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NEWSLETTER

THIRD / FOURTH QUARTERS 2014

USING "PORTABILITY" TO SIMPLIFY YOUR ESTATE PLAN

By Andrew Heinz

Changes to federal tax law may allow you to simplify your wills or revocable living trust. Through the introduction of a concept called "Portability," married couples no longer need to leave their estate to the surviving spouse in trust to preserve the deceased spouse's exemption from federal estate tax. Traditionally, a deceased spouse left up to his or her exemption from federal estate tax to a "bypass" or "credit shelter" trust, naming the surviving spouse as the sole beneficiary during his or her lifetime. Each individual's exemption from federal estate tax is currently $5,340,000, which is reduced by any lifetime taxable gifts. The amount held in trust would not be subject to estate tax in the surviving spouse's estate.

In addition to this trust to hold the federal exemption from estate tax, a separate but similar trust was created under state law to hold an amount up to the deceased spouse's exemption from state estate tax (currently $2,012,000). Some wills and revocable trusts plan for the creation of more than two separate trusts for the benefit of the surviving spouse. With each trust comes separate titling of assets, separate accounting, and separate income tax reporting. Each trust carries an ongoing administrative cost and complication for the surviving spouse.

In addition to setting a permanent federal estate tax exemption and rate, after several years of uncertainty, the American Taxpayer Relief Act of 2012 (ATRA), made permanent this concept of Portability or the "deceased spouse unused exemption amount." What this means is that the surviving spouse may elect on a timely-filed estate tax return to make use of his or her spouse's unused exemption from federal estate tax at his or her death. Assuming neither spouse used any of their exemptions through lifetime taxable gifts, the surviving spouse's estate would not pay any federal estate tax to the extent it does not exceed $10,680,000,

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without having had to shelter the deceased spouse's exemption in a trust as was typical in traditional planning.

Practitioners now generally agree that planning for the surviving spouse to make a "Portability election" is preferable to creating a trust to preserve the deceased spouse's federal estate tax exemption. In addition to creating simplicity and reducing administrative cost to the surviving spouse, Portability is generally more favorable than a trust, considering income taxes during the life of the trust and the ability to avoid capital gain taxes after the trust is terminated.

If you and your spouse have a combined estate that may be exposed to federal estate tax when the second of you dies, your wills may only need one trust to hold the deceased spouse's exemption from state estate tax. Rather than create a separate trust to hold amounts above this exemption, your wills would contain provisions planning for the surviving spouse to make a Portability election to protect against federal estate tax.

EMPLOYEE OWNERSHIP

By Kirsten Barron

Most of our clients point to their employees as a key reason for success. We often have clients ask about transferring a stake in the business to employees. It may be as simple as passing along profit in the company to key employees or more complicated—creating a succession plan where a key employee or employees will acquire full ownership. We have clients who simply give discretionary bonuses to key employees based on profits, and we have other clients who are in 10-15 year buyout plans where key employees will acquire all of the departing owner's interest in the business or an Entrepreneur Rollover Stock Ownership Plan (ERSOP) – and everything in between.

Why Share Ownership in Your Company?

Companies share ownership with employees for a variety of reasons. For some people, the reason may be simply "it's the right thing to do." For most others, however, there are purely practical reasons to share ownership. Employee ownership can have benefits for owners. Among these are:

- *To encourage employees to perform at their best.* Many business owners believe that employees will do their best when the employees are entitled to a share of the profits – why make the extra sale or the extra effort at customer service – because the employee shares in the upside of that.

- *To attract and retain good employees.* Many businesses are concerned about attracting and retaining good employees. Employee ownership can be an important benefit.

- *To buy out an owner.* Owners must pass on their ownership – at least someday. Transferring to employees can be an option.

- *For shared ownership.* Many people find that sharing the responsibilities of ownership with others lessens these burdens.

- *To raise capital.* Employee ownership can help provide additional capital. Employee owners may be willing to contribute to the company by buying shares or taking lower wages in return for an ownership interest.

