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TOM PETTY'S ESTATE IS *FREE FALLIN'* – THE IMPORTANCE OF BUSINESS SUCCESSION PLANNING

By Katie Lepore, CPA, J.D., LL.M., Taxation

Most people are aware of the greatness of Tom Petty. Songs like *Free Fallin'* or *I Won't Back Down* are household favorites. Unfortunately, like so many other celebrities before him, the significant size of his estate combined with improper estate planning created family strife after his death. This strife could lead to a legal battle lasting several years. In Tom Petty's "heartbreaker" case, the need for a keen attention to detail in estate planning becomes ever so apparent; unlike other celebrities such as Prince who died without an estate plan, Mr. Petty did attempt to address his affairs prior to his death but still could not prevent litigation.

Recently, Tom Petty's heirs filed motions in Los Angeles Probate Court regarding his estate. Mr. Petty named his second wife as the trustee of his trust and directed her to create a business entity to carry on his music legacy in the future. However, Mr. Petty gave equal managerial rights in this music entity to his second wife and his two children from a prior marriage. This direction is despite the fact that his second wife and each daughter hold differing ownership interests. Specifically, the language in his trust states:

With respect to the creation of the Artistic Property Entity, the Trustee is directed to create the governing documents of the Artistic Property Entity such that those of the Spouse, ADRIA and KIM who are living at the time of creation of the Artistic Property Entity shall be entitled to participate equally in the management of the Artistic Property Entity, even though their respective economic interests in the Artistic Property Entity are not equal.

Mr. Petty's wife argues that this paragraph requires unanimous consent for managerial decisions such that she, and collectively his daughters, have equal 1/2 powers. His daughters claim that each person has an equal 1/3 managerial right and therefore combined they have a majority 2/3 managerial power.

Estate planners and clients alike should learn a cautionary tale about the importance of business succession planning from Mr. Petty's unfortunate situation, including considering many of the following factors.

Clearly Name a Capable Successor(s)

Naming a successor is a very important decision, particularly if family dynamics come into play. A discrepancy among beneficiaries or a power struggle can cause delays and missed opportunities, not to mention large expenses of administration. In Mr. Petty's case, the disagreements may mean that unreleased recordings and tribute albums do not reach the public, which could represent a significant amount of lost revenue.

Choosing the right successor is one of the most important decisions a business owner will make. One child may have been involved in the family business while other children were not. While a parent may want each child to receive an equal beneficial interest, there may be one clear choice for who should manage the business. However, if choosing one child over another may strain family relationships, perhaps a third party or a trusted employee would be a better choice. It may make good sense to transition power before death so that children are made aware that the parent intended and desired for one child to remain in control. Some entities may allow for voting and non-voting interests concurrently such that each child can have an equal economic interest but differing voting interests.

Alternatively, a child may not have good business sense or have very little interest in running the business, in which case leaving the business to him or her can be more harmful to the business and stressful for the child than if the business was sold or an outside third party was hired to run the business. If partners or other investors are involved in the business, it is a sound idea to have a buy-sell agreement in place or a buy-out option, if desired.

Except in rare instances, having equal ownership without a mechanism to break a tie can be detrimental to both the business and the family harmony.

Consider Tax Consequences

The sale of a business will likely create taxable gains (or losses) for the owner. Depending on the structure of the business, there may be ways to avoid or minimize these gains after death. Business owners should also consider how the structure of their business affects their basis at death. The assets held at death, such as the stock of a C-corporation or S-corporation, or the partnership or LLC interest, receive a new fair market value at death[1]; the assets held by these entities do not. There may be tax elections that can be made to also adjust the entity's basis in its assets, but it may be more beneficial to hold the assets directly in the decedent's name or his or her trust at death for tax consequences.

For instance, take the example of a family limited partnership which holds several rental real properties. At death, the decedent's partnership interest receives a basis adjustment, but the real properties do not. Additionally, in California, real property taxes can be a significant expense for investment properties. Proposition 13 provides owners a way to keep the assessed value of the property fairly low if the property has been held in the family for a long period of time. Frequently, parents pass this low assessed value to their children by using the parent-child exclusion from reassessment. However, property held within an entity is not eligible for the parent-child exclusion from reassessment. Therefore, those owning low-basis real property should discuss with their attorney the best way to hold the property to maximize the use of the parent-child exclusion.[2] From a tax standpoint, it may be more beneficial to dissolve the entity altogether.

