



BUSINESS COUNSELING UPDATE

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FEDERAL RULING ENDANGERS NEBRASKA ANTI-CORPORATE FARMING LAW

A recent decision of the Federal Eighth Circuit Court of Appeals ("8th Circuit") places the future of Nebraska's anti-corporate farming law, Initiative 300, in doubt. In November, the 8th Circuit Court of Appeals in St. Louis upheld earlier decisions by a three judge panel of the 8th Circuit in August and the Federal District Court in South Dakota last year ruling that South Dakota's anti-corporate farming law, Amendment E, is unconstitutional. Each of the decisions determined that Amendment E violates the commerce clause found in the Fifth Amendment to the Constitution of the United States because its provisions discriminated against interstate commerce.

The significance of these rulings is that the provisions of South Dakota's Amendment E were modeled after the provisions of Nebraska's Initiative 300. While Initiative 300 has survived previous legal challenges, the most recent in 1991, the legal argument that Initiative 300 violates the commerce clause has not yet been raised. The 8th Circuit's decision, pending a possible appeal to the United States Supreme Court, will provide a strong legal precedent for a renewed challenge to Initiative 300 on this ground.

While there are some differences in the language of Amendment E and Initiative 300, there is no doubt that the 8th Circuit's decision will create momentum for a renewed challenge to Initiative 300 in Nebraska and to anti-corporate farming provisions in states such as Iowa, Minnesota, Kansas, Missouri, Wisconsin and Oklahoma.

Ryan N. Boe



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IRS CONTINUES ITS ASSAULT ON FLPs AND LLCs

The last several years, the Internal Revenue Service (“IRS”) has been making a concerted effort to frustrate the family gifting and business transition planning that has become popular for many family businesses. In the recent case of *Hackl vs. Commissioner*, 355 F.3d 664 (7th Cir. 2003), the Circuit Court of Appeals for the Seventh Circuit affirmed a Tax Court decision which sustained the Commissioner’s determination of a substantial tax deficiency against Mr. and Mrs. Hackl in a fairly typical limited liability company arrangement. In the *Hackl* case, Mr. and Mrs. Hackl commenced a tree farming business following Mr. Hackl’s retirement. The Hackls formed a limited liability company (“LLC”) and gifted shares in the company to family members. As is typical in this sort of planning, Mr. and Mrs. Hackl initially owned all of the LLC’s ownership interests and Mr. Hackl served as the company’s sole manager. The Hackls subsequently gifted over 51% of the ownership interest in the LLC to various family members. Those gifts were structured in a manner that each donee was gifted approximately \$10,000 per year from each parent. Although the IRS imposes a tax on gifts of a present interest in property, a donor does not pay tax on the first \$10,000 of a gift (now \$11,000), so long as the gift is a present interest in property as opposed to a future interest.

Under the facts of the *Hackl* case, the IRS took the position that transfers of ownership interests in the LLC were gifts of future interests and therefore did not qualify for the annual \$10,000 exclusion.

Because of Mr. Hackl’s dominance of the LLC and because the tree farming

operation, which was being operated by the LLC, was not designed to produce income until many years into the future, the transfers of the LLC ownership interests were gifts of future interests, rather than present interests; and, therefore, the gifts did not qualify for the \$10,000 annual exclusion. In sustaining the Service’s position, the Tax Court and the Seventh Circuit Court relied primarily upon the LLC’s operating agreement and concluded that the terms and provisions of the operating agreement precluded the donees from realizing any substantial present economic benefit. Under the terms of the operating agreement, Mr. Hackl was appointed as manager for life and the various members of the LLC could not transfer their ownership interests in the LLC without the consent of the manager. The court concluded, in substance, that the operating agreement, for all practical purposes, barred alienation of an ownership interest as a means of presently obtaining economic value.

The use of family limited partnerships and limited liability companies continue to be legitimate planning tools for transitioning family businesses.

The Hackls argued that the LLC was set up like any other limited liability company and that its restrictions on the alienability of its shares are common in closely held companies. The Seventh Circuit Court acknowledged that that may be true from a business point of view, but concluded that such a provision does not mean that ownership interests in such companies (family limited partnerships and limited liability companies) should automatically be considered present interests for purposes of the gift tax exclusion.

