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TAX & TRANSACTIONS BULLETIN

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- The IRS has ruled that a Grandparent may pre-pay tuition for each of his Grandchildren free of gift tax and generation-skipping tax.
- The tuition payment must be made directly to the school.
- The tuition payments do not affect Grandparent's ability to make annual exclusion gifts to Grandchild. Thus, Grandparent can simultaneously make tax-free tuition prepayments to School on behalf of Grandchild and give $12,000 cash annually tax-free to Grandchild.
- **Caveat:** The tuition payments are non-refundable, and do not guarantee enrollment of the Grandchild. Thus, Grandparent may lose his tuition payments.
- See IRS Private Letter Ruling 200602002.

Inside this Volume:

GRANDPARENT MAY PRE-PAY TUITION FOR GRANDCHILD TAX FREE

The IRS has ruled that a Grandparent may pre-pay tuition for each of his Grandchildren free of gift tax and generation-skipping tax.[1] The tuition payment must be made directly to the school. Under current law, Grandparent may pre-pay tuition for a Grandchild to attend Private School (grades 1-12), College, or Graduate School.

The new Ruling provides a blueprint to accomplish Family goals and objectives. Many U.S. Families have accumulated significant wealth. Family goals and objectives often focus on preserving this wealth. Specifically, Family goals and objectives often include: (a) keep assets within the Family; (b) protect assets from creditors; (c) reduce income and estate taxes; and (d) avoid probate and guardianship proceedings.

The Ruling confirms that Grandparent's tuition pre-payments are exempt from gift tax and generation skipping tax.[2] There is no income tax consequence to Grandchild.[3] Additionally, Grandparent reduces his taxable estate and saves estate tax dollars. Finally, the tuition payments do not affect Grandparent's ability to make annual exclusion gifts to Grandchild. Thus, Grandparent can simultaneously make tax-free tuition prepayments to School on behalf of Grandchild and give $12,000 cash annually tax-free to Grandchild.[4]

By reducing taxes, promoting education, and providing Family benefits, Grandparent accomplishes important Family goals. The new Ruling confirms certain advantages of a Tuition Prepayment arrangement, thus providing a blueprint for Grandparent[5] to accomplish multiple Family objectives.

[1] PLR 200602002.

[2] Code Section 2503.

[3] *See* Code Section 102(a).

[4] Code Section 2503(b); Regulation 25.2503-6(a). A Tuition Prepayment program has a distinct advantage over a 529 Plan. Under a Tuition Prepayment program, Grandfather can make tax-free tuition payments to a school on behalf of Grandchild and simultaneously give $12,000 cash annually tax-free to Grandchild. Contrarily, if Grandfather makes contributions to a 529 Plan for Grandchild, then Grandfather reduces his ability to make additional tax-free cash gifts to Grandchild. For instance, if Grandparent contributed $8,000 to a 529 Plan for Grandchild, then Grandparent could only give an additional $4,000 tax-free to Grandchild in that year. *See* Code Section 529(c)(2).

[5] The tuition prepayment exemption is not limited to Grandparents. Generally, any U.S. taxpayer may make an exempt tuition prepayment. There is no requirement that donor and donee be related by blood, marriage, or otherwise. Regulation 25.2503-6(a). There is a similar exemption for Medical Care Payments.

GRANDPARENT MAY PRE-PAY TUITION FOR GRANDCHILD TAX FREE (cont'd)

A Tuition Prepayment arrangement is subject to a caveat: the tuition prepayments are non-refundable, become the sole property of the School, and do not guarantee Grandchild's enrollment. Thus, if Grandchild fails to qualify for admission, transfers to a different school, is expelled, or declines to attend, the Family may forfeit the prepaid tuition.[6]

The following Example summarizes a Tuition Prepayment arrangement.[7]

Grandfather proposes to enter into an arrangement to prepay tuition payments for Grandchildren 1-6 directly to School for School Year 1 and for multiple years thereafter. School is an educational organization described in Section 170(b)(1)(A)(ii) of the Internal Revenue Code.