- *To make the business perform better.* There is evidence to support that, on average, employee-owned firms perform better than non-employee owned firms when ownership is combined with employee participation in decisions affecting their work.

- *For tax benefits.* There can be tax benefits in sharing ownership. We encourage you to discuss these with your tax professional.

A Stake in the Business

Employees can receive a stake in the business through a bonus program that is linked to business profits. This can be as simple as calculating a percentage of the gross revenues of the business (or other number) and giving that to employees as a bonus. Sometimes employers will create a Phantom Stock Plan, discussed below, to provide this same sort of profits bonus to employees.

Or employers can give employees ownership. Legally, ownership of a business is a bundle of rights to enjoy the profits (and losses) of the business and to make decisions about how the business is run. The basic rights in a business are the right to company income, the right to the surplus value of the company

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EMPLOYEE OWNERSHIP—CONTINUED

if the company is sold, the right to make decisions about how the business should run, and the right to sell all or part of the value of the business.

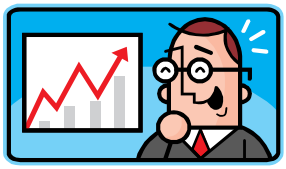
Employees can own part of partnerships, limited liability companies, or corporations. For purposes of this discussion, this article will generally deal with ownership of corporations, but the same concepts can be applied to partnerships and corporations.

OWNERSHIP ALTERNATIVES

Direct Share Ownership

Corporations can give or sell shares directly to employees. New shares can be created or they can be purchased or transferred from an owner. If employees acquire shares directly, they become direct owners and can exercise all the rights associated with ownership, including a share of the company's equity value and voting rights. Employees can receive shares that give only voting rights, only equity rights (or rights to share in the profits), or both. As with the addition of any shareholder, the parties should revisit the need for changes to an existing shareholders agreement or, if no shareholders' agreement exists, whether it is time for one. Shareholders' agreements define the rights and responsibilities among the shareholders – how do you admit new shareholders, how do current shareholders exit the company, how to transfer shares, and often how the company is governed. A shareholders' agreement is a critical part of employee ownership.

Taxation of shares transferred to employees is complicated, and the advice of a tax professional is important in crafting the best path forward. Gifts of ownership to employees can have unintended consequences when tax time comes – these "gifts" are often considered income and subject to income tax just like wages. If the employee is not prepared to pay the taxes associated with these "gifts" – it can end up being a bad experience for the employee, which is not the intention—so plan for any tax liability.



Ownership of shares provides employees with a way to share in the decision-making and profit-sharing of the company – and to share in the event the company is sold and an increase in value results.

Stock Options

Stock options are used when the primary goal of the employer is to provide a method for the employee to share in any increase in the value of the company. Because options are the right to buy something in the future, they typically have no tax consequences when granted to the employee. Because stock options are just the right to buy stock at some point in the future, there is no right to share in the profits until options are exercised.

Stock options give an employee the right to purchase shares at a price fixed today (the grant price) for a defined number of years into the future (the exercise term). Options usually are subject to vesting, so an employee might get, for instance, the right to purchase 25% of the shares available under the option grant after two years, 50% after three, 75% after four, and 100% after five. The exercise term can be any number of years, but most commonly 3-10 years. Here is how an option works - the employee has an option to purchase a share for $1.00 and exercises that option when the company sells for $10.00 a share – the employee buys a share for $1.00 (right before the sale closes) and then immediately sell it for $10.00, netting a profit of $9.00 (and having the cash to pay the taxes on that income). The purchase of the share and the sale happen at the same time so that the employee does not have to bring cash to purchase the share. There are times, however, when the employee does purchase shares before a sales event – and that may be preferred if the employee wants to participate in profits and management. This scenario is more unusual.

Options do not provide employees with any control rights or ongoing profit-sharing rights. Again, the advice of a tax professional is important for the company in the case of options as some options can have advantages for the company and others do not.

Phantom Stock and Stock Appreciation Rights (SARs)

SARs and Phantom Stock are often referred to as "fancy" bonus plans as these plans do not offer rights associated with ownership, but do offer the employee a bonus based on the increase in value of the company – usually on sale – or the right to share in profits. These plans are relatively simpler – akin to a bonus based on annual profits or gross revenues.