Cases such as the *Hackl* case are

typically decided on a facts and circumstances basis. Unfortunately for the Hackls, they had some very bad facts. First, the parties acknowledged that the tree farming business was not designed to produce current distributable income to the members of the LLC for many years into the future. Second, Mr. Hackl was the sole manager of the company and was in a position to prevent, or at least significantly discourage, any transfer of ownership interests to unrelated third parties. Third, future distributions of profits from the LLC were to be made solely in the discretion of Mr. Hackl as the general manager. Based primarily on those facts, the Tax Court and the appellate court agreed with the arguments advanced by the IRS that the gifts of limited liability interests were future interests, rather than present interests; and, therefore, did not qualify for the \$10,000 annual exclusion.

As indicated above, the *Hackl* case represents a continuing effort by the IRS to limit the use of family limited partnerships and limited liability companies for family gifting and transition purposes. The principal arguments over the past 10 or 15 years have been in the area of valuation discounts; however, the Commissioner has been shifting ground during the past four or five years to argue that the gifts should not be respected as gifts of present interests or that there is a retention of an interest in the transferred membership interest by the donor and therefore those transfers are really not completed gifts.

The use of family limited partnerships and limited liability companies continue to be legitimate planning tools for transitioning family businesses from one generation to another, but the *Hackl* case makes it clear that careful planning is essential.

Robert J. Murray



IOWA COURT AWARDS UNEMPLOYMENT BENEFITS DESPITE POSITIVE DRUG TEST

A manufacturing worker's positive drug test could not be used as the basis for denying him unemployment benefits because his employer did not substantially comply with statutory drug testing provisions intended to protect employees' rights, the Iowa Supreme Court recently ruled in a unanimous decision.

The Iowa Employment Appeal Board denied an employee's application for unemployment benefits after Victor Plastics, Inc. fired him for testing positive for marijuana. Remanding the case to the Board for award of benefits to the employee, the Supreme Court held the Board may not rely on a positive drug test to deny unemployment benefits if the employer failed to comply with Iowa's workplace drug testing law.

"Although the legislature now allows random workplace drug testing, it does so under severely circumscribed conditions designed to ensure accurate testing and to protect employees from unfair and unwarranted discipline," the court held. "Although an employer is entitled to have a drug free workplace, it would be contrary to the spirit of Iowa's drug testing law if we were to allow employers to ignore the protections afforded by this statute, yet gain the advantage of using a test that did not comport with the law to support a denial of unemployment compensation."

Like Iowa, Nebraska permits employee drug testing, but places certain restrictions on testing procedures. While there is no reported decision addressing drug testing and unemployment compensation in Nebraska, the result would no doubt be the same. If an

employer fails to follow the law, its employee will still be entitled to benefits even if drug test results are positive. Employers should consult legal counsel if they have any questions about how to legally test their employees for drug use.

Brian J. McGrath

BUY-SELL AGREEMENTS NEED REVIEW

The Financial Accounting Standards Board ("FASB") recently promulgated Statement No. 150 which states that "a mandatorily redeemable financial instrument shall be classified as a liability unless the redemption is required to occur only upon liquidation or termination of the reporting entity." Since 1973, FASB has been the designated organization in the private sector for establishing standards of financial accounting and reports. These standards govern the preparation of financial reports. They are officially recognized as authoritative by the Securities and Exchange Commission and the American Institute of Certified Public Accountants.

The financial instruments impacted by Statement No. 150 are freestanding agreements which embody obligations for the issuer, such as buy-sell agreements, certain LLC restriction agreements, certain partnership agreements, certain employee stock option agreements, and certain ESOP agreements, etc.

The death of a shareholder of such a financial instrument is an event that is certain to occur according to Statement No. 150.

A simple, common and far reaching example may clarify the potential impact of Statement No. 150. Take for example, a corporation that issues stock to its shareholders and requires

its shareholders to execute a buy-sell agreement. Further assume that the buy-sell agreement requires the corporation to redeem shares of stock issued to its shareholders at fair market value upon the death of its shareholder. The corporation, according to Statement No. 150, would have to classify the fair market value of its stock issued to its shareholders as a liability on its books of record rather than as equity. The consequences of that financial reporting requirement could be potentially devastating. Consider the ramifications to this hypothetical corporation if the corporation has outstanding debt with a local lender and a condition of default contained in the debt agreement is the maintenance of a certain debt to equity ratio. According to Statement No. 150 the hypothetical corporation's credit side of its balance sheet would be 100% liabilities and 0% equity, which could be considered an event of default resulting in forfeiture of collateral and other potential remedies for default.

