MILLER, MONSON, PESHEL, POLACEK & HOSHAW

A PARTNERSHIP OF PROFESSIONAL LAW CORPORATIONS

SEPTEMBER 2014 NEWSLETTER

501 WEST BROADWAY, SUITE 700
SAN DIEGO, CALIFORNIA 92101-3563
TELEPHONE: (619) 239-7777
FAX NUMBER: (619) 238-8808

IN THIS ISSUE:

MAKING GIFTS TO A CARE GIVER IS COMPLICATED

DeEtte L. Loeffler, J.D., LL.M. Taxation

Sometimes a client wants to leave assets in a Will (or trust) to a care giver. Such gifts are subject to special scrutiny under California law because those who assist the elderly and/or disabled are often in a unique position to take advantage of them. California law recognizes this danger and imposes special conditions on such gifts.

Gifts to care givers (or “care custodians”) are generally presumed to have been obtained by fraud or undue influence if the instrument making the gift was signed during the time the care custodian was providing services or within 90 days before or after that period. Unless the presumption is overcome, the care custodian is treated as though he or she predeceased the donor (Probate Code Sections 21380, 21386). Gifts to persons who are related to the care custodian are also prohibited.

California defines a “care custodian” as a person who provides “health or social services” to a “dependent adult.” An adult is considered to be dependent if he or she is:

(a) over the age of 65 years and is either (i) unable to provide for his or her own personal needs for physical health, food, clothing or shelter, or (ii) has a mental deficit that causes him or her to have <u>difficulty</u> managing financial resources or resisting fraud or undue influence; or

(b) over the age of 18 years and is either (i) unable to provide for his or her own personal needs for physical health, food, clothing or shelter, or (ii) has a mental deficit that causes him or her to have <u>substantial difficulty</u> managing financial resources or resisting fraud or undue influence.

The phrase “health and social services" is broadly defined to include administering medicine, providing medical testing, caring for wounds, assisting with hygiene, providing companionship, performing housekeeping, shopping, cooking, or assisting with finances (Probate Code Section 21362).

So, how can you make a legitimate gift to a care custodian? There are a few exceptions to the law. First, the law does not apply to spouses, domestic partners and other relatives to the fourth degree of the donor. For example, a donor can make gifts to a child or grandchild who lived with and assisted that donor during his or her final illness (Probate Code Section 21374).

Second, the law does not apply to persons who provide help without remuneration (i.e., who are unpaid) and who also had a personal relationship with the donor (i) for at least 90 days before providing those services, (ii) for at least six months before the dependent adult's death, and (iii) before the donor was admitted to hospice care (if this occurs).

The presumption of undue influence can also be overcome by clear and convincing evidence that the gift was not the product of fraud or undue influence. This standard is not easy to meet and generally requires litigation to prove. Finally, a gift will not be presumed invalid if the donor obtains, at the time the gift is made, a “Certificate of Independent Review” from an independent attorney who counsels the donor outside the presence of the care custodian. In essence, the attorney certifies that the donor understood the nature of the gift and was not improperly influenced to make it.

Even if the gift is not a prohibited one, the gift may still fail if the donor no longer had testamentary capacity when the instrument was signed. To make a valid Will, a donor must be at least 18 years of age (or must be an emancipated minor), and must also be “of sound mind” (Probate Code Section 6100). A person is not considered mentally competent to make a Will or amend a trust if, at the time of making the Will or trust amendment, either of the following is true:

(a) the individual does not have sufficient mental capacity to be able to (i) understand the nature of the testamentary act, (ii) understand what he or she owns, or (iii) remember who is a natural beneficiary of those assets (i.e., issue, spouse, parents, etc.); or

(b) the individual suffers from a mental disorder with symptoms including hallucinations or delusions, and this condition results in the individual devising property in a way that he or she would not have done without the delusions or hallucinations.

Generally, capacity is presumed, but lack of capacity can be proven by clear and convincing evidence. For example, even if a person has been diagnosed with Alzheimer’s disease, he or she is still presumed to have capacity unless a court of law, or a medical doctor, determines the donor is unable to meet the standard set forth above. Please note that if you are diagnosed with a cognitive disease, such as Alzheimer’s, we recommend you obtain a letter of competency from your treating physician before you change your Will or trust. Attorneys are also expected to determine independently if a client appears to have capacity at the time the Will or trust is signed. For example, a client who is inebriated or has just undergone a major surgery may not have sufficient capacity to sign a new Will at that time, but could have capacity when sober or after the recovering from the surgery.

If you are interested in making a gift to a care giver, or have questions or concerns about your (or some else’s) capacity to make a Will or amend a trust, we would be happy to discuss these issues with you.

