



BUSINESS ADVISOR REPORT

A newsletter for closely-held businesses, their owners and advisors

Message From The Firm

Choice of entity as well as state of incorporation can have dramatic legal, tax & operational implications when forming a real estate investment vehicle. Lee Reicher and David Schwartz discuss these issues and suggest solutions.

Liquidating a corporation can be income tax hazardous to your financial health. Rich Luftman and I present a real life example in which the principals were surprised by the negative tax result and the advice we gave to avoid such surprises.

Recent changes in income tax law have provided reduced tax rates on capital gains and "qualified dividends." A controlled foreign corporation that has subpart F income, however, may not qualify for the lower capital gains rate. Robin Gilden and Kalyani Chirra discuss this situation and suggest ways for the corporation to make actual distributions that would qualify for the lower rate.

As always, if you have any questions or comments, please contact me or one of the attorneys who has written an article.

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Key Decisions in Forming a Real Estate Investment Entity



By Lee Reicher (LeeReicher@Reish.com) and
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In forming a real estate investment or development entity, two threshold questions must be asked: 1) what type of entity is most appropriate to operate the venture?; and 2) in what state should the venture be organized?

Considerations in determining the entity that is most appropriate include limited liability, taxation and flexibility. Regarding the state in which to organize, the answer for California investors is typically California, Nevada or Delaware, depending on the extent to which flexibility and liability protection are most important to the persons organizing the entity.

There are three types of entities that afford limited liability protection: limited liability companies, limited partnerships, and corporations. Limited liability companies (LLCs) are generally the most appropriate entities for real estate investment/development. LLCs are the only entity, of the three above, that provide the corporate benefits of limited liability with the partnership benefits of only one layer of income taxation. LLCs also have the ability to issue varying types of common and preferred interests. LLCs, however, are subject to a gross receipts tax if the LLCs gross receipts (rather than net profits)

from doing business in California exceed a certain threshold amount. In some cases, additional structuring will be required to save gross receipts tax, for example, by organizing a limited partnership with a LLC as general partner. An LLC that owns income-producing property outside California is also a factor in selecting the entity and structure.

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Flexibility

The most important objective in choosing where to organize is flexibility in structuring the relationship among the organizing parties, including the rights of the investors vis-à-vis management of the LLC. The Delaware LLC Act, by its terms, is intended to give "maximum effect to the principle of the freedom of contract"—meaning the freedom to determine the relationship among the members. California LLC law, on the other hand, provides certain statutory protections that may not be removed by agreement or otherwise. One such protection is the ability of a member

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Avoiding Potential Hidden Hazards of Corporate Dissolution



By Brad Cohen (BradCohen@Reish.com) and Rich Luftman (RichLuftman@Reish.com)



Whenever a corporation dissolves, there are routine tax and non-tax issues that need to be addressed. In making the decision to dissolve a corporation, a client may be unaware that certain income tax issues should be considered prior to the dissolution. Such income tax issues arise when liquidating distributions are made to the shareholders. This article is designed to alert you to a few of the potential income tax issues for your client while urging you to have us, or the client's other advisors, address these and other possible issues.

The income tax issues raised in this article relate to a California corporation doing business only in California. If the corporation does business in states other than California, the income tax rules of those other states must be reviewed to determine if there are any additional income tax issues that must be addressed.

When a California corporation dissolves, it must comply with procedures of the California Secretary of State, the Internal Revenue Service (IRS), the California Franchise Tax Board (FTB), and with certain provisions of the California Corporations Code. The dissolution procedure involves filing a certificate of dissolution (and possibly a certificate of election to wind up and dissolve) after approval of the board of directors and a majority of the shareholders, giving notice to creditors, and filing certain prescribed forms with the FTB and the IRS. In particular, FTB Form 3555, entitled "Request for Tax Clearance Certificate," requires another person or

entity to assume the dissolving corporation's California income tax liability, if any (unless the decision is made to dissolve the corporation on a taxes paid basis, in which case the final tax return must be filed prior to the receipt of the tax clearance certificate). IRS Form 966, entitled "Corporation Dissolution or Liquidation," requires the corporation to disclose, among other things, to whom the liquidating distributions will be made.