Additionally, recent court decisions in *Estate of Powell v. Commissioner*, 148 T.C. 18 (2017), and *Estate of Cahill v. Commissioner*, T.C. Memo 2018-84 (2018), are causing many estate planners to re-think ownership structures. Planning for possible valuation discounts may be another tax element to consider. With the federal estate and gift tax exemption so high currently, gifting ownership interests in these entities during life to other family members may be a good tax planning strategy, as could

[1] The basis will step-up if the value of the asset has increased, but the basis could also step-down if the asset has lost value.

[2] The parent-child exclusion in California is available for up to $1 million of assessed value of real estate plus a principal residence.

dissolving entities where discounts are no longer needed.

Funding the Transition

There is often a time during the transition where the new manager/owner needs to learn "the ropes" and become comfortable in his or her new role. It may be important to have cash to fund this downtime if the business will be less profitable due to the exit of its key owner. If the business has difficulty maintaining sufficient cash reserves on-hand, owners may want to consider obtaining a key-man insurance policy to provide additional capital. Additionally, if the business will be sold after an owner's death or there is a buy-sell agreement in place between partners, having adequate cash may be necessary to close the sale or redeem the decedent's interest.

It is important to plan for the unforeseen transition as well, such as a premature death or incapacity. If the business owner were to suddenly die, a plan should be in place to provide an alternate revenue stream for his or her family.

Also, if the company has any debt outstanding, such as a mortgage, it is possible in a closely-held business that the loan can be called upon the death of the owner.

Aligning Business Plan with Estate Plan

Business owners should integrate their business plan with their estate plan. This is particularly so if one child is to inherit the business and other children will receive alternate assets of similar value. The business ownership interest should be properly transferred to the owner's living trust, if applicable, to avoid possibly triggering a probate at the owner's death. Probating a closely-held business could be a very long and costly endeavor in probate court. This process would be exacerbated if there was no clear successor mentioned in the governing documents or no clear path to new management.

Clean Title and Contracts

Business owners often focus on the success of the business at the expense of the organization's contracts and legal documents. It is important to ensure the business properly holds title to its assets and has valid contracts in place (such as a ground lease), with the owner and with third parties. Not only does this provide a smoother transition when the owner dies or sells the business, but it also helps to provide liability protection to prevent creditors from "piercing the corporate veil."

Another element to business succession planning that is often overlooked is ownership of the company's intellectual property. Business owners should ensure that the intellectual property attributed to the company is actually owned by the company.

Recordkeeping

Alongside obtaining clean title to assets and contracts, keeping good records is essential to a smooth transition. So many details of running a business seem to be institutional knowledge of the employees. Key facts such as the "go-to" supplier for a certain part or service, or what bills are outstanding, should be documented and easily passed to the successor manager or owner. Good records help provide liability protection from creditors as well as help show the company is a valid business and is consistently treated as such.

Conclusion

The few factors listed above are just some of many that should be considered by business owners to smoothly and successfully prepare for exiting the business. To avoid having a *Breakdown*, and to keep *Runnin' Down a Dream*, business owners should carefully plan their exit. Should you need assistance in planning for the succession of your business or integrating it with your estate plan, please contact our office.

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FEDERAL TAX UPDATE
By Katie Lepore, CPA, J.D., LL.M., Taxation

IRS Publishes Final Regs About SALT Deduction. On June 11, 2019, the IRS released final regulations as Treasury Decision 9864 regarding the state and local tax (SALT) itemized deduction. This Decision eliminated the ability of a taxpayer, in conjunction with a state, to claim a charitable deduction by voluntarily donating the amount of state tax owed to a state created “charity” in exchange for an equal deduction against their state taxes. The Decision requires taxpayers to reduce their federal charitable itemized deduction by the amount of any state or local tax credit they received for making the “contribution.” The IRS also issued Notice 2019-12, which provides a safe harbor for taxpayers to treat payments that are disallowed charitable deductions as state and local taxes, so they can at least attempt to claim the $10,000 SALT deduction on their federal returns. This work-around scheme was previously promoted by the state of New York, among others.

