

H G & G U P D A T E

Hofheimer Gartlir & Gross, LLP

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Form and Substance in Personal and Business Planning

Lawyers and judges are fond of saying that the “substance of a transaction governs over form.” This means that how a particular transaction looks on paper is not necessarily the way a court or a government agency (for example, the IRS) will view it.

In fact, the opposite is often true. In many business or personal transactions, the form of the transaction is just as important as the substance.

Let’s look at some real-life examples:

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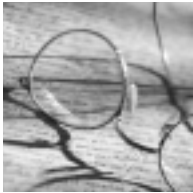
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■ Personal Planning

Owning property jointly with your spouse. This is a typical form of ownership used by many married couples for the ownership of their house, brokerage accounts, bank accounts and other property. A result of this form of ownership is that when Husband dies, the jointly-held property passes to Wife outright, regardless of what the parties provide in their Wills. It might have been possible to save estate taxes in the Wife’s estate or to protect the Wife from unscrupulous relatives or creditors had the Husband’s Will provided that the property went into a “bypass trust” for her benefit. However, because the property was held jointly rather than as “tenants in common,” these other objectives cannot be achieved.

Owning life insurance on your own life. Life insurance proceeds are subject to estate tax in the estate of the policy owner. If Wife owns an insurance policy on her life, payable to her children, the proceeds will be subject to estate tax on her death. If she had transferred the policy to her children during her life, or if the children had been the original applicants for the policy (with Wife in either case giving the children money to make the premium payments), there would be no estate tax at Wife’s death. Similar savings can be achieved by having the policy owned by an “insurance trust”.



Incorrect Beneficiary Designations. A common mistake is to name minor children as contingent beneficiaries of an insurance policy, an IRA or a 401(k) plan. Suppose that Husband names Wife as primary beneficiary and Child as contingent beneficiary. If the contingency occurs (Wife predeceases Husband), Child is entitled to the funds. However, since a minor may not legally hold the funds outright, a court will require that a guardian be appointed to administer the funds. The guardian will have to file annual accountings and post a bond, the expense of which will reduce Child's inheritance. When Child turns age 18, he or she will be entitled to receive the proceeds. Even if the Will had provided that Child's share of the IRA was to be held in trust, the beneficiary designation in the IRA document (pay to Child outright) trumps the Will provision, and the Child receives the funds without restriction at age 18. There are a variety of ways that this result could have been avoided, which you should discuss with your advisors.

Bequests to persons with disabilities. If you make a bequest in your Will or make lifetime gifts to a friend or a relative who is disabled and qualifies for government benefits (for example, Supplemental Security Income and Medicaid), you could disqualify him or her from receiving these benefits. Even putting the funds into a

"standard" trust will not help. What you need to do is to establish a "Supplemental Needs" or "Special Needs" Trust, the form of which is provided by law. This type of trust can allow the beneficiary to receive government benefits that pay for food, clothing and shelter and, at the same time, receive distributions from the trust that will "supplement" the government benefits (for such items as vacations, entertainment, computers).

Ownership of Real Estate in Non-Domiciliary Jurisdiction. Suppose you own a home in New York and a vacation home in Florida. Upon your death, your Executor will probate your Will in New York. In addition, a probate in Florida will be required in order to transfer title to the Florida property (an "ancillary probate"). This second probate proceeding could be avoided if, for example, the Florida property was owned by your "living" trust.

Gifts of partial interests in real estate. Suppose you transfer a 10% interest in a parcel of investment real estate to each of your three children. In the future, you will need four signatures to sell, mortgage or lease the property. If you had first transferred the property to a limited partnership or a limited liability company, you could have retained total control over the property. In addition, you would have been entitled to "discount" the value of the property for gift tax purposes.

■ Business Planning

One of the most important considerations in creating a business (including the ownership of income-producing real estate) is the form in which the business is operated. It is critical to consider the significant differences in the operational and tax aspects of each form.

In most cases, it is important for you to avoid unanticipated personal liability for the liabilities of the business, such as liabilities not covered by insurance, defaults on loans, and similar items. Therefore, the preferred form of ownership is a corporation, limited partnership or limited liability company.

Corporation. A corporation is a distinct legal entity. In order to create it, intention is not enough. You must follow precisely the formalities established by the laws of the particular state in which you wish to organize it, which typically require the filing of a document with the state authorities and the paying of the appropriate fee. If the corporation is not properly created, you may be personally liable under any documents that you sign on behalf of this “intended” corporation.

