

WORKING OWNERS TRUMP BANKRUPTCY TRUSTEE

One of the disadvantages of a pension or profit sharing plan subject to ERISA is that the contributions to the Plan by the company and the employee cannot be taken out until a distribution event (such as death, termination of employment or retirement) occurs. One of the many advantages of placing money in a pension or profit sharing plan is that a creditor of a participant also generally cannot remove the money from that pension or profit sharing plan without the consent of the participant in the plan.

This situation generally results in creditors waiting for a Plan participant to request a distribution from a pension or profit sharing plan before they try to grab onto the money. What has generated some uncertainty has been the status of funds placed in a pension or profit sharing plan by the working owner of a business. Many creditors have taken the position that the sole shareholder and president of a professional corporation cannot qualify as a participant in a qualifying pension plan under ERISA and that any funds that are deposited into the pension or profit sharing plan by that owner must be immediately available to creditors and not wait until the working owner attempts to take the money out of the plan.

The U.S. Supreme Court finally resolved this issue. Dr. Yates was the sole shareholder and president of Raymond B. Yates, M.D. PC, a professional corporation. His company maintained the Raymond B. Yates profit sharing plan. As required by the Internal Revenue Code and Title 1 of ERISA, this plan contained an anti-alienation provision that said that

no funds held in the plan were subject to assignment or alienation, either voluntarily or involuntarily. Dr. Yates was the administrator and trustee of the plan. From the inception of the plan, at least one person other than Yates or his wife was a participant in the plan.



Dr. Yates' business suffered some financial setbacks and Dr. Yates filed bankruptcy. Prior to filing bankruptcy, Dr. Yates repaid a delinquent loan that he had taken out from the plan. The money he used to repay the plan came from the sale of his house.

The bankruptcy trustee attempted to seize Dr. Yates' interest in the plan. The bankruptcy court ruled that the bankruptcy trustee had the right to recover that money, because it had been a preferential transfer under the bankruptcy code. The Sixth Circuit Court of Appeals affirmed the bankruptcy court, stating that Dr. Yates was not a qualifying participant in the profit sharing plan for ERISA purposes because he was the owner of the company.

The U.S. Supreme Court accepted Dr. Yates' appeal and reversed both the lower court and the Sixth Circuit Court of Appeals. Although the Supreme Court admitted that ERISA does have some tangled wording, it went on to say the concept was clear in ERISA that a working owner of a company was a participant in an ERISA qualified profit sharing plan set up by that company so long as at least one employee of that company other than the owner and the owner's spouse was a participant. Since Dr. Yates account was in a plan which always included participants other than Dr. Yates and his wife, the Court held that his account was not subject to attachment by the bankruptcy trustee and would

WHAT'S INSIDE

	page
Owners Are Workers Too	2
Upcoming Seminars	3
Business Section	4
Tax Updates & Planning	5

OWNERS ARE WORKERS TOO!

A physician ("Dr. Brekke") joined with several investors to set up a company to develop and market patents on medical products that had been developed by the doctor. Pursuant to the terms of an employment contract with the company, the doctor received 15% of the common stock of the company for services to be performed. In addition, the doctor served on the board of directors for the company and was a vice president of research and development.

After the company had been operating for over a year, the company made loans to the doctor and received promissory notes from him. These notes were supposed to be repaid in 1991, but the doctor didn't do so. He repaid a small amount in 1993. The company then adopted a practice of only paying employee salaries if it had enough current case flow. As a result, for the period 1993 through 1998, the doctor's salary was accrued but unpaid. The total accrued but unpaid amount as of June 30, 2000 was \$188,872.

The company got lucky twice in the year 2000. First, the company began negotiating for the possible sale of its assets. Second, the company received \$950,000 in settlement of a licensing dispute with a third-party.

As a result of the negotiations to sell the company, the president of the company informed Dr. Brekke that the amount of his unpaid notes would be deducted from his accrued unpaid salary. After further discussions, the company refused to pay him the gross unpaid salary and issued him a net check of approximately \$60,000. This check purportedly included all of Dr. Brekke's accrued salary less tax withholdings and a \$60,000 deduction for the outstanding loans. Although he was an officer and director of the company, Dr. Brekke did not forward his attorney's advice to the company. Instead, he accepted and cashed the \$60,000 check.