Phantom Stock pays employees a cash bonus equal to a certain number of shares (just like getting profits if the employee actually owned the shares) – but there are generally no management rights. Phantom

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EMPLOYEE OWNERSHIP—CONTINUED

Stock can also pay out on the sale of the company as the phantom shares may entitle the employee to share in sales revenue as well; SARs pay employees a cash bonus on the increase in the value of a certain number of shares. Employees are granted a certain number of Phantom Stock units or SARs, almost always with vesting requirements. They pay no tax at grant. When the awards vest, then employees generally pay tax, while the company generally gets a corresponding deduction.

If the employer is using stock value as a tool to reward services, it is important that there be a way to determine value. If there is no third party purchasing your stock, which is almost always the case with small companies, how do you determine value to compensate employees? Value can be determined by a formula based on revenues or growth. Value can also be determined by an appraiser. This is a difficult and important piece to the puzzle for small businesses that have employee ownership – on what basis does the employee realize value?

Considerations

The fundamental decision for those business owners considering employee ownership or profit-sharing is whether it will further the owners' business goals. The fundamental difference is that bonus-type plans generally keep control and decision-making with the current owners and in ownership-type plans, owners share control and decision-making with employees. Is the company looking for a successor owner? Is it acceptable to share ownership of the company with employees if there are some control provisions outlined in a shareholders' agreement? Once that fundamental questions on purpose and intention are answered, then it is important to consider how to structure the plan with employees.

With the bonus-type plans – Phantom Stock and Stock Appreciation plans – employers should consider what they are trying to motivate – longevity of an employee, an increase in profits, an increase in share value or both. How the employer structures the bonus will drive employees towards certain goals.

If the employer opts for ownership, these same considerations are applicable, but also important are how employees will receive their ownership (as part of their compensation, or some combination), is there a vesting requirement to encourage employees to stay at the company, how do employees "cash-in" their shares, how is value determined, are there any provisions required in a shareholders agreement to govern control and decision making?

Employee ownership is a very exciting prospect. Employees can become even more invested in the business if they have an ownership stake. They can also be an in-house succession plan for owners looking to exit the business at some point. However, dealing with additional owners presents its own challenges with regard to control and decision making. For those owners wanting to share the benefits of increased profits and company value but reluctant to share in control and decision making, simple bonus plans based on company performance and Phantom and Stock Appreciation Plans can be very attractive. Every company and every owner is different and has different goals and values – and tax consequences. Sharing profits or ownership with employees requires careful consideration with legal and tax professionals.

Please be aware that a company named ANNUAL BUSINESS SERVICES is mailing notices to business entities requesting that "Annual Minutes" and a fee of $125.00 be sent to it for filing.http://www.sos.wa.gov/corps/consumeralert.aspx.

These notices ARE NOT from the Washington Secretary of State's Corporations and Charities Division. "Annual Minutes" are NOT required to be filed with the Secretary of State. They are to be kept by the business entity itself.

DO NOT confuse these notices with the annual report notices sent by the Washington Secretary of State, or the Business Licensing Services at Department of Revenue reminding each business to file its 2014 annual report.

If you have received a notice in the mail and are uncertain if it is related to the fraudulent mailings, please contact Debbie Nelson at 360-733-0212 or the Secretary of State's office at 360-725-0377.

If you have completed the Annual Business Services form under the impression is was official and paid the $125 fee requested, you may file a consumer complaint with the Attorney General at http://www.atg.wa.gov/FileAComplaint.aspx.

AFFORDABLE CARE ACT (FOR EMPLOYERS)

By Mike Martucci

In an effort to provide quality healthcare to all Americans, the Patient Protection and Affordable Care Act (ACA) requires employers with 50 or more full-time employees (FTE)[1] to provide health insurance to those employees and their dependent children or, in the alternative, pay a monthly penalty or employer mandate, known as an Employer Shared Responsibility Payment.[2] Given the complexity of implementing such a massive reform to our healthcare system, the Treasury Department and the Obama Administration recently announced a "transition relief" under which the employer mandate will not be enforced until either 2015 or 2016, depending on the employer's number of employees.[3] The following is a summary of the newly announced transition relief geared toward employers.