Taxpayer First Act. H.R. 3151, *the Taxpayer First Act*, passed both the House and Senate and was forwarded to the President’s desk for signature as of June 24. Among other things, the bill would restrict the IRS’s use of private debt collectors, establish a separate office of appeals, improve the whistleblower program, and provide for better security surrounding the IRS’s technology to help protect against identity theft.

HSA and HSHP Limits for 2020 Released. On May 24, 2019, the IRS released Revenue Procedure 2019-25 detailing the 2020 inflation-adjusted amounts for health savings accounts (HSA) and high deductible health plans (HSHP). The amount a single person can contribute to an HSA increased by $50 to $3,550 and for a family increased by $100 to $7,100. The maximum amount that is deductible for a single person increased by $50 also to $1,400 and for a family increased by $100 to $2,800. The out-of-pocket maximum amount for a single person increased by $150 to $6,900 and for families increased by $300 to $13,800.

IRS to Stop Faxing Tax Transcripts. On June 28, 2019, the IRS ended its practice of faxing tax transcripts to both taxpayers and third parties, including taxpayer representatives, to help reduce identity theft. The IRS will end its practice of mailing tax transcripts to third-parties in July.

Draft Form W-4 Released. On May 30, 2019, the IRS released a draft Form W-4 to calculate income tax withholding. The form, which includes other non-wage income and deductions in the calculation to determine the proper amount of withholding, was available for public comments through July 1, 2019. A revised draft is due in July and a final draft is expected in the fall. The IRS also issued a draft version of new Publication 15-T (Federal Income Tax Withholding Methods) for the 2020 tax year which is designed to help employers to calculate withholding.

Tax Court Allows Limited Appearances. On May 10, 2019, the Tax Court issued Administrative Order No. 2019-01 allowing attorneys to make a Limited Entry of Appearance, beginning September 9, 2019. An extremely large percentage of taxpayers in Tax Court represent themselves. The change was made in an effort to afford these taxpayers legal representation and to make it more efficient for Tax Court judges to properly administer cases.

SSA Projects Wage Base Increase. The Social Security Administration has projected that the Social Security wage base will increase from $132,900 to $136,800 in 2020. This is a projection only and actual wage bases will be announced in October. Employees and employers pay 6.2% Social Security taxes on an employee’s wages up until the wage base in effect for that year. Employees and employers also pay a 1.45% Medicare Tax on an employee's wages, which has no wage cap. Self-employed individuals pay both the employee and employer portions for a total of 15.3% Social Security and Medicare taxes. High wage earners also pay a 0.9% additional Medicare tax.

ACA in Jeopardy. A U.S. Court of Appeals for the Fifth Circuit in New Orleans is set to hear oral arguments in early July regarding the constitutionality of the Affordable Care Act. The Act was upheld by the U.S. Supreme Court in 2012 under its taxing statutes, but the Tax Cuts and Jobs Act of 2017 removed these tax statutes and opponents claim that without these statues, the entire Act is invalid. A district judge in Texas held the Act was unconstitutional in December 2018.

STATE TAX NEWS
By Katie Lepore, CPA, J.D., LL.M., Taxation

State Gas Tax Now Highest in Nation. On July 1, 2019, California taxes on gasoline increased by 5.6 cents to 47.3 cents, for a combined tax and fee of 57.8 cents a gallon. SB1, which was adopted in November of 2017, initially increased taxes by 12 cents a gallon. The tax, which is indexed for inflation, will increase again in July of 2020. Funds from the tax are supposed to be used for road repairs, but the overall tax revenue falls substantially short of what is needed for these repairs.

Supreme Court Limits State Tax on Out of State Trusts. On June 21, 2019, the United States Supreme Court ruled that states cannot impose income tax on out-of-state trusts solely because a beneficiary of that trust is a resident. *See North Carolina Department of Revenue v. Kimberley Rice Kaestner 1992 Family Trust.* The beneficiary in that case had not received distributions from the trust and had no right to demand any distributions. The Court specifically did not address California's laws on this matter, which remain unclear with this most recent decision.