"In making the decision to dissolve a corporation, a client may be unaware that certain income tax issues should be considered prior to the dissolution."

One potential hidden hazard with the dissolution of a California corporation involves the amount of gain that must be recognized by the corporation and its shareholders with respect to appreciated assets. In general, a liquidating corporation is required to recognize gain for both federal and California income tax purposes when it distributes property to shareholders with a fair market value in excess of its tax basis in the property. The hidden hazard can arise because the corporation's balance sheet generally does not reflect the value of an asset, but rather the cost, adjusted for depreciation or amortization. Additionally, some assets are not reflected on the balance sheet at all.

For example, a corporate client owned only one asset that consisted of residual royalty rights in a television show. Since the corporation did not own the copyright in the television show, the rights were not reflected as an asset on the balance sheet.

When the shareholders decided to dissolve the corporation, the client looked at the balance sheet, determined that the corporation had no appreciated assets and dissolved the corporation. In preparing the final tax return, the accountant realized that the contractual right to receive royalties had substantial value, and the corporation was required to recognize gain on the liquidation, for both California and federal income tax purposes.

Consideration must also be given to whether the corporation is an "S" corporation (a corporation electing to be taxed in accordance with Subchapter S of the Internal Revenue Code of 1986, as amended [the "Code"]) or a so-called "C" corporation, since different income tax issues are involved depending on this status. For instance, under Code Section 311(b), a C corporation that distributes appreciated assets to its shareholders must recognize gain on the distributions (generally subject to a federal income tax rate of 35%). In addition, each C corporation shareholder who receives the appreciated assets also recognizes gain on his or her receipt of such appreciated assets to the extent that the fair market value of the assets exceeds the shareholder's tax basis in the stock of the liquidating corporation. However, a shareholder may be entitled to treat the gain as long-term capital gain (generally subject to a federal income tax rate of 15% if the shareholder is an individual). Nonetheless, the appreciation in the corporation's assets will be taxed at two levels.

If the corporation is instead an S corporation, the analysis may or may not be different. If the corporation has been an S corporation from inception, or elected S corporation status more than ten years prior to the liquidating distribution, the corporation is still required to recognize gain on its distribution of appreciated assets as a liquidating distribution to its shareholders. However, this gain will be "passed-through" to the shareholders and reported on their individual income tax returns. For federal income tax purposes,

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Don't Get Stuck Paying a Higher Tax Rate on Your Subpart F Income



By Robin Gilden (RobinGilden@Reish.com) and Kalyani Chirra (KalyaniChirra@Reish.com)



The good news for shareholders is that the Jobs and Growth Tax Relief Reconciliation Act of 2003 provides capital gains rates on certain dividend income referred to as “qualified dividends.” The bad news is that if you are a shareholder of a “controlled foreign corporation” (CFC)

that has subpart F income, your deemed dividends are still subject to the ordinary income tax rates. Fortunately, if the CFC is able to make an actual distribution, shareholders may still be eligible for the qualified dividend rates.

What is a Qualified Dividend?

Qualified dividend income is dividend income received during the taxable year from domestic corporations and “qualified foreign corporations.” According to the Internal Revenue Code (the “Code”) Section 1(h) (11), qualified dividend income will receive capital gain treatment.

How Can a Foreign Corporation's Distributions Qualify for Capital Gains Rates?

Several tests must be met in order for a foreign corporation's distributions to qualify for capital gains rates. First, the corporation must be a “qualified foreign corporation.” Second, the corporation must pass the “equity test”—the distribution must be considered a dividend for U.S. federal income tax purposes. This means that the underlying security for which the distribution is made must be equity, rather than debt. Third, the corporation must pass the “E&P test”—the distribution must be made out of the corporation's earnings and profits (E&P). Lastly, assuming that each requirement above has been met, the

recipient of the distribution must also satisfy the holding period requirements of Code Section 1(h)(11)(B)(ii) (the “holding period test”).

What Type of Foreign Corporation Is Eligible to Be a Qualified Foreign Corporation?