BUSINESS OWNER WHOSE SON TOOK OVER MANAGEMENT OF BUSINESS STILL MATERIALLY PARTICIPATED

Bradford N. Dewan, J.D., MBA

When a business owner decides to implement a succession and exit plan, that plan is very often a “transition plan.” In this scenario, the business owner has decided that the transfer of ownership, control and management responsibilities will occur over a period of time and not in any one single transaction. A recent Tax Court case exemplifies how a business owner may well start transferring ownership to the next generation but still remain involved in the business to a significant extent while playing a different role than just overseeing the day-to-day management.

This case also reflects how important it may be for the business owner to focus on "working on" the business rather than "working in" the business.

In Wade v. Comm'r, the Tax Court found that the business owner who turned over to his son certain management responsibilities with respect to two S corporations, but remained involved and was in fact vital to the business's survival during an economically difficult time, was not subject to the passive activity loss ("PAL") limitations. The Court also found that the taxpayer's activities were sufficient to establish material participation for both him and his wife.

Passive Activity Losses. Under Section 469 of the Internal Revenue Code ("Code"), individuals may not deduct "passive activity losses" for the year in which they are realized. A passive activity loss is defined as the amount by which the aggregate losses from all passive activities for a tax year exceed the aggregate income from all passive activities for such year. A "passive activity" is defined as any activity that involves the conduct of any trade or business in which the taxpayer does not materially participate.

A Treasury Regulation provides a list of various tests that the IRS uses to evaluate and determine whether a tax payer materially participated in a given trade or business. One such test relevant to this case requires that "Based on all of the facts and circumstances [...] the individual participates in the activity on a regular, continuous, and substantial basis during such year" for at least 100 hours during the taxable year.

Facts. In 1980, Charles Wade and colleague founded the company that later became Thermoplastic Services, Inc. ("TSI"). TSI's business involves acquiring plastic waste from chemical companies and converting it into usable products. Paragon Plastic Sheeting, Inc. ("Paragon") receives raw materials from TSI and uses them to make building and construction materials. TSI and Paragon ("the companies") are both S corporations of which Mr. Wade and his wife are substantial owners. Mr. Wade developed the manufacturing processes that the companies use and established and managed their industrial facilities.

In 1994, after several years working at Lockheed Corporation, the Wades' son, Ashley, moved to Louisiana to help Mr. Wade manage the companies. Ashley received stock in each company and in 2008 owned 30% and 70% of the shares of TSI and Paragon respectively. The remaining stock of each company was owned half by each Mr. Wade and his wife. With Ashley there to handle day-to-day management, Mr. Wade became more focused on product and customer development. Since he did not have to live near the business operations to perform these duties, Mr. Wade and his wife moved to Florida. However, Mr. Wade continued to make periodic visits to the facilities in Louisiana and regularly spoke on the phone with plant personnel.

In 2008, TSI and Paragon began struggling financially as prices for their products plummeted and revenues declined significantly. Interestingly, the Court notes that "Mr. Wade's involvement in the businesses became crucial during this crisis." He made three visits to the companies' industrial facility in Louisiana during that year in which he assured the employees that operations would continue. He also redoubled his research and development efforts, invented a new technique for fireproofing polyethylene partitions, developed a method for treating plastics that would allow them to destroy common viruses and bacteria on contact, and secured a new line of credit. Again, in the view of the Court, "Without Mr. Wade's involvement in the companies, TSI and Paragon likely would not have survived."

It is important to point out where Mr. Wade decided to put his efforts and time. Mr. Wade determined it was most important for him to put his time and energy into the research and development of new products and techniques rather than focusing on the day-to-day management issues. Apparently, he was confident that his son could handle these duties while he focused on his research and development efforts. Clearly, he had made the decision to "work on" the business rather than "work in" the business.

Passive Activity or Active Involvement. This change in focus and activity by Mr. Wade resulted in the IRS raising issues as to what level Mr. Wade was actively involved in the business. This arose because Mr. and Mrs. Wade claimed losses on their Federal tax returns. On their 2008 Federal income tax return, Mr. and Mrs. Wade claimed a deduction for approximately $3.8 million in nonpassive losses from three "pass-through" entities (i.e. TSI, Paragon and a third entity), which they carried back to 2006 and 2007. The IRS reclassified the $3.4 million of losses as passive on the basis that the Wades had not materially participated in 2008, resulting in the IRS claiming deficiencies for 2006, 2007 and 2008. The Wades conceded that the losses from the third pass-through entity were passive. Thus only the losses from TSI and Paragon were at issue in this case.

