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## PLANNING POTPOURRI

**Prudent Executors: Most executors make these errors: [1] Liquidate most estate assets leaving the proceeds in a checking and/or money market account; [2] Hold onto securities under the mistaken belief that they can do so without exposure since the decedent died holding them. While liquidity is important in many estates, and some heirs want distributions in kind, executors should hire an investment adviser to evaluate the relevant factors affecting the estate and beneficiaries, develop a written investment policy statement (IPS) and act in accordance with the Prudent Investor Act. Thanks Gary.**

**Graegin Loans can Sell Life Insurance: So many readers loved the recent checklist column on reasons to buy life insurance, here's an encore (yeah, they were probably all insurance agents!). Here's a creative technique that can be used for estate planning with insurance. It can help advisers close an insurance sale. Life insurance can be structured to be owned by insurance trusts (ILITs) to avoid taxation in your estate. When the insured dies the ILIT cannot pay estate taxes directly so the ILIT can loan funds to the estate, or buy assets from the estate. Either approach provides the estate with the use of the cash received from the insurance proceeds. If the ILIT loans the estate the money, and the note mandates that the loan cannot be repaid or accelerated, so that the estate must in all events pay all the interest required under the note, the estate may qualify to deduct, as an expense, all of the interest to be paid back to the ILIT as an administrative expense. This special type of loan is called a "Graegin Loan" after the court case that first sanctioned it. So not only can the insurance proceeds be used to pay estate tax on the family business (don't try this with a securities FLP), it may also generate a huge estate tax deduction thereby reducing the estate tax it is helping to pay! This can be a grand-slam in planning and closing an insurance sale (if you're an agent—smile). Planning pointers: ◘ Read the footnotes to the Graegin case; the forms used by some planners are dangerously deficient. ◘ Carefully craft default provisions to simultaneously provide protection, yet not void the mandate that the interest be paid. ◘ Consider usury issues.** PP



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# PRACTICAL PLANNER

*Martin M. Shenkman, CPA, MBA, JD*

## GIFTS OF FLP INTERESTS: HOLMAN CASE—PART I

Summary: A recent Tax Court case, *Thomas Holman*, 130 TC No. 12, 5/27/08, has lessons for planners and taxpayers using family limited partnerships ("FLPs") and limited liability companies. While professionals have heard a lot about Holman, most taxpayers haven't heard much. For example, www.leimbergservices.com, featured four articles covering this case! (If you're an estate planner and haven't subscribed, you're missing great stuff). An analysis of the case will be presented below. Next month, in Part II, planning lessons and technical points will be discussed.

Facts.
Dad worked at Dell Computer and received substantial Dell stock options which he exercised, and both Dad and Mom bought additional shares. Mom and Dad formed an FLP and contributed their Dell stock to it. Thereafter, Mom and Dad gave FLP interests to one child's custodian account, and larger gifts to a trust for all four of their children. They claimed discounts aggregating nearly 50% on the value of these FLP interests. This reflects discounts (i.e., reductions in value) for minority interests (the recipients of the FLP interests could not control the partnership since they owned small percentages), and for lack of marketability (tough to sell interests in a family entity). There were both good and bad facts in the case. Bad Facts: ◘ Tax returns were never filed. ◘ Almost no income was earned. ◘ Only one asset, Dell stock, was owned. ◘ No business plan. ◘ No employees. ◘ No letterhead or telephone listing. ◘ No accounting reports. Good Facts: ◘ FLP formalities were generally adhered to. ◘ The Dell stock was properly transferred to the FLP prior to gifts of FLP interests being made.

Issue One.
The IRS argued that the taxpayers made indirect gifts of Dell stock (i.e., no discounts) to their children's trust. If the gifts are considered indirect gifts of Dell stock, instead of gifts of FLP interests, no discounts would apply. Just the market price of Dell stock would determine the value of the gifts. See *Sheperd v. Commr.,* 115 TC 376 (2000), aff'd 283 F.3d 1258 (11th Cir. 2002) and *Senda,* TC Memo 2004-160. Point to the Taxpayer. Treas. Reg. Sec. 25.2511(a), (h)(1). A classic example of an indirect gift is illustrated if you make a gift to a corporation. This is treated as the equivalent of a gift indirectly from you, through the corporation, to each of the corporation's shareholders. Holman won this issue by observing the appropriate steps of first properly transferring assets to the FLP, waiting a period of time, then making the gifts of FLP interests. Had the Holman's transferred FLP interests to the trust on the same day, the court might well have held otherwise. Thus, Holman doesn't represent the end of the IRS indirect gift argument. But it seems clear that if you observe the formalities of the partnership, that argument should be toothless. However, if you mishandle the paperwork (like in the *Sheperd* case), the IRS indirect gift argument might well be asserted. It still bites!