One of two tests must be satisfied by a corporation to meet the criteria of a qualified foreign corporation. Subject to certain exceptions, a qualified foreign corporation is any foreign corporation that is either (i) incorporated in a possession of the U.S. or (ii) eligible for benefits of a comprehensive income tax treaty with the

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U.S. which the IRS determines is satisfactory for purposes of this provision and which includes an exchange of information program (the “treaty test”). Notice 2003-79 provides a list of countries that satisfy the treaty test.

Subject to the same exceptions, a foreign corporation that does not satisfy either of the above two tests may still be treated as a qualified foreign corporation if the underlying security for which the dividend is paid is readily tradable on an established securities market in the U.S. (the “readily tradable test”). Certain categories of foreign corporations are ineligible for treatment as a qualified foreign corporation. These include any company that, for the current or preceding taxable year in which

the dividend was paid, is a foreign personal holding company (a “FPHC” as defined in Code Section 552), a foreign investment company (a “FIC” as defined in Code Section 1297), or a passive foreign investment company (a “PFIC” as defined in Code Section 1297).

Is Subpart F Income Eligible For Qualified Dividend Treatment?

Shareholders who own 10 percent or more of the total combined voting power of all classes of voting stock of a CFC are required to include in ordinary income their pro rata share of the CFC's Subpart F income, regardless of whether such income is distributed to them.

Subpart F income generally includes certain “passive income” (i.e. dividends, interest, rents and royalties) of a CFC. Code Section 957(a) defines a CFC as any foreign corporation of which either, (i) more than 50 percent of the total combined voting power of all classes of voting stock, or (ii) more than 50 percent of the value thereof, is directly or indirectly owned by U.S. shareholders.

In order to satisfy the equity test and the E&P test, and be deemed a qualified dividend, there must be an actual dividend. Code Section 316 generally provides that a dividend means any payment made by a corporation to its shareholders out of E&P. Subpart F income that is not accompanied by an actual distribution is not treated as a dividend (Regs. Section 1.951-1(a)), and is therefore not eligible for treatment as a qualified dividend. If an actual distribution is made to shareholders out of a qualified foreign company's E&P, this distribution will be treated as a qualified dividend.

Bottom line: Assuming the shareholders can satisfy the holding period test, to the extent that there is Subpart F income that must be recognized and the company has sufficient cash and E&P to make a distribution to its shareholders, it should make the distribution to take advantage of the qualified dividend treatment. If you're going to pay tax anyway, you might as well pay it at a lower rate. ❖

Real Estate

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to challenge the reasonableness of provisions governing the termination of a member's interest and return of his or her capital contribution, or varying the rules allowing a vote of the members on mergers or dissolutions. The Delaware LLC Act also provides little resistance to allowing LLC members to prepare an agreement that reflects the terms of their deal.

LLC members will also want certainty regarding whether future capital calls may be made, and the consequences of not satisfying capital call obligations. This is especially important in the context of real estate development, where cost overruns are more often the rule rather than the exception. Delaware allows the operating agreement to govern the consequences of a member's failure to make a required capital contribution. Nevada also provides for liability for failure to make a capital contribution, but only to the extent of the unpaid contribution. California, like Delaware, allows the operating agreement to govern the consequences for failing to make a required capital contribution. However, California allows a member to invalidate the penalty for failure to make a required contribution if the member can establish that the provision was "unreasonable under the circumstances existing at the time the operating agreement was made." This exception creates substantial uncertainty as to whether liability will be imposed if a member desires not to make an otherwise required capital contribution.

Liability Protection

Members and managers of a real estate investment entity will always want to minimize their personal liability. While members of California LLCs are not personally liable under a judgment, debt, or obligation, except to the same extent that a shareholder of a corporation is personally liable, the Delaware LLC Act makes no reference to the possibility of "piercing the veil" of the LLC and asserting liability against a member or manager for

the actions taken by the LLC. Instead, under the Delaware LLC Act, all debts, obligations and liabilities of the LLC—whether arising in contract or otherwise—are treated as obligations of the LLC and not of a member or manager. Likewise, Nevada law makes no reference to the possibility of "piercing the veil" of the LLC.

