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Planning Potpourri

Reminder that GRATs as we know them may no longer be available if pending legislation is passed. Any GRATs in progress that need to be funded by year end should be pushed as banks require time to open accounts, due to the Patriots Act and other regulations.

Citizens for Tax Justice noted IRS data showing only 0.6 percent of deaths resulted in an estate tax payment in 2009 so the estate taxes could be strengthened beyond what President Obama proposed without harming American families and small businesses. He recommended making permanent the 2009 estate tax rate of 45% and a $3.5 million exemption level indexed for inflation. Sen. Bernie Sanders proposed a tiered tax with higher rates on the wealthiest estates. The "Responsible Estate Tax Act" (S. 3533) would raise the tax rate to 50% for estates between $10-$20 million, for those over $20 million a 55% tax, and for those over $500 million, an additional 10% surtax.

Roth conversion Guru Ed Slott suggested some interesting tips at a recent conference: Should you recharacterize because the market declines? If you recharacterize you cannot re-convert until 2011 and you won't get the 2 year tax deferral. So unless the decline is a biggie, you may still not want to reconvert. Watch the impact of conversion on the income tax return that is used for college aid or elect to get it into years you are not showing for financial aid.

Year End Tips: No one knows what the law will be in 2011 so planning that makes sense whether there is a $1M exclusion or a $5M exclusion will be the most flexible and perhaps best. If you gift to a trust that is supposed to be for later generations (GST tax exempt) few advisers believe that future law will let you get away with a freebie so that if you want to really maximize tax benefits on gifts to grandchildren ("skip persons" in GST "speak") do it out right, not to trusts. □ Discounts on family entities and GRATs have all been proposed to be repealed or greatly restricted so the planning consensus is do those now. □ Reasons to make taxable gifts now: 1) get assets that still have unusually low values because of the economy out of your estate; 2) pay tax at 35%

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PRACTICAL PLANNER

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FLP Update: How to Flip your FLP

Summary: FLPs and LLCs remain the focus of many estate plans, and the tax implications are significant. Common use, however, does not imply simple or assured tax results. The following comments were gleaned from a presentation by a panel consisting of Michael Mulligan, Esq., Richard Oshins, Esq., John Porter, Esq., Sanford Schlesinger, Esq. and Martin Shenkman, Esq., at the recent NYU 69th Institute on Federal Taxation in NYC.

The Dating Game: In Pierre v. Commr. 133 TC No. 21, No. 753-07, 8/24/09) the taxpayer gave 5% of an FLP and sold 45%. The taxpayer's valuation expert set a 45% discount on FLP interests. Since the IRS said both transfers were made the same day to the same transferee it was really equivalent to a transfer of a 50% interest which should not be afforded that discount. The Tax Court agreed, reasoning that transfers on the same day when nothing of tax significance occurred between the transfers, should be aggregated. So, a seed gift to a trust (e.g. $250,000 of interests in an FLP), followed by sale of interests in same FLP to the trust, may be aggregated. If the combined FLP interests gives you supermajority power you might even get tagged with a control premium instead of the sought after discount elixir. So how long does your seed gift have to bake before you can consummate a transaction? In the Holman case the Court looked at the underlying FLP asset, Dell stock, and felt it was sufficiently volatile that a 6 day wait sufficed. Some chefs recommend 30 or 60 days between the transfers. Some recommend using a guarantee in lieu of seed gift since you cannot aggregate a guarantee for a note given by a trust with the FLP interests sold to a trust. Other gurus suggest a tax year so an intervening income tax return is filed (e.g., make the seed gift in November and the sale the following February). There is no shortage of opinions. The more time between the gift and sale the better. Finally, when you're a contestant on the Dating Game documents should be signed and notarized as of the date they were signed. This is preferable to signing a document when the only dates is an "effective as of" date. Having documents notarized gives independent corroborating evidence that it was transferred as of that date. That's why all important documents are always notarized by the taxpayer's personal secretary or the lawyer's secretary -- - independent corroboration.