Grandfather proposes to enter into a separate written agreement with School with respect to each of Grandchildren 1-6. Under the terms of each agreement, Grandfather agrees to prepay the total annual tuition for the respective Grandchild for each grade level through graduation (grade 12). The amount to be paid under each agreement is set forth on a schedule attached to the agreement and is determined based on the current tuition rates charged by School. The agreements provide that the tuition payments are in payment of tuition for each Grandchild through completion of Grade 12. Under the agreement, Grandfather acknowledges that tuition may increase in subsequent years and the balance due after the application of the prepayment for that year will paid by Grandfather, or by the parents of the respective Grandchild (who will a sign a consent and joinder.) The agreements provide that the tuition payments are non-refundable, and once paid become the sole property of School. Finally, the prepayment does not afford the respective Grandchild any additional rights or privileges over any other student, does not guarantee enrollment, and the School expressly reserves all rights under its standards policies and procedures.

Caveat: The tuition payments are non-refundable, and do not guarantee enrollment of the Grandchild. Thus, Grandfather may lose his tuition payments.[8]

[6]The Grandparent could have a written agreement with the School stating that if Grandchild enrolls in a new school, then the remaining tuition monies will be forwarded directly to that new school. However, the IRS has not approved this technique.

[7]From PLR 200602002.

[8]Grandfather is not entitled to an income tax deduction for his initial tuition prepayment, since his payment to School is made in exchange for goods or services. However, if a Grandchild later fails to attend School, then Grandfather may be entitled to an income tax deduction for a charitable contribution. See Code Section 170(c); U.S. v. American Bar Endowment, 477 U.S. 105 (1986) (Supreme Court).

COVENANTS NOT TO COMPETE – BUSINESS AND TAX ASPECTS

A service business depends on good relationships with its clients. Protection of these client relationships is essential to profitability. A business will therefore expend considerable effort to protect its client relationships from competitors.

One tool which a service business uses to protect its client relationships is the Covenant Not To Compete. Also known as a "Restrictive Covenant" or "Non-Compete," this contract provision often appears in a written employment agreement. The business, as employer, desires to protect its valuable client relationships from employees who may jump ship. The Restrictive Covenant provides this protection by barring an employee from taking client relationships to a competitor.

COVENANTS NOT TO COMPETE – BUSINESS AND TAX ASPECTS (cont'd)

The employer may find it difficult to enforce the Non-Compete, as courts are protective of the employee's right to earn a living. In a typical case, the employee leaves to join a competitor or establish her own business. The employer then seeks a preliminary injunction in court to enforce the Non-Compete and bar the employee from working in her new job.

To be enforceable in court, the Non-Compete must survive a battery of legal tests. First, the Restrictive Covenant must pass the "nature of the business test." Under this test, courts determine whether a near-permanent relationship exists between an employer and its customers. Such relationships are more likely to occur in professional service organizations or businesses that generate customer loyalty by offering unique products or services (as opposed to sales-oriented businesses). Second, the employer must show that it intended to develop near-permanent long-term relationships with its clients, and that the employee would not have met these clients but for her job. *Midwest Television, Inc. v. Oloffson, 699 N.E.2d 230 (Ill.App. 3rd Dist.,1998).*

Third, the Restrictive Covenant must contain reasonable terms. To be reasonable, the Non-Compete must specify: (1) a restricted geographical area which is coextensive with the employer's business territory; (2) a restricted duration which corresponds to the time the employer needs to acquire customers (e.g. 2 - 3 years); and (3) a restricted set of prohibited new-job activities which only prevents the employee from performing the same job functions at her new position. Fourth, the Restrictive Covenant must survive any affirmative defenses raised by the employee. For instance, the employee may show that the employer is in material breach of the written employment agreement. The employee would therefore not be required to comply with the Non-Compete, since material breach of an employment agreement relieves a party from any obligation to obey a covenant not to compete. Fifth, the employee may show the employment agreement is unenforceable as an adhesion contract, or that the employer waived its right to enforce the Restrictive Covenant by ignoring it with prior employees. *Galesburg Clinic Association v. West, 706 N.E.2d 1035 (App. Ct. of Ill., 3rd Dist., 1999); Wyatt v. Dishong, 469 N.E.2d 608 (App. Ct. of Ill., 5th Dist., 1984).*