For tax purposes, a “regular” corporation (sometimes called a “C” corporation) is a separate taxable entity. It is subject to tax on its taxable income (income less deductions) at a Federal rate that can reach 35%. (Most states impose a corporate income tax as well.) If the corporation pays dividends out of its remaining funds, the shareholders will be subject to income tax at rates that can rise to 39.6 % (for individuals). Thus, the total income tax bite to the shareholders of a C corporation can reach 60%.

In order to avoid this second tax, the shareholders will often elect that the corporation be treated as an “S” corporation (formerly, a “Subchapter S” corporation). This is done by filing a written election, in a specified format, with the IRS and state and local tax authorities. The “S” corporation will, in general, not be subject to tax on its net income; its income is “passed through” to the shareholders who report it on their own income tax returns and pay tax at their own individual rates.¹ Not all states and cities recognize the “S” corporation (notably, New York City) so that the corporation may be liable for a local income tax even though it does not pay Federal income tax.

Because the “S” corporation does not pay income tax, it is sometimes assumed to have the same tax results as a partnership, which is also a type of “pass-through” entity. This is a dangerous assumption. The “S” corporation is subject to specific (and, in most cases, very rigid) rules that govern its organization and operation. Violation of these rules, even if unintentional, will terminate the “S” election. In that case, it becomes a “C” corporation and the “pass-through” benefits are lost. In contrast, the tax rules for partnerships afford greater flexibility and, in most cases, simplicity. There are many other tax differences between “S” corporations and partnerships (including LLCs) that must be considered before choosing either form of ownership.

Partnership. There are two basic types of partnerships (not including professional partnerships, or LLPs). A “general partnership” may be created by agreement of the parties; nothing has to be filed with the IRS or the local authorities in order to create it.² The main drawback to a general partnership is that each partner is liable for all of the liabilities of the partnership. Each partner, as a general partner, has the authority to bind the business and, thus, the other partners. For income tax purposes, a general partnership is a pass-through entity.

To achieve limited liability, a “limited partnership” should be used. This is done by following the formal rules (typically, filing documents with the state and publishing a notice in a local newspaper). A limited partnership requires at least one “general” partner who is personally liable for all partnership obligations. The remaining partners (the “limited” partners) will not be personally liable; their only financial exposure is the amount of capital



¹ This “pass-through” occurs whether or not the corporation makes any actual cash distribution to the shareholders.

² Many states or cities require a partnership to file a “doing business” certificate, but this does not determine whether the partnership has in fact been created.

they have contributed. Note that a limited partner cannot take an active role in the management of the business of the partnership; the partner who takes an active role will become personally liable for partnership debts as if he or she were a general partner. The limited partnership is also a “pass-through” entity for federal income tax purposes and in most states (Texas being an exception to the rule); it is important to check local laws before assuming that the limited partnership will not be taxed.

Limited liability company. The limited liability company (LLC) is a relatively recent creation of the law and is becoming the entity of choice where a corporation is not desired. It is treated as a partnership (“pass-through”) for tax purposes, yet it affords its members (i.e., partners) with the limited liability protection of a corporation. The LLC is organized by filing the appropriate documents with the state. One significant aspect of an LLC is that the members can participate in management without fear of personal liability.

Conclusion

In certain ways, our daily personal and business lives have become more complex and more regulated than they were in the past. Businesses are subject to greater regulation by federal, state and local governments than in previous years, and our personal lives have become complicated by various retirement programs and numerous investment vehicles that did not exist previously. When property is transferred by a gift or at death,

when wealth is being created through a business or through an investment, and when business relationships are created through contracts and leases, it is important that your intention be expressed and executed exactly as you want it so that costly disputes do not arise out of ambiguously expressed ideas or imprecise or incorrect documentation. The complexity of daily life can be mitigated by precise planning and drafting. For more information, please call your partner at the firm.

Partner Lecture

Our partner **Edward S. Schlesinger**, a Director and a Member of the Advisory Committee of the Philip E. Heckerling Institute on Estate Planning at the University of Miami School of Law, presented a lecture entitled “What To Do With Life Insurance After the Hearse Leaves With Your Client In It” at the Institute’s 2002 Program, which was held from January 7 - 11.



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- general business and commercial law
- cooperative and condominium matters
- financial institutions (loan transactions, leasing, acquisitions, credit restructuring, workouts and foreclosures)
- estate planning
- trust and estate administration
- general litigation and alternate dispute resolution
- matrimonial and family law
- taxation

Clients of the firm range from major financial institutions and public corporations to closely-held businesses, individuals and families.

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