Dr. Brekke consulted with an attorney. His attorney informed him that the company's actions in reducing his unpaid salary without his consent would expose the company to a statutory penalty of double the withheld amount (\$120,000) under Minnesota statute 181.79.

At the same time, Dr. Brekke made positive representations to the purchasers of the company about the accuracy of the corporation's balance sheet even though it did not reflect any unpaid liability to Dr. Brekke. In addition, Dr. Brekke signed an officer's certificate that represented that the company had no undisclosed liabilities. Dr. Brekke received just over \$2,000,000 when the assets of the corporation were sold. Within 60 days of closing, Dr. Brekke commenced a lawsuit to recover \$120,000 from the company under Minnesota statutes §181.79.

In addition to denying any liability for the \$120,000, the company asserted the affirmative defense of waiver and estoppel in defending this lawsuit. After considering these issues, the District Court concluded that the company had wrongfully deducted \$60,000 from Dr. Brekke's wages, doubled that amount under Minnesota statutes §181.79 and awarded Dr. Brekke \$120,000 in damages.

The District Court did not make any findings or otherwise address the corporation's waiver and estoppel defenses. The court did conclude that Dr. Brekke's position as an officer, director and shareholder did not disqualify him from relying on §181.79 and that none of his actions or inactions provided consent to the corporation deducting the \$60,000 from his payment. The Court of Appeals affirmed the judgment in favor of Dr. Brekke. The corporation then appealed the case to the Minnesota Supreme Court.

The Supreme Court affirmed that Minnesota Statute §181.79 applied to Dr. Brekke's unpaid salary. The Court said that Dr. Brekke was an employee of the company. His additional positions as an officer, director and shareholder did not give the company the right to either treat him as a non-employee or to treat his salary as other than wages. The Court went on to state that Minnesota Section §181.79 contains only four exceptions which authorize a company to deduct claimed indebtedness to the company from an employee's salary.

These exceptions are:

- a. The employee was held liable in court for the indebtedness,
- b. There is a contrary provision in a collective bargaining agreement,
- c. The deductions are made pursuant to

- rules established by the employer for commission salespeople, or
- d. The employee voluntarily authorized in writing, after the indebtedness arose, that the debt shall be deducted from the employee's wages.

Even though Dr. Brekke was more than just an employee of the company, the court stated that it was undisputed that he also was an employee, and the money he was to receive as accrued salary were wages. As a result, the court agreed with the Court of Appeals that the corporation made an unauthorized deduction of a debt running from the employee to the employer.

After affirming on that issue, the court went on to state §181.79 does not eliminate a company's ability to raise the affirmative defenses of waiver and estoppel. Since there is factual support for these defenses in the record and the District Court made no findings or conclusions regarding them, the Court reversed the judgment and remanded it to the District Court to address those issues.

The Brekke case confirms that shareholders, officers, and directors also are entitled to the same statutory protections that are provided to plain folks in their companies. It may not always be a level playing field, but this case emphasizes that the partnership and corporate laws apply across the board and cannot be ignored even when it looks like the big folks are using those laws to their advantage.

If you have any questions, please contact Mark Radke or Terry Cullen of our Minneapolis office.

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TAX UPDATES article continued from page 5

a shareholder at a lower cost and preserve the shareholder's basis for a later time when he or she is ready to completely exit the business.

Tax-Free Exchanges for Tangible Personal Property

In Revenue Procedure 2003-39, the IRS provided safe-harbor rules for companies that regularly buy and sell large quantities of tangible personal property. These guidelines clarify existing rules and provide a framework for establishing ongoing tax-free exchanges under a "like-kind exchange program." Under such a program, a company enters into a master exchange agreement with a single qualified intermediary. The company then assigns to the intermediary its rights under existing and future agreements to buy and sell property. The assets are segregated into groups and the exchange is executed via a matching of groups. Each exchange is considered separate and distinct, which means that each transaction must independently qualify as a tax-free exchange under Section 1031.