Simply put, the employer penalties will go into effect starting in 2015 for employers with 100 or more FTE and in 2016 for employers with 50 or more FTE.[4] Specifically, employers must offer affordable health insurance to 70% of their FTE in 2015 and a substantially all, or 95%, of their FTE in 2016 and beyond.[5] If an employer fail to do so or at least one FTE receives a tax credit or subsidy in a state or federal marketplace, the employer must pay a penalty.[6]

For insurance to be considered "affordable," an FTE's share of the premium costs cannot exceed 9.5% of that employee's household income, which can be obtained from various employer "safe harbors" such as the employee's Form W-2.[7] Further, the affordable health insurance must also be of minimum value (MV). MV is satisfied if the plan covers at least 60% of the total covered health care expenses.[8] For further clarification, the Department of Health and Human Services provides a "minimum value calculator" on its website. As for purchasing employee health insurance plans, employers with more than 50 but less than 100 FTE can shop for health plans using the Small Businesses Health Options Marketplace (SHOP).[9]

Finally, employers with fewer than 50 FTE for a calendar year are not subject to the Employer Shared Responsibility Payment; that is, they will not be penalized for choosing not to provide health insurance.[10] Similarly, employers with 25 or fewer FTE are eligible to apply for a health insurance tax credit, which could be up to a 50% tax break, if they choose to provide employees with healthcare.[11] To qualify, an employer must pay at least 50% of their FTE premiums and the average annual wage for employees cannot exceed $50,000.[12]

In sum, this brief explanation of the ACA is meant only to provide a broad framework for employers and should not be relied on for any legal or tax advice. Employers should be proactive in taking steps to fully digest an in-depth understanding of the ACA and how/when it will affect their business. To help encourage these proactive steps, listed below are excellent resources for employers to learn more about the ACA.

ACA Employer Resources:

(1) "Questions and Answers on Employer Shared Responsibility Provisions Under the Affordable Care Act" – http://www.irs.gov/Affordable-Care-Act/Employers/Questions-and-Answers-on-Employer-Shared-Responsibility-Provisions-Under-the-Affordable-Care-Act#Transition

(2) "Employer Responsibility Under the Affordable Care Act" – http://kff.org/infographic/employer-responsibility-under-the-affordable-care-act/

(3) U.S. Treasury Department ACA Fact Sheet – http://www.treasury.gov/press-center/press-releases/Documents/Fact%20Sheet%20021014.pdf

(4) "ObamaCare Employer Mandate" – http://obamacarefacts.com/obamacare-employer-mandate/

(5) "Resources for Employers on Responsibilities Under the Affordable Care Act" – http://www.leadingage.org/Resources_for_Employers_on_Their_Responsibilities_Under_the_Patient_Protection_and_Affordable_Care_Act.aspx

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[1] Under the ACA, a full-time employee is one who averages at least 30 hours of service per week or 130 hours of service in a calendar month, but also includes part-time employees' hours, which can be averaged to count toward an employer's FTE. *See* IRS, *Questions and Answers on Employer Shared Responsibility Provisions Under the Affordable Care Act*, Dec. 10, 2014, *available at* http://www.irs.gov/Affordable-Care-Act/Employers/Questions-and-Answers-on-Employer-Shared-Responsibility-Provisions-Under-the-Affordable-Care-Act#Identification [hereinafter IRS].

[2] *See* ObamaCare Facts, *ObamaCare Employer Mandate, available at* http://obamacarefacts.com/obamacare-employer-mandate/.

[3] U.S. Treasury Dep't, *Fact Sheet: Final Regulations Implementing Employer Shared Responsibility Under the Affordable Care Act (ACA) for 2015*, Feb. 10, 2014, *available at* http://www.treasury.gov/press-center/press-releases/Documents/Fact%20Sheet%20021014.pdf.

