

BUSINESS ADVISOR REPORT

August 2003
Vol. 9, No. 1

A newsletter for closely-held business owners and advisors

Message From The Firm

Our business practice continues to grow despite the stressful economic times. In our capacity as general counsel to closely-held, middle-market companies, we are helping clients position themselves for the rebound of the economy.

We are enthusiastic about the expansion of the firm's services to clients in complex real estate transactions including purchases, sales, financing and leases; corporate tax strategies; mergers and acquisitions; employment law and business litigation; tax and succession planning; and international taxation. Many of our lawyers have advanced degrees or expertise in complex business and tax issues faced by closely-held companies. We also have a wealth of experience representing successful entrepreneurs. Our broad-based knowledge and superior tax expertise allow us to design creative solutions for clients' complex business transactions.

We are pleased to announce that Brad Tabach-Bank has joined the firm as Of Counsel. Brad has expertise in real estate matters and was recently named Chairman of the Board of Vista Del Mar Child and Family Services, one of the nation's leading child services centers.

As our firm continues to develop, there are increasing opportunities for lawyers who represent middle-market businesses to join in the growth of our firm and expand their practices. We welcome inquiries from those attorneys or your referral of them to us.

Jon Karp
JonKarp@Reish.com

Lay-offs and Plant Closings: Make Informed Choices and Avoid Claims

By Mark Terman (MarkTerman@Reish.com)



Problem: A large science and manufacturing client was about to undergo a mass lay-off—a reduction in force (RIF)—in one of its divisions. While the company had to take

this drastic measure to protect its future, it wanted to be as fair as it could to employees selected for the RIF and did not want to get sued.

Solution: A well thought out and implemented RIF can achieve both the business and liability avoidance objectives of the company. The following are some of the key issues to consider.

Business Need. Courts seldom question the business need for a large RIF. Typically, the division or operating unit affected is not performing financially, has lost regulatory approval, or is in an industry where growth prospects look dim.

Employee Selection. The more objective the selection criteria, the easier it will be to support those decisions in court. First, senior management should identify both the specific business needs that will remain after the RIF and the worker skills required to fulfill those needs. Next, determine what job positions are needed for each of the required skill sets. Only then, consider which employees would fit into those jobs.

Favor employees with multiple necessary skills over those who have limited skills. In addition, favor employees with positive prior written job evaluations over those whose performance has not been reviewed in the past. Be cautious about selecting employees with claims pending against the company. Such action could result in accusations by employees that their selection was retaliatory and illegal.

Do **not** consider any “protected class” factors such as age, race, national origin, gender, disability, or religion in your selection. A valid business reason for layoffs can still give rise to employee claims if the selection process exposes a discriminatory motive **or** effect. With a preliminary RIF list in hand, only then look at protected class factors to make sure that the company's objective criteria have not unintentionally impacted a protected class.

Communications to Employees. Once selection decisions have been made, management will need a communications plan both to shore up the confidence of those who will remain employed and to inform those who will lose their jobs. The California “W.A.R.N.” Act requires 60 days advance notice or 60 days pay by employers with 75 or more employees where 50 or more employees are subject to lay-off, relocation or termination within a 30-day window. Federal law imposes similar requirements for employers with 150 employees. These rules are more complicated

(Continued on page 2, column 3)

Rewarding and Retaining Key Employees with Incentive Stock Options

By Adam Cohen (AdamCohen@Reish.com) and Jon Karp (JonKarp@Reish.com)



Problem: An ambitious management team is in the early stages of purchasing a company from the founding shareholders through an Employee Stock Ownership Plan (ESOP). The management team wants to induce a key executive employee (Executive), whose continued involvement and contribution to the business is critical, to remain loyal to the Company.



In order for Executive to feel like an “equal” member of the management team, the parties want to increase Executive’s relatively small stock ownership (3%) to equal that of the other members of the existing management team (14%). However, for personal financial reasons, Executive is unable to pay full price for the shares. How can the Company increase Executive’s ownership interest and secure his continued loyalty, without giving away too much immediate control, and fit within Executive’s limited budget?

Solution: To facilitate Executive’s purchase of stock, the board of directors (the current management team) proposed issuing additional shares to Executive at a 40% discount with the understanding that all the shares will be held in escrow for a period of two years and be subject to forfeiture if Executive resigns or is terminated for cause. Since Executive is purchasing the shares at a substantial discount and the shares are subject to forfeiture, the normally advantageous route of making a IRC Section 83(b) election would impose a sig-

nificant tax liability, which he is unable to bear. As an alternative, the Company plans to establish an Incentive Stock Option Plan (ISO Plan) that will grant Executive incentive stock options (ISOs) that will in essence increase his potential stock ownership to 10% without triggering any immediate tax consequences. The ISOs will be exercisable in two years, which is the target date for the management team to purchase the Company from the founding shareholders. Immediately following the grant, the Company will issue Executive an additional 4% interest in the Company at the 40% discount. These shares will be held in escrow and bear the tax consequences described above, which, at the 4% level, are affordable to Executive.