Indemnification of management is also important. Unlike under California or Nevada law, the Delaware LLC Act allows managers to be indemnified and held harmless by the LLC from and against any claims whatsoever. Managers of California LLCs may be indemnified and held harmless by the LLC from and against any claims, except those made in connection with a breach of fiduciary duty. Managers of Nevada LLCs may be indemnified and held harmless by the LLC from and against any claims, unless the manager "did not act in good faith and in a manner that the manager reasonably believed to be in the best interests of the LLC."

Fees

Assuming the LLC is operating in California, there are additional costs of maintaining a non-California LLC. In addition to the California fees, there are also fees for maintenance of a registered agent in the applicable state, qualification to do business in California, and with respect to Delaware, an annual tax. These additional fees might be worth the substantial protection of members and managers against personal liability to third parties afforded by the Delaware LLC Act.

Conclusion

Overall, the flexibility, greater liability protection, and greater assurances of damages if a member fails to comply with a mandatory capital call make Delaware appear more attractive, and will probably be worth the nominal additional cost of organizing an LLC there. However, if the foregoing factors are not required as part of the agreement, for example, because the deal is among related members, then there is no significant benefit to organizing outside California. ❖

Dissolution

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it is likely that the gain will be subject to an applicable tax rate of 15%, rather than the 35% rate. Note that California will tax the S corporation on the gain, generally at a tax rate of 1.5% (which is deductible on the shareholder's individual federal income tax return). This gain, however, will cause an increase in the tax basis of the shareholder's stock in the corporation. It is unlikely that the shareholder will be required to recognize additional gain on the shareholder's receipt of appreciated assets.

If the S corporation was a C corporation at inception, had built in gain at the time of its S election, and elected S corporation status less than ten years prior to the liquidating distribution, the liquidating distribution will be taxed as if the corporation were a C corporation, as described above. The tax will only apply to the appreciation that existed in the corporation's assets at the time the S election was made.

In making the decision to dissolve a corporation, clients must consider these and other tax issues, in addition to the other non-tax issues related to the dissolution. Failure to do so can result in negative tax consequences to the corporation and to its shareholders. ❖

Advisor Alert

It is important that all accountants, business managers and other similar professions and/or advisors be aware that there is no longer a section on the Statement of Information form to provide for a mailing address different from the corporation's business address.

As a result, corporations will receive the form at the business address and will be responsible for filing the Statement by the preprinted due date. A penalty will be assessed to the corporation for failure to timely file the Statement of Information.

Around the Firm

Jon Karp gave an all-day presentation in Universal City on August 11th for the California CPA Education Foundation on "Succession Planning for the CPA Firm." Jon also spoke on "Selecting the Right Entity for Your Client" at the California CPA Education Foundation's Flow Through Entities Conference on July 19th in San Francisco and July 20th in Los Angeles. Mark Terman and Kyle Neal were co-presenters with Roberta Bennett, a family law attorney, at the California Society of CPAs Business Managers Committee meeting in Los Angeles on August 18th on "Selected Legal Issues for Same Sex Couples." Mark gave a speech on "Use and Abuse of Independent Contractor Status" to the CPA/Law Forum in Los Angeles on July 28th and in Pasadena on July 29th.

In July, Jon was honored with the Conference Volunteer of the Year Award by the California CPA Education Foundation in recognition of his service to the Foundation's conferences, both chairing and speaking at them. Mark has been appointed as General Counsel to the UCLA Alumni Association and made a member of its Board Of Directors. Effective July 1st, Mark will oversee the legal affairs. Mark previously served in this position for two consecutive terms from 1996 to 2000.

Brad Cohen was quoted in the May 28th issue of the *BNA Daily Tax Report* in the article "Film Industry Given Leeway to Amortize Costs of Shelved Scripts and Screenplays." Jon was quoted in the July 19th *AICPA CPA Insider* on mergers and acquisitions activity in the CPA profession in the article "6 Things You Must Do Today to Thrive Tomorrow." Brad co-wrote an article with David Schwartz in the July 15th issue of the *BNA Daily Tax Report* entitled "Determining Entertainment Industry Deductions for Creative Properties Deemed Abandoned or Worthless Remains Difficult Despite IRS Guidance."

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