[4] *See id.*

[5] *See id.*

[6] The Henry J. Kaiser Family Foundation, *Employer Responsibility Under the Affordable Care Act*, Nov. 24, 2014, *available at* http://kff.org/infographic/employer-responsibility-under-the-affordable-care-act/.

[7] *See* IRS.

[8] *See* ObamaCare Facts, *ObamaCare Employer Mandate, available at* http://obamacarefacts.com/obamacare-employer-mandate/.

[9] *See id.*

[10] *See* IRS.

[11] *See* ObamaCareFacts, *ObamaCare Employer Mandate, available at* http://obamacarefacts.com/obamacare-employer-mandate/.

[12] *See id.*

NEW—WASHINGTON ALLOWS FOR ENTITY CONVERSIONS

By Debbie Nelson

Washington's legislators unanimously passed Senate Bill 5999 concerning entity conversions.[1] The bill amends Washington's Limited Liability Company Act and the Business Corporation Act to allow conversions between LLCs and Corporations (including conversions to and from other states having a similar conversion statute). The bill became effective on June 12, 2014.

Washington's Uniform Limited Partnership Act already allowed for conversions (within Washington); however, the new law now allows for the conversions to and from other qualifying states as well, so with the amendments to the Acts mentioned above, Washington now supports conversions of the three main business entities – corporations, limited liability companies, and limited partnerships.

Nonprofit corporations, miscellaneous corporations, and governmental or quasi-governmental organizations are excluded.

Also, the new law does not allow for sole proprietorships to convert to an entity structure.

You may recall that prior to this law, if you wanted to convert from a corporation to an LLC (or vice versa), you had to form a new LLC, transfer the assets to the LLC and then dissolve the corporation. You had to obtain a new EIN and UBI number—new bank account, etc. This is because you had to create a new "person" in the eyes of the State.

Is Conversion Right for Your Entity?

Most businesses experience change in its lifetime – changes in ownership, tax laws, or the economy may make it essential to restructure its entity, sometimes requiring an entity to be domiciled in a different state or changed to a different entity type. Prior to passing the new conversion law, the options to consider were limited, more complicated, time intensive, and costly - often requiring the formation of a new entity and either a merger or a transfer of assets and dissolution.

The new conversion law provides for a less expensive, easier method of changing an entity's type, state of formation or, both. Depending on the conversion type, the conversion will be effected by the filing of articles of conversion or similar document depending on entity type, and origination document for the new entity (i.e., Certificate of Formation or Articles of Incorporation).

Pursuant to RCW 25.15.419(1) a plan of conversion must be consented to by all the members of a converting limited liability company.

Likewise, pursuant to RCW 23B.09.030(1), the plan of conversion for a corporation must be adopted by the board of directors of the converting entity, and the shareholders entitled to vote must approve the plan. A voting shareholder may dissent from conversion and receive a fair-value payment for their shares when the shares in the newly converted organization are not as favorable in all material respects.

Effect of Conversion

A converted organization is for all purposes the same entity that existed before the conversion in a new form. The title to all real estate and other property, both tangible and intangible, owned by the converting entity remains vested in the converted organization without reversion or impairment. All debts, liabilities, and other obligations of the converting organization continue as obligations of the converted organization. (RCW 25.15.422, RCW 23B.09.050 and RCW 25.10.771). This saves a tremendous amount of administrative work over the prior process.

There are other things to consider, such as "restrictions on approval of conversions," meaning, if a member, shareholder, or partner of a converting entity will have personal liability with respect to a converted organization. Then, in addition to the approval requirements, approval of a plan of conversion must also require the signing, by each such member/shareholder/partner, of a separate written consent to become subject to such personal liability (RCW 25.15.423, RCW 23B.09.030(7), and RCW 25.10.796). We note the conversion itself does not create personal liability for owners.

The unanimous adoption of this bill by our State's legislators is a very positive sign of their commitment to providing efficient, cost-effective ways to keep businesses healthy and to encourage new growth.

This is a brief summary and specifics of your situation should be addressed with legal counsel.