Indirect Gift Argument. If you gift assets to an FLP (e.g. rental real estate), and on the same day gift limited partnership interests in the FLP owning the real estate to your heirs, the IRS and some courts wills view this no differently than if you had simply given the underlying real estate assets directly to your heirs. The IRS position is that the transfer of assets to the FLP (funding) and gifts of the FLP should be collapsed. The more time that passes between funding the FLP and the gifts of FLP interest (sounds a tad like the time recipe above), the better your tax cake will be baked. Time in between is good. Independent risk during that time period (e.g. volatility of the assets) is good. In the Gross case 11 days baking with ingredients consisting of a mixed portfolio was a sufficient recipe. In Senda interests transferred at the same time the entity was funded were viewed by the IRS as a transfer of the underlying assets. The documents were not sufficient to show that the transfers of assets to the FLP occurred before the transfers of interests in the FLP to the family members. If viewed as an indirect gift, the transfer won't support discounts for lack of control or marketabil-

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Checklist: Health Proxies

Summary: R. Edward Townsend, Esq. suggested that we make a few more points on living wills and health proxies. Ed offers his comments from a New York law perspective but the comments really have wide applicability to wherever you might be. The comments, as is Ed's style, are practical, to the point (well before I threw in my two cents) and real. Ed, in offering his practical insights, continues a process begun many decades ago. I worked with Ed and his firm while in law school. No young attorney could find a better mentor.

√ Make certain the health care proxy addresses nutrition and hydration (required by New York law). [2¢] Be really careful of "standard" forms and especially cheapo internet documents. The provisions are often woefully inadequate with respect to this important point, and in some cases horrific in application.

√ Make certain the health care proxy contains HIPAA language. 2¢ That's the Health Insurance Portability and Accountability Act which created specific requirements for authorizing a person to access your medical information. The language should clearly authorize an agent to

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...FLP UPDATE: HOW TO FLIP YOUR FLP

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ity. While Holman and Gross permitted a short waiting period for volatile assets, a longer time is required for non-volatile assets. What is volatile and how long do you wait? Ah, that is the question for your tax psychic. The moral of this: Maintain a clear paper trail proving proper funding of the FLP before transfers of FLP interests.

Annual Gifts: Many folks make annual gifts of interests in family business entities, FLPs, etc. It's a simple and inexpensive (so you thought) way to use your annual exclusion, conserve cash, and shift wealth to the next generation. In 2002 the Hackl case nailed a taxpayer trying annual gift planning. The Hackl court held that the gifts did not qualify for the annual exclusion because they were not gifts of a "present interest." The Hackl LLC owned raw land that had once been a tree farm but the trees were cut and it would take 30 years for new trees to grow. Mr. Hackl made 200+ gifts to family members. But the IRS argued that none of these gifts constituted present interests because of the nature of LLC assets (growing trees) and the restrictions on transfer in the LLC operating agreement. The Tax Court agreed with the IRS, and the Sixth Circuit affirmed. T.C. Memo 2010-2 (1/4/10). Recently in the Price case, an FLP held marketable securities and the partnership agreement included common transfer restrictions (e.g. consent of all partners is required for a transfer, there was no right to withdraw capital, distributions could only be made in the discretion of the GP, etc.) There were even significant actual distributions made. Nevertheless, the IRS argued that the gifts of LP interests should not qualify for the annual exclusion since the LP interests given did not satisfy the "present interest" requirement. This was because the donees did not have a right to the immediate enjoyment of the LP interests given to them. The Tax Court agreed because the LP interests were subject to tough restrictions on transfer. No capital could be withdrawn. The donees were mere assignees. This reasoning is disturbing because real partnership agreements between unrelated folks commonly have these clauses (don't confuse "tax reality" with "real reality"). How can a typical FLP survive the Price test? Consider including a "put" right (i.e. allowing donees to sell their LP interests back to the FLP). This might be similar to the annual demand or "Crummey power" withdrawal right included in many trusts to support characterization of gifts to the trust as constituting present interest gifts. Perhaps you can give an LP the right to put back an amount of the LP interest at a fair market value for a specified period of time. But this isn't a cake walk either. The IRS has argued that put rights are not always valid. But if you win the "put" right you might sacrifice discounts, after all if the donee can realize the fair value of the gifted LP interest how can you argue its value is reduced as not being marketable? The IRS may get you coming or going! The IRS can argue that the put right makes the interest more liquid and hence worth more (i.e., lower discount). Giving LPs a right to sell, subject to a reasonable right of first refusal provision, may be another option.

Costs: Is it even worth making an annual gift of $13,000 of FLP interests? You need an appraisal for the gift. The fact that you are only making $13,000 annual gifts doesn't absolve you from needing a proper appraisal to determine the percentage interest in the FLP that is worth $13,000. It is probably advisable to file a gift tax return reporting the gift of the partnership interest in order to toll the statute of limitations. If you "adequately disclose" the gift on the return after three years you're entitled to a "Get out of Audit Free" Monopoly card. This is all quite cumbersome and costly for a mere $13,000 annual gift. Seems that the time honored way most small family businesses were passed to the succeeding generation is under harsh and unfair attack.

