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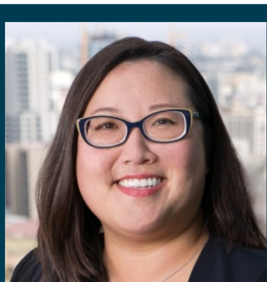

Congratulations to Attorney Judy Bae who was recently elected to the San Diego County Bar Association – Estate Planning, Trust and Probate Law Section as a Member-At-Large for 2015. Judy was also elected to the Board of Directors of the Pan-Asian Lawyers of San Diego and will begin her two-year term in late January of 2015. Judy's practice focuses on probate/trust litigation disputes including accountings, messy trust administrations, will and trust contests and fiduciary liability litigation.

IN THIS ISSUE

Is an ABLE Account Right for You or Your Loved One?

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

In December of 2014, the President signed into law the Tax Increase Prevention Act of 2014. This Act extended over 50 popular temporary tax breaks through December 31, 2014. The bill also included provisions for an entirely new tax break intended to help individuals with disabilities save for their own future expenses.

The new Achieve a Better Life Experience ("ABLE") Act allows "individuals with a disability" diagnosed before the age of 26 years to have special 529 plans. The phrase "individual with a disability" is defined to include:

1. Individuals receiving or deemed to be receiving a Social Security Income Benefit;
2. Beneficiaries under Title II of the Social Security Act, such as SSDI, or Disabled Adult Child benefits;
3. Individuals with a medically determined physical or mental impairment which results in marked and severe functional limitations and which can be expected to result in death, or which has lasted or can be expected to last for a continuous period of not less than 12 months; or
4. Individuals who are blind and can provide a copy of the diagnosis signed by a physician.

ABLE Accounts can be used not only for the beneficiary's education, but also for housing, transportation, wellness, employment training and support, assistive technology and personal support services, financial management, legal fees, funeral and burial expenses, and other services to be determined by the IRS. It is important to note that disqualified distributions are subject to a 10% penalty tax.

Individuals and their families are able to establish ABLE Accounts and deposit a total of $14,000 annually (this amount will adjust for inflation over time). While the money used to fund the account will be post tax dollars, the funds in the account will grow tax deferred (i.e., the interest is not taxed) and withdrawals for the listed purposes will not be subject to tax either. Gifts to these accounts are treated as present interests for gift and generation-skipping tax purposes, but not as qualified medical or education gifts.

Importantly, the funds in these ABLE Accounts will not affect the beneficiary's eligibility for federal assistance such as Social Security or Medicaid (Medi-Cal in California). Under current law, individuals with more than $2,000 in liquid assets at any one time cannot qualify to receive government benefits. Beneficiaries with ABLE Accounts will be able to hold up to $100,000 in the account before affecting Social Security benefits (SSI), and all distributions from the account for disability needs are disregarded. In addition, like any other 529 plan, these accounts can be transferred to family members upon the death of the beneficiary, and disabled individuals can also receive 529 plans from others.

But is an ABLE Account the best choice for you or your loved one? Unlike special needs trusts, the disabled individual can establish and contribute to such an account, possibly allowing some to qualify for government benefits. However, unlike special needs trusts, upon the death of the beneficiary, the funds are subject to government claims for reimbursement. If the individual is unable to create a Will, the funds may also be subject to probate in the owner's estate. Further, these accounts can only accept cash, while special needs trusts can accept any asset, including a residence the beneficiary can live in. California also limits the size of 529 Plans to $371,000; once the account reaches this size, no further contributions can be made. Family members of persons with disabilities should therefore still include special needs planning in their own plans to address these limitations and to protect the remaining trust funds for the benefit of the family upon the death of the disabled individual.

If you have a loved one with a disability and are interested in knowing more about special needs trusts or the new ABLE accounts, we would be happy to meet with you to discuss these options.

Forming New Business Entities: California LLC vs. S Corporation

By Timothy C. Polacek, J.D.

As the economy improves, we are seeing more individuals form new business entities. If you decide to start a business venture and there is a need to protect your personal assets from the liabilities that may arise from the new business, choosing the right business entity can be a daunting task. Generally, the choice to be made is between an LLC and an S corporation. Although these entities are fairly similar, there are noticeable differences that exist, and sometimes one entity is preferable to the other.

LLC – Basics.

An LLC is a business structure that may engage in any lawful act or activity. To form a California LLC, the members must file Articles of Organization with the Secretary of State, should enter into an operating agreement (although it is not per se required to enter into an operating agreement, it is highly advised for a multi-member LLC), and file a Statement of Information within 90 days after filing the Articles of Organization.

A member's investment in the LLC is the limit of his or her liability as an owner. In terms of profits and losses, the members have the flexibility to structure the distribution of profits and losses, distributions, management, and voting rights as they see fit. There is no maximum for the number of members an LLC may have, and LLCs may have as few as a single member.