[1] SB 5999 http://apps.leg.wa.gov/documents/billdocs/2013-14/Pdf/Bills/Senate%20Passed%20Legislature/5999.PL.pdf

Minimum Wage Increase

Effective January 1, 2015, Washington's minimum wage will increase from $9.32 per hour to $9.47 per hour.

UPDATE—WASHINGTON SECRETARY OF STATE REPLACEMENT SYSTEM

By Debbie Nelson

The Washington Secretary of State's office (SOS) is in the process of revising its Corporations Division's filing system and website interface to maximize desired technical and customer service requirements.

Our firm has a high volume of activity with the SOS regarding formations, mergers, dissolutions, registered agent services, etc.; therefore, we were invited to send one person from our firm to represent the executive/policy level discussions to maximize the services the SOS provides. It has been my honor to represent our firm by attending focus groups both at our State's Capital and remotely for the past two years. This focus group is contributing ideas that influence legislature and find efficient, cost-effective ways to start and grow business in Washington State.

The SOS's customer user interface design for the web pages is complete. The focus group is currently working with the SOS to maximize interoperability and customer convenience. The SOS is hoping to deliver a live and publicly available system by the first quarter of 2016. Our participation allows us an opportunity to create efficiencies for our clients.

Washington's workers' comp rates will increase 0.08% in 2015

The Department of Labor and Industries ("L&I") announced on November 25, 2014, that the 2015 average 'base' rate for workers' compensation premiums will increase by 0.08% across 324 risk classifications in 2015.

The proposed adjustment will:

1. Ensure steady and predictable rates.
2. Benchmark against wage inflation (this happens automatically in other states).
3. Slowly rebuild reserves to protect against expected changes.

HAPPY

NEW YEAR

A PERSONAL NOTE FROM THE FIRM:

Season's Greetings . . .

Some of you know that I am soon ending a six-year term on the Washington State Supreme Court's Access to Justice Board. I am deeply committed to people in our State doing well – not just my clients, but others who face barriers to accessing our justice system, whether poverty, race, language, disability, or the myriad of other things that require something more to overcome. I am grateful for the opportunity to serve—I have learned a lot about our State and more about our legal system. This work meant lots of driving. On my way to Seattle, or Olympia or Omak, I have listened to a lot of good books and countless hours of NPR—a great fringe benefit.

Earlier this month, I was listening to NPR – mid program – and a woman was explaining that during the holiday season she does something she calls "stepping back." Every time she pulls out her phone to check her mail or her texts, she stops and looks around. She says that invariably she sees something that is beautiful, sweet or just interesting. She starts this right after Thanksgiving and continues through the new year. I have adopted her suggestion and found that it has slowed me down a bit and reduced some of the freneticism that these infernal devices cause.

The end of the year can feel like a tsunami – the rush to prepare, shop, bake, and the rush to bring business and personal projects to conclusion - all culminating in a gathering of family and friends that comes with great expectations. I certainly feel all of that, but I am working on cell phone "stepping back" to capture the sweet moments and some of the meaning of the season.

I hope this holiday season brings sweet moments and the meaning of the season. All of us at Barron Smith Daugert are grateful for your confidence in us, for the privilege of working with you, and for your collegiality.

Regards,

Kirsten Barron

Happy Holidays!

CONTRIBUTORS AND EDITORS TO THIS PUBLICATION

Kirsten Barron is a partner in the firm and focuses her practice on business and employment law. Kirsten currently serves on the Board for Washington State Access to Justice, which works to achieve equal access for those facing economic and other significant barriers.

Andy Heinz joined the Firm in January of 2014 when he and Brian Hansen merged their practices with Barron Smith Daugert's estate planning department.

Debbie Nelson has been a paralegal with the firm for over 13 years, assisting in various practice areas. She has extensive experience in corporate legal services.

Mike Martucci is a guest contributor to our Newsletter. He is a new member of the Washington State Bar. Mike recently moved to Bellingham from Boston. He is currently doing contract work and looking for employment here. He was Editor in Chief, New England Law Review, which is one other reason he is such an excellent writer. We thank him for his contribution.