


The Rodi Review

Spring 2008

LETTER FROM THE EDITOR

In this edition we take pride in introducing our newest business lawyer, Randal Schwartz, a 2006 USC graduate with a joint JD/MBA degree. His article about "personal goodwill" focuses on a controversial tax issue pertinent to sales of corporate businesses. We welcome his contribution to The Rodi Review.



Tom Curtiss

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LEGAL ALERT!

"REGISTERED DOMESTIC PARTNERS MUST NOW FILE CALIFORNIA INCOME TAX RETURN AS MARRIED COUPLE"

By Walter T. Killmer Jr.

California now treats domestic partners formally registered with the Secretary of State as married persons for income tax purposes. This change applies to personal income tax returns for 2007 and subsequent years. Because of this change in the California income tax law, registered domestic partners may no longer elect the "single" status when filing a California personal income tax return. Instead, they can either file a joint California return,

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WHOSE GOODWILL IS IT ANYWAY?

By Randal Schwartz

FFor many corporations, goodwill can constitute a significant portion of their overall value at the time of sale.

Goodwill is the value of the portion of a business corporation attributable to its customer base, name recognition, product reputation and similar factors that differentiate the corporation's business from a start up. Valuing goodwill can require a complicated formula, and even identifying who owns that goodwill can pose analytical challenges.

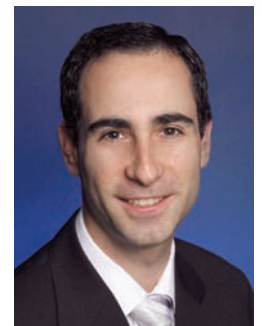
PERSONAL GOODWILL AS A SEPARATE SALEABLE ASSET AND THE TAX BENEFITS TO THE SELLING SHAREHOLDERS

In closely-held corporations managed by a small number of shareholders, the corporation may not actually own all of the goodwill associated with its business

operations. Rather, the shareholder(s) may have a personal ownership interest known as "Personal Goodwill."

Corporate goodwill, owned by the corporation, and Personal Goodwill, or even joint ownership of goodwill, may even all exist concurrently.

Most buyers of a corporate business will prefer to purchase the corporate assets, rather than the shares of the corporation itself, whereas the selling shareholders of a C-corporation, will generally prefer a stock sale. A sale of the corporate assets, including goodwill, will be subject to double taxation, first to the corporation and then to the shareholders individually. If Personal Goodwill can be sold separately from the assets of the corporation, the gain on the sale of the Personal



"LET'S BUY THEM A HOUSE"

By William R. Christian

Many clients reach a point in their life when they have accumulated a substantial net worth, and feel comfortable in parting with some of that wealth to benefit their adult children, most often by assisting them in the purchase of their first home. A triggering event may be a child's contemplated marriage or the expectation of grandchildren. A variety of alterna-



tives are available to them in accomplishing this goal.

AN OUTRIGHT GIFT AND ITS IMPLICATIONS

The simplest approach is to make the home a "wedding gift" by deeding the property to the bride and groom. Under the current gift tax law each parent can make an outright gift of \$12,000 to each recipient, and the gifted amount is then excluded from any gift tax or gift reporting requirements. Taking advantage of this exclusion, a couple could transfer \$24,000 worth of equity to their child alone and \$48,000 if they wish to include their child's spouse. Of course, \$48,000 will almost certainly not purchase a residence, at least not here in California, nor even represent a meaningful down payment.

If the parents wish to make a gift in excess of the exclusion amount, they

can do so without paying a gift tax by each drawing down on his and her \$1 million lifetime gift tax exemption. Once they exceed the annual exclusion amount, they must file gift tax returns in order to report that draw down, but so long as they do not exceed the exemption amount, they will pay no gift tax. Because the parents can gift as much as \$2 million combined, they should be able to gift a house more than adequate to the couple's needs without having to pay any gift tax and with only the inconvenience of having to file a gift tax return.

A gift of this sort is, however, not without its complications. If the parents make the gift jointly to their child and the child's spouse, the spouse will own a 50% interest, which could, in the event that they later dissolve their mar-

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using the "married/RDP filing jointly" filing status, or each of them can file a separate return, using the "married/RDP filing separately" status. A registered domestic partner may also be eligible for "head of household" or "qualifying widow(er)" filing status.

Registered domestic partners must continue to file separate federal income tax returns on the same basis as in the past. Therefore, in order to prepare their California returns, they may need to complete a worksheet provided by the Franchise Tax Board.