Buy Sell Agreements. Rights of first refusal and transfer restrictions were ignored in Holman. IRC Sec. 2703. The IRS has refocused on a new approach, attacking not the FLP but the transfer restrictions in the partnership agreement that restrict an owner's ability to transfer inter-

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Review: Andrew Wolfe, CPA, Esq.

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...CHECKLIST: HEALTH PROXIES

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access your records and should include specific references to HIPAA.

√ Don't designate multiple agents. Doctors don't like this, and I believe it is not allowed in some states. I sometimes have clients who want two or more kids involved in the decision making, in which case I designate a primary health care agent (e.g., the older child), and then a successor (e.g., the younger child), and then provide that the former should consult with the latter. Sometimes you have one kid in New York and one in California. In this case, I might provide that the kid in New York has the power when the parent is in New York, and vice versa when the parent is with the kid on the West Coast. [2¢] Even if multiple agents are permitted under your state law, don't do it. Emotions run high when these issues arise and even children who always were of like mind could differ in dramatic ways making decision making impossible.

√ I steer clients away from overly specific living wills. I find they only confuse the health care agent, the doctor and the hospital, and the health care problem that eventuates is invariably one which is not specifically addressed. Then everyone gets into the act with an opinion as to how the exact language should be interpreted, etc. I stress that the client should set forth his/her basic wishes, and then select a health care agent with judgment to act on this when necessary. [2¢] We've advocated in prior articles to be quite clear about religious issues, organ donations and burial instructions, but those are different from detailed medical specifications. We fully agree with Ed. The Myriad of medical possibilities make it inadvisable to get specific. Often when people do get specific, the actual situation that arises is different than the details specified in the document and confusion results.

√ Make certain the living will is not part of the health care proxy. The doctor never needs to see the living will. Keep it simple. The only thing the doctor/hospital needs to know is who will be making the decisions. [2¢] Agreed again, but we like to list the powers and authorities the agent has in the proxy to endeavor to minimize situations where a medical provider questions the authority.

√ A client should never appoint as health care agent anyone, even a spouse or child, if the client remotely feels he/she will let his/her religion get in the way. Accordingly, no special language is needed. [2¢] We've opted for the opposite approach. Ed is right, simplicity is best, but we've seen situations where a client's religious views may not be known, or erroneous assumptions made, or the professed views of the agent are not reflective of their real attitude.

√ In New York, use the statutory form. The hospitals are familiar with it and, therefore, can more readily accept the designated health care agent. I even have my New Jersey clients sign a New York statutory form, since there is significant chance they will be treated in a New York hospital. [2¢] Good point. We haven't done this but will offer it to clients in the future if they wish. We haven't had much kickback on lawyer prepared forms that were comprehensive in the powers they've

RECENT DEVELOPMENTS

Summary: John Porter, the maestro of FLP and LLC litigation, offered some key planning tips for practitioners helping clients with FLPs and LLCs at the recent NYU 69th Institute on Federal Taxation in NYC. Here's a few of them:

Document non-tax reasons for the transaction. Partnership agreement. Understand the terms of the agreement, and be certain that the terms are adhered to in the operation of the partnership. Example. The GP is required in the partnership agreement to disseminate partnership income tax returns no later than June 30th of each year. If this is not done the IRS will argue a failure to adhere to the terms of the agreement. The boilerplate provisions must be adhered to. Accurate books and records. Some do it on Quicken, Quickbooks, others have their CPA do it. However you handle it, the FLP must have an accurate P&L and balance sheet. Pro-rata distributions, if required, must be made. Plan this proactively, don't recharacterize inappropriate distributions after the fact. Never distribute all income. A retained right under 2036 is a retained right to income. In the Black case, most of dividends were distributed out to Mr. Black. Similar arguments appeared in the Schutt case. No personal use assets should be held in the FLP. Avoid "as needed" distributions. Example, no distributions for years then Mom wants to build a vacation home and a distribution is made before the purchase. "As needed" distributions that correlate with the donor's personal needs give the IRS fodder to argue that there was a retained right via an implied agreement with the donor. If there is a cash flow need a better approach is to set up a distribution policy and distribute according to that policy on a regular basis. This might detract from discounts but may salvage the entity overall. If the family respects the integrity of the entity there is a good likelihood of success. Many of the 2036 cases have been lost based on bad facts. Don't give a senior