LEE R. PHILLIPS

TOOLS OF WEALTH

USING THE LAW TO MAKE MONEY

OCTOBER
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LEE PHILLIPS SHARES THE LEGAL TOOLS OF WEALTH WITH YOU

GOT QUESTIONS?

What are your needs, concerns, or challenges?

Email Lee with questions you would like to see answered in this newsletter.

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LIFE OR DEATH OF YOUR BUSINESS

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Your little business and your real estate investments are your two most important tax shelters. We've talked about that. They are also your ticket to wealth. Most upper middle-class folks have made their wealth in their little business or real estate investing. The question is, what happens to the business when you die?

People often forget about the business when they do their estate planning. The lawyer would prefer to ignore the business because it complicates things. You may think of a business such as a grocery store, shoe store, engineering firm, law office, dental office, or some type of place with customers. You may be thinking that you don't have a little business. However, if you have an LLC that owns real estate, you have a little business.

Why Does Your Business Die?

Actually, your business and/or real estate investments are probably your most valuable asset(s). Real estate is a "hard asset" that you can pass on to your family when you die. It won't automatically lose value when you die. There are a number of ways you can get your real estate down to your heirs after you die. For example, the real estate could be passed through the probate process. You could put someone else's name on the deed to the real estate as a "joint tenant with rights of survivorship," or you could have deeded the real estate over to your living revocable trust.

Your business is a little messier to "pass on" to your family after you die, because it probably depends upon you to make it work. That's one reason the vast majority of small businesses die within five years of the death of the founder. When the founder is gone, the business loses its driving force and it just can't survive.

Another reason that a small business won't survive the death of the founder is the business gets caught in the legal aftermath of the owner's death. Unless a lot of planning takes place long before you die, your business will be caught in the probate process. Probate can be a long process and the business often simply won't survive the probate process.

One of our neighbors died years ago. He was a young doctor with his own practice. The family quickly got a buyer for his practice, but everything had to go through probate before the transfer could actually be made. It took a year to go through probate, even though the doctor's wife was an attorney. In the year it took to go through probate, the potential buyer changed his mind, and the patients had all drifted off to other doctors. There really wasn't much left to sell, and the family got very little for what had once been a good practice. Time is critical when a business is fighting for its life after its leader dies.

Probate is a public matter and all the financials of the business have to be filed with the court. Many businesses would rather not expose all their financials to the public. If the business gets caught in probate, it doesn't come out. Or if it does come out, it comes out battered and bruised.

The easiest way to keep a business out of probate is to make sure ALL its ownership is owned by a living revocable trust. What is the "ownership" of a business? The ownership of a limited partnership is the general partnership interest and the limited partnership interests. The ownership of a corporation is represented by the stock that has been issued. An LLC's ownership is the membership interests.

Ownership interests in companies can actually be transferred at the owner's death just like real estate can be transferred. You want to put ownership in

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the name of your living revocable trust. The other ways of transferring ownership don't work as well, with the exception of one possibility.

It's Not Joint Tenancy

It isn't uncommon to own real estate, stock or membership interests, bank accounts, or other assets as joint tenants with rights of survivorship. I will say you can do this with a husband and wife, but nobody else. Don't use joint ownership. Never put kids' names on any of your assets. Kids are like yogurt. You never know when they are going to go bad. The child's name on an asset exposes that asset to the child's creditors, divorce settlements, and other situations. In fact, the child's name on an asset exposes the entire value of the asset to the IRS, if the child doesn't pay their taxes. (The IRS has way too much power.)

Remember, when you put the child's name on the asset, you are making a gift of the ownership. For example, if you have a $400,000 property and you put the child's name on the deed as a joint tenant with you, you have just given the child a $200,000 gift. When you give a person gifts valued over $15,000, you need to file a gift tax return.

Biden's proposed law in the Senate will cut that number back to $10,000 and drop the estate/gift tax life-time exemption from the current $11.8 million to $3.5 million. The tax will be raised from 40% to 45% beginning at $3.5 million and up to 65% for the big boys. It will also do away with the step-up in basis upon death. Your kids will have to take your original

basis in your house you bought 30 years ago. If they can't definitively prove the basis, the IRS says the basis is zero. The object is to destroy the middle classes' hope of leaving their kids better off than the prior generation. Thus, eliminating the middle class.

Not only does ownership using joint tenancy give you asset protection and gift problems, joint tenancy with rights of survivorship is an income tax disaster, because the person receiving the gift has to take the donor's original basis in the property to report income taxes when the gifted asset is sold. Under today's law, if a person receives the asset due to the death of the prior owner, then the asset gets a step-up in basis to the value the asset has on the prior owner's date of death. That could save your child a ton in income taxes versus putting their name on the deed and giving them ownership today.

Just like any other asset, if your business is transferred because of death, the business will get a step-up in basis to the value it has on the owner's date of death—today. For estate tax purposes, an active business will be valued by the IRS for estate tax purposes at five times the average of the businesses' last three years GROSS income. The business could probably only be sold for about 1.5 times its annual net income, but the IRS has its own way of doing things. You or your family will argue with the IRS and meet somewhere in the middle. Obviously, if your "business" is an LLC that owns a piece of real estate, the business' value is the value of its only asset.

Say It in the Company Paperwork

A living revocable trust is the best way to transfer ownership without probate. The other possibility of making a smooth transfer is to amend the entity's paperwork to describe the transfer. It is possible to write into the partnership agreement of a limited partnership, bylaws of a corporation, or operating agreement of an LLC what happens to an owner's interest in the entity when the owner dies. This isn't done very often, but it works effectively to transfer ownership to someone after the owner of the business dies. #

The operating agreement in an LLC, for example, would simply say that upon your death, your ownership will be distributed equally to your issue per stirpes. That means your membership interests will be divided equally among your children, and if one child has predeceased you, his or her share will be divided equally among his or her children, and on down the family tree.