Registered domestic partners should analyze whether they are better off filing jointly or separately. Furthermore, domestic partners who are considering registration should add California

Registered domestic partners must continue to file separate federal income tax returns on the same basis as in the past.

income tax to the list of financial implications to be considered. For example, a registered domestic partner who wishes to file a separate return must include one-half of the employment income of both partners on his or her return and pay the California tax accordingly. For federal purposes, however, the earned income of each partner is still only includible on his or her own personal return.

Tax preparation for registered domestic partners has therefore become much more complicated, but with complexity comes opportunity. Consider the sale of a registered domestic partner couple's principal residence, owned entirely by one partner, with a long-term capital gain of \$400,000. On that partner's fed-



eral return, he or she could exclude \$250,000 of the gain and would pay capital gains tax on the remaining \$150,000. For California tax purposes, however, the couple could file a joint return and exclude all of the gain, because the California capital gain exclusion for sale of a principal residence is \$500,000 for a married couple or registered domestic partners filing jointly.

domestic partners who are considering registration should add California income tax to the list of financial implications to be considered.

The new legislation applies to taxable years beginning on or after January 1, 2007. Registered domestic partnership status is determined as of the last day of the taxable year. Special rules apply if one or both partners are non-residents, if partners have separated but have not dissolved their partnership or if partners have entered into an equivalent legal union in another jurisdiction.

"LET'S BUY THEM A HOUSE"

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riage, confer a financial windfall on the former spouse. Many parents are not comfortable with this result, and actually prefer to gift only to their child.

Assuming that the parents restrict the gift to their own child, even if the gift of the residence is free and clear of a mortgage, the child must not "commingle" community assets with the residence, which could contaminate the separate property nature of the residence. This "commingling" problem can easily occur simply by making capital improvements, or paying property taxes, or if the purchase included mortgage financing by making a house payment, from earnings after marriage. Any of these financial actions would convert what was initially a separate property asset into a commingled community asset. A premarital agreement can usually avoid this problem, but such agreements are not always palatable to the young couple in love.

In order to avoid the risk of inadvertent commingling, the parents can instead gift the house into an irrevocable trust for the benefit of their child, and a properly structured trust could qualify the gift for the present interest exclusions of an outright gift. Assuming that the trust is administered carefully, the trust ownership totally avoids the risk of commingling. Furthermore, a trust of this sort will shelter the house from creditors of the couple because they have no ownership. If the arrangement is that the couple rent the home from the trust, the trust can then rely on the rental funds to pay the mortgage (if any), property taxes or extraordinary maintenance/renovation expenses.

THE LIMITED BENEFITS OF A LOAN

Another possibility would be simply to lend to the couple the funds necessary to purchase the residence. Although the residence would belong

to the child and his or her spouse, the parents would still own the "loan".

To be sure, any future growth (in excess of the loan amount) would accumulate as the community property of the child and his or her spouse, but the initial purchase price amount, structured as a loan, could later pass either by gift or through testamentary disposition to the child as his or her separate property.

BUY, RENT AND LATER GIFTING CAN POSTPONE TAX IMPACT

Another alternative is for the parents to buy the residence themselves, and rent it to the couple. So long as the rental is at fair market value, the couple can avoid any immediate gift transfer to their child. Indeed, this arrangement is not even a form of wealth succession unless in future years the parents should elect to forgive some portion of the rent or to transfer fractional interests in the residence.

If the rent forgiveness or the fractional interest transfer does not exceed the annual exclusion amount in any year, no particular gift realization should arise. The parents can transfer ownership later on either by gift or by inheritance.

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WEIGHING THE RELATIVE BENEFITS OF SIMPLICITY AND COMPLEXITY

As the prior discussion highlights, the simple wish to provide a home to a child can entail tax and other complexities that give rise to an array of alternative structuring vehicles. Parents must decide, at a practical level, how much complexity they want to inject into a gift of this nature. Concerns about creditors and a possible failed marriage may justify the complex vehicles required to provide protection for their child.

AVOIDING THE TAX COSTS OF JOINT TENANCY

By Thomas Curtiss Jr.



Sharing ownership in their joint residence is often the most ardent wish of domestic partners; however, practitioners are reluctant to recommend this

form of ownership unless the parties have purchased their residence together with equal contributions. A transfer into joint tenancy, which establishes equal ownership and also automatic succession of ownership to the survivor, could result in a gift from the person owning the greater interest to the other and could in the past also trigger a reassessment for property tax purposes.