Benefit: Under this arrangement, Executive will become a 7% shareholder and his percentage will increase to 14% within two years. In order to alleviate Executive’s financial burden, he will purchase the additional 4% of stock at a 40% discount with a small yet manageable tax payment pursuant to an 83(b) election. However, since such shares are held in escrow for a two-year period and are subject to forfeiture, Executive is induced to remain with the Company.

Immediately preceding the planned management succession, Executive will purchase the additional 7% interest in the Company by exercising his ISOs at an exercise price that is expected to be much lower than the then current fair market value of the Company. Executive will not pay any taxes on such additional shares (other than a possible alternative minimum tax) until he sells them, which, in order to avoid adverse tax consequence, will not be for at least another year.

Thus, a mechanism has been put in place, which provides that if the Executive remains with the Company for another three years, he will be an equal member of the management team that owns the Company on a tax-favored basis. Furthermore, Executive will be able to purchase his shares over a time frame that better fits his personal finances. It’s a win for the Executive and a win for the Company. ❖

Lay-offs

(Continued from page 1)

than described here and should be reviewed with counsel.

Severance for Releases. If the company has the economic resources to do so, a severance program in exchange for a release of claims is an effective way of helping workers transition to other employment. It also cuts off potential claims by, for example, underperformers selected in the RIF who may be lying in wait to assert some type of claim. An objective formula for calculating severance should be uniformly applied (e.g., one week for each year of employment up to a certain maximum amount).

Security. Before announcing the RIF, consider who has access to the company’s confidential, proprietary and trade secret information. Plan steps with counsel to protect that information from theft by unhappy employees. Also plan for computer and other plant security measures, including the potential for workplace violence. Don’t forget to consider the employee benefit plan aspects of the RIF, including partial termination, blackout and other issues.

Benefit: Our client followed the foregoing and other steps we recommended. Most importantly, our client provided everyone subject to the RIF a dignified exit even in difficult times. Nearly all laid-off employees signed releases and received severance packages. One worker initiated a claim, but we negotiated a modest additional amount to be paid in exchange for a release. No lawsuits have been filed. ❖

Are Family Limited Partnerships Still Viable Estate Planning Tools?

By David Schwartz (DavidSchwartz@Reish.com) and Michael Luftman (MichaelLuftman@Reish.com)



Problem: The family limited partnership (FLP) is a popular estate and wealth planning technique that may substantially reduce the tax cost of transferring assets to or for the benefit of family members and later generations. However, recent court cases have made it clear that FLPs must be properly set up and managed, and clients need to be more vigilant than ever in how their

FLPs are administered. Translation: a person cannot simply set up an FLP and then forget about it, or use the FLP as his or her personal bank account. Otherwise, under Internal Revenue Code Section 2036(a)(1), the value of assets transferred to the FLP (rather than the discounted value of the interest in the FLP) will likely be included in the transferor's estate for estate tax purposes, and the costs of creating and administering the FLP prior to the transferor's death, as well as any discounted gifts of FLP interests for the purpose of satisfying the transferor's annual exclusion gifts, will have been wasted.

In addition to the operations of FLPs, the Tax Court has challenged the extent of the transferor's ability as general partner to control the beneficial interests in the FLP. Specifically, the Tax Court has suggested that, where the transferor retains control over distributions of FLP income, without significant restraints or oversight, it is possible that the assets transferred to the FLP will be included in the transferor's estate under Section 2036(a)(2).

Solution: Recent cases provide a roadmap of how an FLP should be set up and maintained to ensure, to the extent possible, that it will be respected and its benefits allowed.

The solution can be divided into two categories: FLP operations and FLP management.

FLP Operations. In order to avoid inclusion in the transferor's estate under Section 2036(a)(1), individuals who already have or are considering creating an FLP should follow this list of "do's" and "don'ts":

- **DO** establish valid, non-tax reasons for creating the FLP, such as liability protection, creditor protection and unified management of assets.
- **DO** keep accurate books and records reflecting the FLP's operations and make sure that all actions are taken in the name of the FLP.
- **DO** ensure that assets transferred to the FLP are retitled in the name of the FLP (*e.g.*, deeds to real property and title to securities).
- **DO** comply with the FLP agreement, including amending the agreement to reflect changes in circumstances.
- **DO** establish and maintain separate FLP bank and other accounts and make sure all FLP receipts and disbursements flow through them. Any cash generated by assets transferred to the FLP, such as rents, dividends or interest, should be deposited into the FLP account and managed according to the FLP agreement. The transferor's personal bills should not be paid from the FLP account and the transferor's other assets should not be commingled with FLP assets.
- **DON'T** transfer assets that the transferor will continue to use personally, such as his or her residence.
- **DON'T** contribute all or substantially all of the transferor's assets to the FLP.
- **DON'T** make distributions from the FLP unless they are made pro-rata to all partners (or otherwise in accordance with the terms of the FLP agreement).
- **DON'T** liquidate the FLP until well after an estate or gift tax audit period ends.