With regard to the maintenance of an LLC, the requirements are more relaxed than an S corporation. Meetings are not required; however, holding meetings will bolster the personal limited liability protection and is generally considered a good business practice.

LLC - Tax Considerations.

By default, for federal income tax purposes, an LLC is treated as a flow through entity. In situations where the LLC has only a single member (which can include LLCs formed by spouses), the profits and losses are reported on Schedule C of the member's individual income tax return without the need to file a federal income tax return for the LLC (although a California information return must be filed). Conversely, multi-member LLCs, by default, are taxed as a "partnership" and are required to report income and loss on IRS Form 1065 and California Form 568. Each member of the LLC, under partnership tax treatment, receives a Schedule K-1 reporting the member's share of the LLC's income or loss, which is then reported on the member's individual income tax return.

An LLC may elect to be taxed as an S corporation. If the LLC elects to be taxed as an S corporation for federal tax purposes, it is also treated as such for California tax purposes.

An LLC is very flexible in how its members may allocate income amongst each member. In an LLC, the operating agreement usually states what share of profits each member is to receive.

Similar to an S corporation, LLCs have a minimum $800 franchise tax payable to the State of California. However, LLC's are also subject to fees on California source "gross receipts" incurred in connection with the LLC's business. This fee begins at an additional $900 once the LLC's California revenue exceeds $250,000, and gradually increases until revenue exceeds $1,000,000. For many businesses, the amount of this fee can make use of an S corporation a more attractive business entity choice.

LLC - Management and Control.

In an LLC, management and control lies either with the members (in a "member managed" LLC) or with one or more managers (in a "manager managed" LLC) who may or may not be members. The difference is that in a member managed LLC, each member is authorized as an agent to bind the LLC by virtue of membership, whereas in a manager managed LLC, there are one or more named managers who have the power to bind or execute any document on behalf of the company.

S Corporation – Basics.

An S corporation is a limited liability entity that has made a Subchapter S election for federal tax purposes with the IRS. Such an election results in the income of the S corporation being passed through to the shareholders (and doesn't get double taxed). This corporation comes into existence upon filing Articles of Incorporation with the Secretary of State. In order to protect the shareholders from personal liability for debts of the S corporation, a California S corporation must observe certain "corporate formalities" and has more maintenance requirements than the LLC. For an S corporation to provide maximum limited liability protection and avoid piercing the corporate veil, the corporation should:

1. Properly notice, hold, and document annual meetings of shareholders and directors, in addition to any special meetings, to authorize and affirm certain corporate acts;
2. Timely file all documents required under applicable law;
3. Be funded with sufficient capital and insurance;
4. Keep and maintain a corporate minute book; and
5. Never mingle corporate funds with the shareholders' own personal funds.

S Corporation - Tax Considerations.

The corporation's net profits, losses, and tax credits are passed through and taxed to the shareholders of the corporation individually, and not to the corporation. Thus, S corporations are similar but not identical to LLCs.

An S corporation is very strict in terms of allocating income amongst its shareholders. Each shareholder shares in the corporation's income in the same proportion as his or her ownership. If each shareholder is a 50% owner, each will be allocated 50% of the corporation's income for purposes of computing income tax, regardless of any other agreements between the parties.

California applies a 1.5% flat tax on all income of an S corporation, plus an $800 annual franchise tax fee (but it is not subject to the "gross receipts" fee imposed on LLCs).

In an S corporation, only the wages of the shareholder who is an employee are subject to employment tax. The remaining income is paid to the shareholders as a distribution which is taxed at a lower rate, if at all. This can result in lower payroll/self-employment taxes compared to an LLC, but a shareholder who is an employee must receive reasonable compensation and can't take an unreasonably low salary. The S corporation's ability to minimize self-employment tax is a great benefit compared to an LLC.

In an S corporation, if there is net income remaining after the owners are paid a salary, this amount would not be subject to the self-employment tax, and will be taxable to the shareholders. Conversely, in an LLC, all net income is subject to the self-employment tax for a member who is active in the business.

S Corporation - Management and Control

S corporations are managed by a Board of Directors who appoints officers to run the day-to-day business of the corporation. The officers (President, Secretary, and Chief Financial Officer) are granted authority to bind the corporation.

The Shareholders elect the Board of Directors. However, the Shareholders have no right to participate in the day-to-day business unless elected as a director or appointed as an officer. Generally, in an S corporation with a single individual Shareholder, such individual would serve as both a Director and/or an officer.

Summary.

Both LLCs and S corporations can protect a business owner's personal assets from the liabilities of an operating business. If the business has small revenue, a comparison of the annual maintenance costs (i.e. fees paid to the State of California) to the additional amount of self-employment tax can dictate which entity should be selected.

Modifying "Irrevocable" Trusts

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

Although it may seem something of an oxymoron, in California, "irrevocable" trusts can sometimes be amended or revoked. When and how such changes can be made depends in large part on the reason for the amendment and the cooperation of the remainder beneficiaries. However, not all modifications will obtain the desired results, especially if the IRS has an interest in those results.