AVOIDING PROPERTY TAX REASSESSMENT

The State Board of Equalization has now ruled that one partner who holds exclusive title to the partners' residence can add his or her non-owner partner as a joint tenant without triggering a reassessment. Because one of the resulting joint tenants will be the original owner, he or she is considered an "Original Transferor", and the creation of the joint tenancy title is excluded from reassessment. Furthermore, when either joint tenant subsequently dies, the survivor will succeed to 100% ownership without reassessment because for purposes of that later transfer the surviving joint tenant will also be considered an "Original Transferor."

As an aside, for domestic partners who have formally registered their status with the California Secretary of State, the rule is different and more generous.

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AVOIDING THE TAX COSTS OF JOINT TENANCY

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Registered domestic partners can transfer real estate between themselves in any way they wish without reassessment because those transfers are excluded altogether from reassessment under general California Law.

AVOIDING A GIFT TAX IF THE PARTNERS' CONTRIBUTIONS ARE NOT EQUAL

Because joint tenancy title establishes an equal ownership of record, the partner with the greater contribution to the purchase risks making up a gift to the other of one-half of the difference. To avoid this result, the joint tenants can enter into a "partnership" agreement that treats their equity interests in the residence as capital contributions to the partnership. Such an agreement would

set forth the amount of "capital" each already contributed and the respective obligations to contribute to the mortgage payments and any improvements.

Because one of the resulting joint tenants will be the original owner, he or she is considered an "Original Transferor", and the creation of the joint tenancy title is excluded from reassessment.

The agreement would then provide that, upon any subsequent sale, each partner would be entitled to his or her respective accumulated equity contribution prior to dividing equally the remaining proceeds. If one partner has invested more than the other in a renovation project, that additional amount would

augment the "capital account" of the contributor for purposes of such later division of proceeds upon sale.

The partnership agreement will avoid any realization of capital gain by the owner of the greater interest until the partners make an actual sale to a third party. The resulting gain would be calculated as the gross sales price less their basis, and would be allocated based upon a formula set forth in the agreement.

To be sure, the use of joint tenancy and a partnership agreement will complicate the acquisition, ownership and succession of the partners' residence. The tax benefits should, however, more than adequately reward such efforts.

WHOSE GOODWILL IS IT ANYWAY?

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Goodwill will be included only as income to the shareholders.

ESTABLISHING PERSONAL GOODWILL FOR INCOME TAX PURPOSES

Personal Goodwill is very difficult to establish, even in closely-held corporations. In determining if Personal Goodwill exists, Courts have looked at the existence of employment agreements, covenants not to compete and the continued presence of a specific individual participating in the business.

The absence of an employment agreement between the actively participating shareholder and the corporation may persuade a court to view goodwill as personal to the actively participating shareholders and therefore a personal asset. Conversely, if an employment agreement exists between the actively participating shareholder and the corporation, the court may rule that the goodwill belongs to the corporation because the shareholder's activi-

ties are deemed to be owned by the corporation. Even where an employment agreement is in place, the lack of an effective covenant not to compete may still persuade the Court that the goodwill is personal to the shareholder, because the corporation failed to protect what might otherwise be a corporate asset.

Internal contractual arrangements aside, courts will attempt to determine whether such goodwill is directly traceable to the continued presence of an individual participating in the business. A determination that Personal Goodwill exists is more likely if the shareholder has maintained a strong personal relationship with the corporation's customers.

As a rule, most buyers of a corporate business will prefer to purchase the corporate assets, rather than the corporation itself

The buyer in the purchase of Personal Goodwill separate from corporate assets must clearly agree to a purchase structure that separates the sale of the Personal

Goodwill and the assets of the corporation. In practice, however, buyers of closely-held C-corporations will not oppose such deal structures because the overall purchase price will be the same. The tax treatment to the buyer of the Personal Goodwill purchase will also be the same as if it were included as part of the corporate goodwill.

PROCEED WITH CAUTION

The availability of Personal Goodwill in the sale of a C-corporation is not fully settled in the law, and the Internal Revenue Service may elect to challenge its separate existence because of the resulting favorable tax consequences to the shareholder.

Personal Goodwill has no precise legal definition and is always factually dependent. Therefore, before pursuing a sale of Personal Goodwill separate from other corporate assets, the shareholders need to establish a strong factual basis for both the existence of Personal Goodwill and its value.