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Statement No. 150 takes effect with respect to mandatorily redeemable financial instruments issued by nonpublic entities for fiscal periods beginning after December 15, 2004. Thus, there is an opportunity for business owners to review and analyze their buy-sell agreements with their legal counsel in order to amend the agreements if necessary to avoid the potentially devastating impact of Statement No. 150.

Matthew J. Bock



ESTABLISHING ACCOUNTS FOR MINORS

Parents and grandparents often are interested in establishing accounts for minors, most frequently for the purpose of saving for future education expenses. There are several different financial vehicles by which this can be done. Traditionally, Uniform Transfers to Minors Act ("UTMA") accounts were most commonly utilized. However, college savings plans or Section 529 plans as they are commonly called have become increasingly popular. Transferring the assets of a UTMA account to a 529 plan offers some benefits, but raises several tax, fiduciary and asset protection issues that should be examined before converting a UTMA account to a 529 plan.

The minor in a UTMA arrangement is considered the owner of the property in the account, while a 529 plan

beneficiary has no rights to the property in the 529 account. The custodian of a UTMA account is held to certain standards of accountability under state law, while the owner of a 529 plan has no parallel duty to act in a certain fashion towards the account assets.

Contributions to 529 plans grow in an income tax-deferred environment and distributions for specified higher education expenses are free from federal income tax. Thus, there are clear income tax advantages to 529 plans. However, Section 529 plans accept only cash contributions which will require the liquidation of a UTMA account before the UTMA account assets can be transferred to a 529 plan. Such a liquidation will most likely be a taxable event and cause the UTMA account to incur tax liability reducing the relative advantages of converting to a 529 plan, and also raises fiduciary concerns for the custodian of the UTMA account.

Transfers made to 529 plans are generally not included in the donor's estate, while transfers to UTMA accounts may be included in the donor's estate in certain circumstances. It is unclear whether transferring UTMA account assets to a 529 plan eliminates such inclusion. In addition, UTMA account assets are protected from attacks by creditors of the donor, while assets in a 529 plan may not be as well protected.

Liquidating a UTMA account and transferring the assets to a 529 plan is an option custodians of UTMA accounts should consider, but custodians need to examine the numerous tax, fiduciary and asset protection issues before doing so.

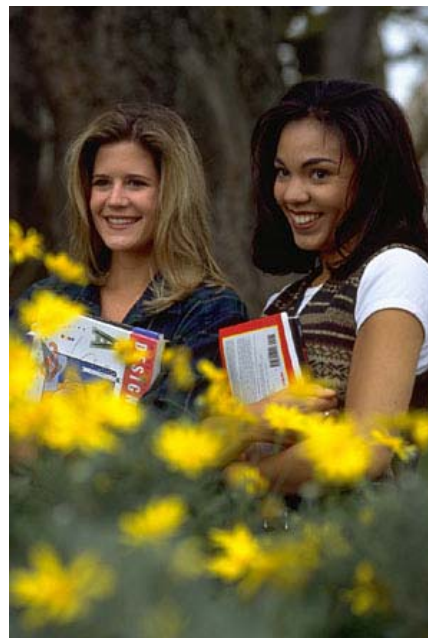
Angie M. Pelan

EMPLOYERS GET REPRIEVE ON COBRA NOTICES

The Department of Labor recently issued new rules concerning COBRA notices. They would require employers to give special notices to new and departing workers about their right to buy health care coverage after leaving the company. The new rules were expected to become effective on January 1, 2004, but have been postponed to July 1, 2004, giving employers six extra months to get up to speed. Some employers had complained that more time was needed to adjust their computers. The proposed model notices can be used right away, however, if an employer chooses.

For a review of the new rules, visit the Federal Register at <http://www.dol.gov/ebsa/newsroom/fs052803.html>

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