reduce the risk of litigation.

- Methods for Avoiding or Addressing Liquidity Issues
  - Reduce Estate Tax
    - **Possible Techniques**: Sale to Intentionally Defective Trusts; Grantor Retained Annuity Trusts; and Partnership Freeze under IRC §2701.
    - **Maximize valuation discounts:** Lack of marketability and/or lack of control.
    - **Remove future appreciation from decedent's estate**
    - **Income tax planning with grantor trusts –** Shift income tax burden from beneficiaries to grantor. IRC §671-679.
  - Life Insurance
    - **Key Person Life Insurance**: The business can purchase a life insurance policy to ensure the business has sufficient liquidity to survive the transition period or offset any short term loses following the death of the decedent.
    - **Irrevocable Life Insurance Trust**: Establish an Irrevocable Life Insurance Trust (ILIT). The Trustee of the ILIT purchases the policy on behalf of the Trust. The cash proceeds provide liquidity to the decedent's estate to facilitate distributions to beneficiaries. Furthermore, an infusion of cash may prevent a hasty sale.

- Graegin Loan - A mechanism to finance payment of estate tax and administration expenses. If done correctly, a Graegin loan can provide low liquidity estates with the ability to both defer and reduce estate tax liability.

- To Maximize Tax Planning
  - Choice of Entity Considerations – What entity structures are best suited for my estate planning goals?
    - **C Corporation** – No "inside" basis adjustment like a partnership. Only adjustment to basis in stock.
    - **Partnership** – Do I anticipate my beneficiaries or partners wanting to participate in a 1031 exchange?
    - **S Corporation** – Must make a QSST or ESBT election following the death of the decedent. A QSST requires all income to be distributed to beneficiaries annually while an ESBT permits discretionary distributions but income is taxed at the highest income tax rate.

- Methods for Reducing Property Tax Liabilities
  - Purchase Property in LLC – To avoid the "cumulative transfer" rule, have the LLC or Corporation purchase the property.
  - Purchase Property as Original Joint Tenants – Death of original joint tenant doesn't not require reassessment.
  - Intentionally Trigger Reassessment – Create a change in ownership or control before death when property tax basis is lower.

PART III. CASE EXAMPLES, SCENARIOS, AND HYPOTHETICALS

PART IV. DISCUSSION AND Q&A