This will eliminate probate and should provide a smooth transfer of ownership upon your death. Other provisions of the operating agreement should be reviewed because they were written envisioning you as the sole owner of the LLC. Does each provision in the operating agreement make sense if each one of your children owns an equal share of the company? What about the voting majorities, etc.? Just read each provision of the operating agreement and envision multiple owners. Does it say what you want it to say in light of the multiple owners? There isn't any set legal language in op-

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erating agreements or any other company documents. So, does the language say what you want it to say? If not, change the language to the way you would want it to read.

Life Insurance

Life insurance companies have figured out that small businesses have cash issues when a founder/owner dies. If there are partners, they may want to buy out the family of a deceased partner. Of course, in a corporation or LLC they are not actually "partners" in a legal sense. They are just co-owners. Life insurance companies have a number of products, such as key man insurance, that can be used to help with cash flow needs when an owner of a small business dies.

For purposes of a buyout, the value of the business should be calculated at least annually. That way there isn't an issue (fight) between the key man's family and the other business owners when the key man dies. A formula for determining the value of the business can be described in the operating agreement, bylaws, or other business documents. You get to make up the formula and describe it. There isn't any magic boiler plate language to cover such a formula.

The life insurance could simply be used to supplement the inheritance of a specific child/children. It isn't unusual for one of the children to make their life's work in the family business. The other kids have gone off and done their own thing. It is perfectly appropriate to leave the business to the child that has worked along side dad for the past 30

years.

But, the business may be the bulk of dad's wealth. How do you compensate the other kids when you want one child to own and take over the business? One way of doing it is to purchase a life insurance policy that can supply cash to "make up" the extra value the child who gets the business is getting. Essentially, the child who gets the business is buying out the interest the other kids would have in the business when dad dies.

Sometimes people come to me, and they want to leave this LLC to this child, and that LLC to that child, and so on. I really discourage that. I know they have valued everything today and are trying to make everything even, but ten years or thirty years from now when the client dies, there is a good chance some of the LLCs will not be there, and it is for sure that the assets held in the various LLC will have changed value. Just leave all the kids equal shares and they can probably sort out who gets what asset and what each asset is worth.

Putting the Business into a Trust

It is actually pretty easy to put your business into your living revocable trust. Your "ownership" documentation in the business simply needs to be titled in the name of your living revocable trust instead of your name.

If the business is a partnership, you'll have to rewrite the partnership agreement to reflect the trust as the partner instead of you. If it is a corporation, you need to amend the bylaws to make sure the trust is named in each place where your ownership is referenced. You will continue to be the officer/director or any position you are filling, but where it lists ownership, that will have to be changed from you to your trust's name. The stock certificate you issued to yourself (I am sure you did that!!) will have to be changed and a change will have to be made in the stock ledger.

The same process will have to be followed in an LLC. The operating agreement will have to be changed, the membership log changed, and the membership interests reissued. "Call in" each old membership certificate, void it, and enter it in the log as having been turned in. Then reissue the certificate/stock in the name of the trust.

Remember that your trust has three parts to its name. 1. Name of Trust , 2. Date of Trust, and 3. Name of trustee.

How do you change the ownership to the trust for the land, bank accounts, vehicles, and other assets that are in the business? That's a question I often get. The assets of the entity (partnership, limited partnership, corporation, or LLC) are owned by the entity. They do not change ownership. If you or your trust owns the entity, by extension you own the assets of the entity. So, the assets of the entity will continue to be owned by the entity and not your trust. Whoever controls the entity controls the assets. You don't own them, so they won't go through probate when you die. You will continue to "manage" the assets in whatever capacity you now "claim" to manage the assets (President, Manager, Partner, or whatever).

Schedule C or Schedule E

If you are a Schedule C business, that means you are a sole proprietor. You actually own the assets of the busi-

Membership Certificate

This Certifies that ______________________________
is a member of the above named Limited Liability Company and is entitled to the full benefits and privileges of such membership, subject to the duties and obligations, as more fully set forth in the Limited Liability Company Operating Agreement.
In Witness Whereof the Limited Liability Company caused this Certificate to be executed by its duly authorized members this ____________ day of ____________, 20________, and its Limited Liability Company seal to be hereunto affixed.

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ness in your name. If you are operating your real estate and filing a Schedule E, then you "own" the real estate. It isn't owned by an entity. That's not actually true in some cases. You could have an LLC (only an LLC) and be filing a Schedule C or Schedule E. The assets of the business would then be owned by the LLC, and you would have to change the ownership of the LLC to avoid probate.

Assuming you are actually a simple sole proprietorship, you will have to change the ownership of each asset in the business to ownership by the trust. You can still use your Social Security number and file your Schedule C, but the assets will have to be owned individually by the trust in order to avoid probate. You can still print the name of your business on the checks and letterhead and everything, but the underlying ownership of the assets will need to be in the trust's name.

It is probably better to change to a partnership or S Corporation form of taxation by using an LLC and filing a 1065 or 1120s tax form. You may have to take on a partner (in common law states that could be your spouse) in order to file as a partnership. A single member LLC can file as a Subchapter S entity. You will want the partnership taxation if you are making your money as passive income. You will want a Subchapter S taxation if you are making your money as earned income.

The reason you want to be taxed as a partnership or Subchapter S entity is because it will substantially cut your chances of being audited. With the IRS going from a $12 billion operation to a $100 billion operation, keeping your head as low as possible is a good idea.

With a little planning and some actual work (not too much really), you can give your business the best chance possible for survival after you die. It's something you have to pay attention to, but you can do it. ■