The Wades claimed that with respect to the losses from TSI and Paragon, there was "material participation," and argued that they satisfied two of the tests set forth in Treas. Reg. 1.469-5T(a). First, the Wades claimed that Mr. Wade spent more than 500 hours in 2008 working on the activities of TSI and Paragon. Importantly, the Court decided to treat the companies as a single economic unit for the purpose of applying the passive activity loss rules under Section 469. The Court felt that this was appropriate since it determined that the companies were interdependent and shared common ownership and control. Thus, the hours worked for either of the two companies could be aggregated. Secondly, the Wades contended that Mr. Wade participated in the companies' activities on a regular, continuous and substantial basis during 2008.

Court Ruled Taxpayers Materially Participated. The Tax Court concluded that Mr. Wade materially participated in the companies' activities in 2008. The record showed that he spent over 100 hours participating in the companies' activities during that year and that his participation consisted primarily of product development and customer retention activities. The Court stated that: "A taxpayer who participates in the activity for 100 hours or less during the year cannot satisfy this test, and more stringent requirements apply to those who participate in management or investment capacity." Importantly, the Court concluded that Mr. Wade's participation consisted primarily of non-management and noninvestment activities. The Court found that, although Mr. Wade "took a step back" when his son became more involved, he still played a major role in the companies' 2008 activities by, among other things, developing new technology to improve products and securing financing to allow the companies to continue operations. Since these efforts were continuous, regular and substantial during 2008, the Court found that Mr. Wade materially participated in the activities of the companies.

The IRS then argued that the Wades had failed to prove that Mrs. Wade participated in TSI and Paragon. The Court rejected this argument as irrelevant because, for purposes of the passive loss limitation, married taxpayers who file a joint return are treated as a single taxpayer and participation by a married taxpayer is treated as participation by his or her spouse. Under the facts of this case, Mr. Wade's material participation in the companies was sufficient, the Court held, to establish material participation for both spouses.

Conclusion. This case presents an interesting scenario in which challenges for the business occur after the owner has initiated the business succession and business transition process. With his son having assumed primary responsibility for the daily operations and management of the companies, Mr. Wade was insightful enough to focus on the larger issues of product development and research as well as client retention.

STATE TAX NEWS

DeEtte L. Loeffler, J.D., LL.M. Taxation

Will Gas Prices Increase Sharply in 2015? California is looking for new sources of revenue to repair roads, bridges and other crumbling infrastructure. California's current gas tax, which is adjusted annually based on consumption, is not adequate to fully fund these projects. One option currently under consideration is to impose a per-mile tax similar to the one being tested in Oregon. Under this system, a tax would be imposed on drivers based on the number of miles driven instead of on the number of gallons of fuel purchased, thus potentially increasing taxes on those who drive hybrids and electric cars and decreasing taxes on those who drive less gas-efficient cars.

On January 1, 2015, the cost of gasoline and diesel may also increase for another reason, but the increase will not help to repair infrastructure. A 2006 law intended to reduce California's greenhouse gas emissions is expected to increase the price of gasoline starting January 1, 2015. Under the law, oil refineries will be required to buy permits that allow them to emit greenhouse pollution relating to gasoline and diesel production. These refineries will pass this cost on to consumers. While estimates of the cost per gallon vary widely, an increase seems certain unless implementation of the law is postponed or the law is repealed.

FEDERAL TAX NEWS

DeEtte L. Loeffler, J.D., LL.M. Taxation

Congress went on recess in August, leaving a significant number of tax issues unresolved. One item of concern for Congress is how to discourage corporate "inversions," which happen when an American company purchases a foreign company in a low-cost tax jurisdiction (such as Ireland), then relocates their headquarters to that other country. By funneling money through the new headquarters, corporations avoid paying US taxes on the income (provided they do not try to repatriate the income). While legal, the technique has cost the US significant amounts of tax revenue over the last decade, and more large companies are considering moving. The Department of the Treasury, as well as members of Congress and the Senate, is reviewing possible ways to discourage inversions, including denying federal contracts to such companies, reducing available tax benefits and changing the way an inversion is defined. More proposed legislation is expected to be introduced in September.

MILLER, MONSON, PESHEL, POLACEK & HOSHAW
A Partnership of Professional Law Corporations
Providing quality legal services since 1959

RALPH GANO MILLER, RETIRED
THOMAS M. MONSON
MARY J. PESHEL
TIMOTHY C. POLACEK
WILLIAM D. HOSHAW†
SUSAN L. HORNER
BRADFORD N. DEWAN
PHILIP R. FREDRICKSEN†
DeETTE L. LOEFFLER
JUDY S. BAE
†OF COUNSEL

http://www.mmpph.com