Issue Two.
The IRS also argued that the taxpayers made indirect gifts of Dell stock under the step transaction doctrine. This doctrine provides that if steps in a transaction are so integrated and interdependent, economic reality may be better reflected by collapsing the various steps into a single step. Thus, the IRS view of Holman was that the transfer of stock to the FLP and the gift of FLP interests to the children's trust would be more realistically viewed as a mere gift of the Dell stock directly to the trust. The doctrine might be **applied if there is a binding**

*(Continued on page 2)*

## CHECKLIST: RICH/POOR KID

Summary: Estate planning when you have heirs of significantly different means can be quite a challenge. When your kids are the financial version of **Danny DeVito and Arnold Schwarzenegger in the movie Twins d**o you bequeath assets equally? If equal is not equitable, what should you do?

**√ What do you do when your children have different situations? Most parents still leave everything equally. "They're both our children", "We love them the same"…. Are all common refrains. So perhaps the most common approach is to ignore the disparities between the children. This ostrich approach has one major benefit, it is simple.**

**√ Leave the child in greater financial need a larger bequest in your will. For example, bequeath 40% to the rich kid and 60% to the poor kid. A problem with this approach is that if there is a major change in the size of your estate the percentages may be more or less of a differential than you intend. Alternative approach: Make a fixed dollar bequest to poor kid, then leave the remainder of the estate in equal (or other percentages). Depending on the circumstances, you might feel this approach takes the sting**

*(Continued on page 3)*

# ...GIFTS OF FLP INTERESTS: HOLMAN CASE-PART I

(Continued from page 1)

**commitment to consummate all of the steps involved. The taxpayer's in Holman, however, were not under any obligation to make gifts to their children's trust. The doctrine may be applied if the various steps involved are interdependent steps. This means that the legal implications of one step would be fruitless if the other step wasn't also completed. This was not the case in Holman. Mom and Dad could have stopped once the FLP was formed, that step would not have been meaningful and relevant even if the gifts were not later made. Point to the Taxpayer. The court reasoned that during the six day time period that the FLP held the Dell stock from the time stock was contributed to the FLP, until the date the gifts were made, created a "real economic risk of change in the value". The Court believed this risk occurred because the FLP was holding a highly volatile, heavily traded, stock.**



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**The court indicated that it might view the time period differently (i.e., six days would not be enough time for a real economic risk) if the FLP held a preferred stock or long term government bond. The court apparently viewed these as stable assets that would not have the likelihood of a "real economic risk of change in value" over a period as short as a week. Huh? Say you contributed a 30-year Treasury to your FLP. Two weeks later, before you could make gifts of FLP interests Bernanke ratchets up interest rates to fight inflation. That supposedly secure long term government bond that the Holman court presumes has a stable value, would look like the economic equivalent of a bowling ball heading down a ski slope. What about real estate? Yeah, real estate always holds its value over the short term (don't they get CNN in the Judges chambers?). If you have a shopping center with long term AAA tenants that might not change in the short term. But what if a key tenant goes bankrupt? What if you have a single use commercial property used as a back office for a residential mortgage processing company? That's about as stable as Sybil. Should you analyze commercial tenants to determine how long real estate should be held in an FLP before gifts can be made? The Holman holding period is not practical, simple, clear or reasonable. But hey, if it was cookbook simple think of all the unemployed tax attorneys.**

**<u>Comment</u>.**

**Courts are often sticklers to find real non-tax business purposes for FLP transactions. Yet, the concept of needing a time period between funding of the FLP and the gift is inconsistent with business reality.**

**<u>Issue Three</u>.**

**The Holman FLP agreement, similar to most partnership agreements for family entities, contained significant restrictions on transfer. The court held that these were to be disregarded in determining the value of the FLP interests because they did not pass muster under Code Section 2703 (a)(2). Under this provision, restrictions will not be respected unless they are: 1) Bona fide business arrangements. The Holman FLP had no real business. Holding one stock, Dell, didn't suffice (how many stocks must you hold?). While an FLP doesn't have to involve an actively managed business to have a business purpose for the Code Section 2703(a)(2) rules, there must be an adequate bona fide business purpose. Educating the kiddies and preserving assets by preventing the kids from dissipating them, weren't enough. 2) The restrictions aren't a device to transfer value to the taxpayer's family. Holman used the FLP to transfer Dell stock to his heirs. 3) The terms are comparable to similar arrangements made by unrelated people. They were, but the Court never got past the first two tests. Point to the IRS. Some commentators describe this as match point in the FLP volley. While it's a biggie, that might not really be the right characterization. The taxpayers still achieved 16% - 22.4% discounts from the underlying value of a publicly traded stock with some bad facts.**