FLP Management. It is not clear from the recent cases how much control the transferor is entitled to assert over the FLP assets before the IRS will claim that the transferor

has too much control for purposes of Section 2036(a)(2). However, the Tax Court has suggested that the presence of the following "favorable" factors might cause the transferor to avoid inclusion of the FLP assets in his or her estate:

- If there are unrelated owners with greater than a de minimis interest in the FLP, the general partner will have a fiduciary duty that should be a sufficient constraint on the right to control distributions.
- If other owners have made substantial contributions to the entity, whether or not related to the transferor, the "bona fide sale exception" should apply.
- If the transferor does not have control over distributions, Section 2036(a)(2) should not apply.
- The transferor's status as a limited partner should avoid application of Section 2036(a)(2), as long as there is no evidence of an implied agreement that the transferor will continue to control the FLP distributions.
- If the transferor makes significant gifts of interests in the FLP to family members, a court might find that the fiduciary duty of the transferor, as general partner, is a sufficient to avoid inclusion of the FLP assets in the transferor's estate.

Benefit: The courts have applied a balancing test to weight how many of the "do's" have been complied with relative to the "don'ts," which have been breached, to determine whether the FLP should be included in the transferor's estate. Clearly, the more "do's" and the less "don'ts," the greater the likelihood that the FLP assets will not be included in the transferor's estate.

The FLP is not likely to have many of the management characteristics described above that are arguably necessary to avoid application of Section 2036(a)(2). In most situations, there will not be unrelated owners, and the transferor will typically insist on being general partner. These factors could be dangerous from a Section 2036(a)(2) perspective. Since it is unclear how the court or IRS will act with respect to each distinct set of circumstances, anyone who currently has an FLP, or anyone considering setting up an FLP, should have his or her situation reviewed, because it is a different world than it has been in the last few years. ♦

Around the Firm

Brad Cohen presented a "Tax Update" to the Business Managers Committee of the Los Angeles Chapter California Society of CPAs on August 4th. Jon Karp taught all-day seminars on August 4th and 19th on "Succession Planning for the CPA Firm" for the California CPA Education Foundation. Jon presented "Ten Traps for the Unwary in the Sale of a Business" to the Members in Industry Committee of the California Society of CPAs on August 20th. Jon also spoke to the CPA/Law Forum in Santa Monica and Pasadena on "Exit Strategies" on August 27th and 28th.

In addition, Jon spoke at the California CPA Education Foundation's Flow-Through Entities Conference on "Exit Strategies" in San Francisco on July 28th and in Los Angeles on July 29th. Mark Terman spoke on June 25th to the CalCPA Society L.A. Managing Partners group on "2003 Employment Law Developments that Accounting Firms Need to Know About." David Schwartz co-presented "Tax Planning in Light of the 2003 Tax Act" with Brad Cohen on June 25th and with Mike Foster on June 26th to the CPA/Law Forum in Santa Monica and Pasadena. Lee Reicher was a member of the planning committee for the California CPA Education Foundation's 2003 Real Estate Conference in May. He was also a speaker at the conference on "Tax Traps in Loans and Property Transfers."

Mark's article on "Trade Secrets Need to Be Identified to Get Protection" was published in the July 14th issue of the *Daily Journal Extra*. Jon's article on the value of due diligence, entitled "Know What You're Getting Into," was published in the July issue of *California CPA*. Lin Meyer's article entitled "Employer's Duty to Accommodate Has Some Limits" appeared in the July 18th issue of the *Los Angeles Daily Journal*. Gary Wexler wrote an article on "Litigation Traps in Purchasing a Business" for the June issue of *The Corporate Counselor*.

©2003 Reish Luftman & Reicher. All rights reserved. *THE BUSINESS ADVISOR REPORT* is published as a general informational source. Articles are general in nature and are not intended to constitute legal advice in any particular matter. Transmission of this report does not create an attorney-client relationship. Reish Luftman & Reicher does not warrant and is not responsible for errors or omissions in the content of this report.

Reish Luftman & Reicher

A PROFESSIONAL CORPORATION

ATTORNEYS AT LAW

N E W S L E T T E R

11755 WILSHIRE BOULEVARD

10TH FLOOR

LOS ANGELES, CA 90025-1539

ADDRESS CORRECTION REQUESTED