Companies that own heavy equipment, fleets of vehicles or other big ticket items can benefit from tax-free exchanges. Because of the relatively short depreciable life of these types of assets, a disposition every few years can generate a tax on the sale while requiring additional cash outlay for the replacement property. A Section 1031 exchange will simply roll over the basis of the old property to the new, defer the gain, and may free up cash for the business. Property acquired in a Section 1031 exchange and placed in service before January 1, 2005 is eligible for the 50% bonus depreciation allowance.

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TAX UPDATES & PLANNING

Economic Substance of Circular Loans

A shareholder's basis in his or her S corporation stock is important for a myriad of reasons, including the ability to deduct losses resulting from corporate business activities. In general, S corporation shareholders can deduct their share of corporate losses only to the extent that they have basis in their S corporation stock. Shareholders' bases are increased by their respective share of income, contributions and loans to the corporation, and reduced by withdrawals and losses.

Unlike a partnership, the entity-level debt of an S corporation does not increase the stock basis of its shareholders. This is true even if the shareholders personally guarantee the corporate debt. Only a direct loan by a shareholder to the corporation increases the stock basis of that shareholder. Hence, S corporation shareholders may borrow from a third-party source of financing, and then loan the funds to their corporation. In a recent Eighth Circuit case, *Oren v. Commissioner*, 357 F.3d 854 (8th Cir. 2004), the taxpayer tried to take this concept a step further.

In *Oren*, the taxpayer's family owned three S corporations, two of which generated substantial losses due to accelerated depreciation. The taxpayer had insufficient basis to deduct the losses. Consequently, he borrowed money from the profitable corporation, and loaned the funds to his two loss corporations. The two loss corporations, in turn, loaned the funds back to the profitable corporation. All of the transactions had the same payment terms and interest rates.

The IRS disallowed the claimed increases in basis, asserting that although all of the formalities for a binding loan arrangement were observed, the loans were not real investments. The Tax Court agreed and upheld substantial deficiency assessments by the IRS. On appeal, the Eighth Circuit affirmed, stating that the loans were not actual economic outlays and that the transactions "much more closely resemble[d] offsetting book entries or loan guarantees than substantive investments."

Oren demonstrates that loans by S corporation shareholders to their corporations must involve real economic outlay with a genuine risk of loss to the shareholders.



To ensure economic substance, such loans should be made from the shareholders' own money or funds for which they are individually liable, such as third-party loans. If the funds are derived from a related corporation, they should come from actual distributions made to the shareholders.

Taking Advantage of the Reduced Dividend Tax Rate

The reduction of the dividend tax rate to 15% has created unique opportunities for owners of closely-held businesses. The reduced rate applies even to dividends paid using borrowed funds. Consequently, for those business owners looking to tap into their equity, the reduced rate provides an opportunity for the company to take out a loan and distribute the funds to shareholders. Caution should be taken, however, to not excessively leverage the company to the extent that there would be adverse consequences, such as interest expense deduction disallowance or violation of state law relating to adequate capitalization and dividend distributions.

In addition, for businesses whose older shareholders and members are looking to retire in a few years, the lower dividend rate allows such individuals to gradually phase out of the business. Generally, unless specific requirements are met, a redemption is treated as a dividend under the Internal Revenue Code, which, prior to the tax rate reductions, generated an effective tax rate as high as 60%. Using the reduced rate, a closely-held business could partially redeem

Dividends will continue to be less advantageous for tax purposes than capital gain transactions, if there is any basis to be counted. Nevertheless, the rate reduction may open some planning opportunities that were previously tax-cost-prohibitive.

WORKING OWNERS article continued from page 1

remain in that account until a distribution event occurred for Dr. Yates' account under the plan. The Yates' case did clarify this situation and get all of the federal courts pointed in the right direction.

However, you should think twice before assuming that parking your money in a pension plan will protect you from creditors. There are restrictions on the dollar amounts that can be placed into a qualified pension plan under ERISA. In addition, there are restrictions on when the money can be removed. Money held in a pension or profit sharing plan can not simply be shifted from item to item to take care of the expenses of the owners in the business.

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Business Report

The Business Report is an update on legal developments. It is not intended to be legal advice and should not be relied upon without consulting counsel.

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