*Terms in red defined in the glossary at www.laweasy.com. For e-newsletter sign up at www.laweasy.com.*

**<u>Conclusion</u>.**

**Next month will conclude the analysis of Holman, give planning recommendations, and review issues overlooked in the literature. PP**



# ...CHECKLIST: HEIRS WITH DIFFERENT WEALTH

(Continued from page 1)

**out of the difference because the residuary (what is left after the dollar bequest) is divided equally.**

**√ Use Bactine! Remember, unlike hydrogen peroxide it doesn't sting. Add a statement to the will to the effect that: "I have made a larger bequest to my son Sam, out of consideration for his greater financial needs, and not in any way to indicate greater lover or affection for him than for my other children." May sound corny but the reality is most heirs equate love and money, and saying it "ain't so", even if you think it is obvious, can take the sting out of unequal bequests. Just be careful how you word such "fuzzy" provisions; you don't want to create a condition that could affect the distribution, or raise the likelihood of one of the children challenging the will.**

**Leave the child in greater financial need more assets, but minimize offending the wealthy child by making the disparate transfers less obvious. Avoid "in your face" disparate bequests in your will.**

**√ Set up 529 plans for the poor child's children to alleviate the college cost burden. These gifts are made outside your will, and if under the annual exclusion amount ($12,000 in 2008), they won't appear on a gift tax return. You might wish to avoid the front loading of 529 plan gifts (you're allowed to make 5 years of gifts at once) to avoid a gift tax return that would advertise it. Another plus is that if the child in greater need has more children there is a sense of fairness to defraying college costs. These gifts, while they directly benefit the grandchildren, can defray substantial costs for the child/parent. Importantly, if the financial tides shift, you can reclaim some or all of the 529 plan funds as the account owner for the plan. This is a key point many people planning for heirs of disparate wealth overlook, financial tides can be fickle. The kid worth mega-bucks today could be holding a patent for rotary dial phones. They might not be Richie Rich tomorrow.**

**√ Buy a life insurance policy naming the poor child as the owner and beneficiary. This can minimize the tax costs of disparate gifts and avoid an obvious affront to the wealthy child.**

**√Buy an annuity in the name of the poor kid using annual exclusion gifts. This can be a way to assure a cash flow overtime. If the poor kid is irresponsible use a trust or a non-cancellable annuity.**

**√ Set up a joint bank account with the poor kid that transfers on death automatically and leaves everything under the will equally. You can always change the account if circumstances change. But if your estate is taxable this asset will appear on an estate tax return.**

**√ Use a "sprinkle" trust to distribute based on need. If the "rich" kid stays rich an independent trustee can distribute more to the poor kid. If the rich kid develops a health problem or business set back, the independent trustee can modify the distributions.**

**√ Leave say 40% to rich kid, 40% to poor kid, and 20% to a trust for all heirs with an independent trustee able to address circumstances. PP**

# RECENT DEVELOPMENTS

**<u>Tax Authorities Weren't Chicken:</u> The widow of Colonel Sanders estate left charitable bequests to two colleges. The will was silent as to which beneficiaries should pay estate taxes. Kentucky law doesn't exempt charitable beneficiaries from paying their share of estate taxes. So, the charities had to kick in. This is generally not the intended result because there is a "spoiler" effect when a charity has to pay tax. The bequests to the charity are tax deductible, but the deductions are reduced if dollars are allocated to the tax man. Taxpayers frequently don't want to bother with many of the administrative details ("boilerplate") of their estate documents, but ignoring details is not a good recipe. *Hael v. Moore*, Nos. 2005-CA-001895-MR & 2006-CA-000662-DG, 2008 (Ky. Ct. App. 1/4/08).**

**<u>Divorce Digs New Depths</u>: Ugly divorces seem to know no bounds. A recent case, however, plumbs new depths with a vain attempt at creative legal maneuvering. Here's the play by play: 3rd period, a minute to play. Mom was about to die. Son was so behind on child support and alimony only a miracle kept him out of the penalty box. Mom revised her will leaving Son's inheritance to Daughter so that Son's ex-wife (no longer in the running for family MVP) wouldn't be able to use his inheritance to pay arrearages in child support and alimony (OK, so Son wasn't an angel either!). Not to worry, Daughter promised Son (her brother) she'd give him all his inheritance when the divorce issues disappeared (some gift tax issues on that one). Son's ex-wife had a creative attorney who argued that Mom's changing her will was a fraudulent conveyance. The judge declared no goal because Son had no right to Mom's estate, so Mom could do as she pleased. But this game may go into overtime. The court suggested that Ex-Wife allege a constructive trust based on the Daughter's promise to transfer assets to Son. *Cabral v. Soares*, 69 Cal. Rptr. 3d 242 (Ct. App. 2007). Go Red Wings! PP**