Clearly, the employer should monitor its own actions to ensure enforceability of the Restrictive Covenant. The employer must be aware of all duties it owes the employee under any written employment agreement (or otherwise), since a violation of these duties may render the Non-Compete unenforceable. If the Non-Compete becomes unenforceable, the employer may lose valuable clients and suffer economic losses.

Non-Competes also have important federal tax aspects. Service businesses are regularly bought and sold. Equally often, a majority shareholder or key employee resigns from the business and hands control to a successor. In many of these business-sale transactions, the departing owner signs a Restrictive Covenant promising not to compete with the buyer. The structure and value of these Non Competes can be critical to reducing tax on the sale.

Reducing tax on the sale of a business requires advance planning. Tax planning will focus on the Choice of Legal Entity of both buyer and seller (e.g., C corporation, S corporation, General or Limited Partnership or Limited Liability Company, or Irrevocable Trust). Also important are the values placed on the seller's intangible assets. Intangible assets include goodwill and going-concern value. The seller's goodwill is defined as "the probability that the old customers will resort to the old place."[1] The seller's going-concern value is defined as "the ability of a business to continue generating income without interruption notwithstanding a change in ownership."[2] (Collectively,

[1]*Horton*, 13 TC 143 (1949).

[2]IRS Regulation 1.197-2(b)(2).

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COVENANTS NOT TO COMPETE – BUSINESS AND TAX ASPECTS (cont'd)

goodwill and going-concern value are referred to as "Goodwill"). Generally, the residual selling price of a business in excess of the fair market value of all tangible assets is attributable to Goodwill.

The tax cost of selling a business is affected by treatment of the Goodwill. The tax cost is also affected by treatment of preexisting or newly-signed Non-Competes. Understanding the tax rules governing Goodwill and Non-Competes can reduce the cost of selling a business. This cost savings translates into extra dollars for buyer and seller.

Although both Goodwill and Non-Competes are intangible assets, the two are taxed differently. Taxation of both intangible assets was revised on August 10, 1993, with the enactment of Code Section 197. Since the pre-1993 rules occasionally still apply to current transactions, a knowledge of both sets of rules is helpful. Certain key rules are:

- Payments <u>received</u> by the Seller under a Non-Compete constitute ordinary income.

- On or before August 10, 1993, all payments <u>made</u> by the Buyer under a Non-Compete are deducted ratably over the years to which the contract relates.

- After August 10, 1993, payments <u>made</u> by a taxpayer under a Non-Compete *generally* are deducted ratably over the years to which the contract relates.

- After August 10, 1993, payments <u>made</u> by the Buyer under a Non-Compete *entered into in connection with a direct or indirect purchase of an interest in a business* are deducted ratably over fifteen (15) years.

- If the Seller <u>has</u> a <u>preexisting</u> Non-Compete that prevents its employees and shareholders from taking clients, then the Seller owns the Goodwill (<u>Corporate</u> Goodwill).

- If the Seller <u>fails</u> to have a <u>preexisting</u> Non-Compete and its employees or shareholders are free to take clients, then those employees or shareholders individually own the Goodwill (<u>Personal</u> Goodwill).

Additional tax rules may apply to a particular transaction, depending on its unique facts. To maximize tax savings, the Buyer and Seller should plan carefully in advance of the transaction. Advance planning will often result in significant tax reduction.

Edited by William B. Fox, B.A., J.D., LL.M. Tax