There are two major categories of trusts: ones that can, by their terms, be amended or revoked ("revocable" trusts), and ones that cannot be amended or revoked ("irrevocable" trusts"). Most trusts begin as revocable documents that can be changed by the people who establish them (i.e. the "Trustors" or "Settlors") and eventually become irrevocable upon the death of the Trustors. Some trusts are also made irrevocable when they are established, usually for gifting or creditor protection reasons.

Generally the Trustors have the power to amend or revoke a revocable trust while both are still living. However, most trusts become irrevocable if one of the Trustors becomes incompetent or dies (although the trust may allow the well or surviving spouse to amend the trust as to his or her share of the assets).

Sometimes Trustors do not fully understand the terms of the documents they have signed and later determine these terms are not what they intended. In addition, over time laws change and the circumstances of the Trustors, their assets, and the beneficiaries may also change. When this occurs, some trust terms may no longer be beneficial or even may be detrimental to the beneficiaries (such as when the trust terms require the trust income to be distributed to a person who is now disabled and such distributions could jeopardize that person's government benefits). California law recognizes this reality and provides exceptions which allow an otherwise irrevocable trust to be amended in certain circumstances.

Reformation to Correct Errors.

If a trust includes provisions that are unclear, contradictory, or the trust is missing key dispositive or administrative provisions, the trustee may petition the Probate Court for instructions regarding how to administer the trust. The trustee should provide evidence of what the Trustors originally intended, and if the Trustors are still living, obtain their consent and testimony. The trustee is required to notify all of the current and remainder beneficiaries of the trust and to give them a copy of the petition. If the court agrees the evidence supports the changes, the court will issue an order reforming the trust.

Amendment Due to Changed Circumstances.

Sometimes the beneficiaries want to change the terms of the trust in order to obtain a better tax or other result. As discussed below, the IRS generally refuses to recognize reformations made to a trust purely for tax reasons. The Probate Code allows a trust to be amended in circumstances where the Trustor (if living) and all of the beneficiaries consent, provided the change does not violate a purpose of the trust. For example, amending the trust to allow the assets to be distributed to a special needs trust for a disabled beneficiary is generally permissible, but it might not be permissible to change the trust to distribute the assets outright to the beneficiaries if there is evidence the Trustor wanted to prevent the beneficiaries from wasting the assets.

Amendments Solely for Tax Reasons.

Sometimes a better income tax or transfer tax result can be obtained if a trust is amended. In this situation, even if all the beneficiaries consent and the court approves the amendment, the better tax result might still not be available. The IRS takes the position that court ordered modifications of a trust which are made solely for tax reasons are not binding on the IRS unless the order reflects the decision of the state's highest court. This is because the IRS is not a party to the probate court proceeding so cannot adequately protect its interests, and because the decision of the probate court is not binding state law (while a decision of the California Supreme Court would be).

Irrevocable trusts can be amended in limited circumstances. If you are a Trustor or a beneficiary of an irrevocable trust and wish to amend it, you should seek advice from your estate planning attorney.

STATE TAX NEWS

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

Will the Cost of Legal Services Go Up in 2016? New state Senator Robert Hertzberg has proposed a bill that would impose a sales tax on services while reducing the income and corporate tax rates. The new tax would not be imposed on health care or education costs, or to businesses with less than $100,000 in revenue. It would, however, presumably apply to most legal fees. Polls indicate that a sales tax on services is not favored by the majority of Californians, but possibly coupling it with lower income tax rates may make the proposal more palatable.

Further, Governor Brown has hinted that he may want to overhaul the entire state tax system. In addition, two taxes passed on a “temporary” basis in 2012 are already being considered by some legislators for extension beyond 2018: the sale tax increase, which affects everyone, and the increased income tax on the state’s most affluent residents. However, Governor Brown has indicated he does not favor extending these taxes.

These tax proposals, and two others from independent parties, are likely to be put forth as Propositions in 2016. One independent party tax proposal would remove Prop 13 protections for transfers of commercial properties. Another independent proposal would impose a new tax on oil extractions. Anticipate hearing more about these proposals in the coming year.

FEDERAL TAX NEWS

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

As discussed in more detail above, in December of 2014, the legislature adopted the Tax Increase Prevention Act of 2014. The Act extended through December 31, 2014 more than 50 popular tax breaks that expired at the end of 2013.

Legislators also managed to agree this month on a federal budget bill which funds most branches of the government through the end of the fiscal year in September 2015. This bill again cuts funding for the IRS, leaving in doubt the IRS’ ability to properly police tax scams and audit returns. The IRS has warned that refunds may be delayed in 2015 due not only to funding cuts, but also because the IRS has a major role in the implementation of the health care bill. IRS funding was cut in part as punishment for what some in Congress saw as abuse of its discretion in denying non-profit status to certain right-leaning organizations. Another agency receiving less than full funding is ICE, which saw its funding extended only until late February in response to legislators’ concerns over President Obama’s new immigration policy.

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