Property Tax Appeals Open. Beginning July 2, 2019, taxpayers may appeal their property tax assessment. The period to appeal the assessment ends either September 16 or December 2, 2019, depending on whether the county assessor has notified the clerk of the county assessment appeals board of his or her intent to mail assessment notices by August 1 to all taxpayers with property on the secured roll. The last day to file an appeal for San Diego County is December 2 (since November 30 falls on a Saturday).

Los Angeles Parcel Tax Effective. Los Angeles residents approved Measure W on the November 2018 ballot, which imposes a parcel tax of 2.5 cents per square foot of impermeable land. The new tax became effective July 1. The median annual tax will be approximately $83, based on a 2,100 square foot house on a 7,500 square foot lot. The collections from the tax will be used to improve stormwater capture, flood control, and ocean pollution. Taxpayers may opt to replace their impermeable land with a permeable surface instead of paying the parcel tax.[1]

Clarification Regarding Sales Tax. On May 23, 2019, the California Department of Tax and Fee Administration (CDTFA) held a meeting to discuss proposed amendments to the sales and use tax regulations. After the *Wayfair* case, California announced that it would subject out-of-state retailers to paying California sales taxes after having over $500,000 in sales into California, effective April 1, 2019. The proposed amendments clarify that the requirement to collect sales tax does not begin until the first dollar past $500,000 of sales. At this point, the

[1] Morrison Foerster: https://www.jdsupra.com/legalnews/los-angeles-county-voters-passed-a-96900/

amendments are only proposed and not enacted.

Housing Commission Considers Tax on Vacant Homes. The San Diego Housing Commission discussed at a meeting on June 14 a possible tax on vacant homes in San Diego. With demand for housing being so high, the Commission thinks that a tax on homes left vacant for more than 6 months of the year would encourage owners to rent the home when not in use. The money raised from the taxes could then be used to fund the building of affordable housing. A similar tax was enacted in Vancouver, British Columbia, in 2017 and since the implementation, approximately half of the vacant units have been converted into rentals, according to the *San Diego Union Tribune*.[2]

San Diego Budget Passed. On June 10, 2019, the San Diego City Council approved a budget of $1.6 million for the next fiscal year. The budget generally retains "aggressive spending . . . on street repair and programs to fight homelessness."[3] One of the largest increases in the budget relates to the program Clean San Diego.

Future of CalSavers Program Uncertain. On March 29, 2019, the U.S. District Court for the Eastern District of California dismissed a lawsuit brought by the Howard Jarvis Taxpayers Association to invalidate the CalSavers Retirement Savings Program. The Association claimed the Program was preempted by federal law under ERISA since it provides retirement plans for private workers in California who do not otherwise have access to a retirement plan sponsored by their employer (see our January 2019 newsletter). The Court held that the CalSavers plans are not governed by ERISA since they are not offered by employers. The Taxpayers Association has since amended its complaint and the lawsuit is continuing.

FTB Launches New Website Design. The FTB has renovated its website to be more taxpayer friendly, focusing on tasks (such as paying tax, refund status, etc.). Any websites that were previously bookmarked or saved will need to be updated. In the event users are unable to find what they are looking for or have an old link saved, they can request help from the FTB which promises to send users the information requested within a few business days.

CA State Bar to Increase Attorneys' License Renewal Fees. The State Bar of California announced that it is seeking to substantially increase license renewal fees for attorneys beginning in 2020. The State Bar reports that the fees have not increased since 1998 and if they had been adjusted for inflation, would be significantly higher today. The proposal also includes some large one-time charges. SB-176 was amended May 22, 2019 and seeks to amend Business and Professions Code Sections 6140 and 6141 to reflect these increases. The bill passed the Senate on May 28, 2019 and is currently with the Assembly. The State Bar will be seeking input from practicing attorneys this summer.

[2] Gary Warth, "Housing Commission Considers Tax on Vacant Homes," *San Diego Union Tribune: Real Estate News*, June 14, 2019. https://www.sandiegouniontribune.com/business/real-estate/story/2019-06-14/housing-commission-considers-tax-on-vacant-homes?_amp=true

[3] David Garrick, "Council Passes $1.6 Billion Budget," *San Diego Union Tribune: Local*, June 11, 2019. https://www.sandiegouniontribune.com/communities/san-diego/story/2019-06-11/san-diego-adopts-1-6b-budget-city-leaders-call

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