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Planning Potpourri

Alternate Valuation Date: Usually when someone dies you value the estate assets at the date of death for tax purposes. A special election permits you to value all assets six months after death. This is useful when the stock markets are tanking. More than a score of states have decoupled their estate taxes from federal law so you could owe state tax even if your estate is less than the $2 million required to file a federal estate tax return. So how do you make the election for a state return when no federal return is filed? The State of New York Department of Taxation, Estate Tax Department advised that you can elect the alternate valuation for New York tax purposes, even if there is no federal return filed. However, you have to prepare a federal estate tax return using the alternate valuation. This "mock" federal return must be filed with New York, even though it is not required to be filed with the IRS.

GRAT Operations: No, this is not a new form of surgery. Grantor Retained Annuity Trusts (GRATs) leverage gifts to children. Word is the IRS is planning greater audit scrutiny of the operations of these trusts. This means the periodic annuity payments must be made properly and in a timely manner, and this should be documented. Other trust provisions will likely be considered. Get an annual GRAT checkup. Have a counsel review the trust document and coordinate with your CPA and wealth manager to assure that all formalities are met. Get an investment policy statement. If the GRAT owns closely held business interests, have the trustees sign shareholder agreements like real shareholders.

1031 Exchanges of a Residence: Real estate investors love 1031 exchanges that avoid current taxable gain on swapping properties. To qualify the property has to be held for productive use in a trade or business or for investment. Can a residence ever qualify? Yes, according to a recent IRS Revenue Procedure, 2008-16. You have to have owned the residence for 24 months before the exchange and in each of the two 12 month periods you had to rent it 14 or more days and your personal use had to be less than the greater of 14 days or 10% x rental days. With housing prices in meltdown mode, how many folks have profits to 1031 a residence any how? Is the IRS giving free ice in winter? PP

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PRACTICAL PLANNER

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Gifts of FLP Interests: Holman Case — Part II

Summary: A recent Tax Court case, *Thomas Holman*, 130 TC No. 12, 5/27/08, has important lessons for planners and taxpayers using family limited partnerships ("FLPs") and limited liability companies ("LLCs") for gifts. Last month's article was an overview. This month's article reviews planning lessons and other points.

General Planning Considerations of the Holman Case.

The IRS has had a lot of success attacking FLPs and LLCs for estate tax purposes under Code Section 2036. The Section 2703 attack may become the IRS' new weapon of choice on gifts of FLP and LLC interests. Expect repeat performances. Evaluate the magnitude of discount that may be achievable. Weigh the potential gift tax benefit versus the income tax detriment (no step up in basis, and the possibility of higher capital gains rates under the next administration). Weigh the discount benefits of an FLP (or LLC) versus mere tenants in common ownership which is cheaper and simpler (but it doesn't provide control, asset protection and other FLP non-tax benefits).

Specific Recommendations,

Document real non-tax business reasons for the FLP and the transactions. These should be reflected in the partnership agreement. Observe all formalities that an independent real business would (well, at least as the Tax Court defines "real"). File tax returns. Have a CPA prepare annual financial statements (or at least QuickBooks or equivalent reports). Be sure all appraisal assumptions are subjected to sensitivity analysis. What happens if an assumption changes? What are the consequences if an assumption is projected forward? Do the results remain reasonable? All positions should be consistent. The *Holman* court was clearly disturbed by inconsistent assumptions and positions by the taxpayer's appraiser. Appraisals shouldn't use guesstimates. Use letterhead. Have younger generation family members contribute assets to the FLP on formation (but something more than the .14% contributed by the Trust in Holman would probably be a good thing). Have a written business plan (or an investment policy statement, or both). Execute governing documents (e.g. partnership agreement) for each phase and transfer to corroborate that each step of the transaction (e.g., after each gift) is a complete and meaningful step. This should help demonstrate that each step is independent and legally sufficient. File gift tax returns. Obtain an FLP telephone listing. Every document should be dated the date it is signed (regardless of whether it has a different effective date). Clients should understand the partnership agreement. The *Holman* Court said "Tom impressed us with his intelligence and understanding of the partnership agreement…" Make changes to conform it to your wishes. Hold non-marketable assets. The *Holman* Court accepted the use of general equity funds for the evaluation of discounts of the Holman FLP which held only Dell stock. Introduce non-marketable assets and your discount may favorably exceed those found in *Holman,* and some of the analysis of the *Holman* court that was detrimental to the taxpayer may take a different spin. If subsequent contributions are made to the FLP document the change in interests in a restated agreement.

(Continued on page 2)

Checklist: Spendthrift Kid

Summary: So Junior wants to spend his inheritance faster than you can earn it and has his eye on a new red Lamborghini. What can you do to assure that Junior won't burn through his inheritance faster than a meteor hitting the Earth's atmosphere (for you science buffs re-entry temperatures can reach as high as 3,000 degrees F). Here's a checklist of things you can do:

√ **Buy an annuity:** Mandate that your executor take some portion of Junior's inheritance and buy a non-cancellable annuity. If Junior cannot cancel or accelerate the annuity, the principal should remain relatively secure. If Junior is young, consider an annuity that will pay Junior an inflation adjusted amount every quarter for the rest of his life. This will assure Junior has enough money to buy chips and beer forever.

√ **Trust:** Put Junior's entire inheritance in a trust and name a tough trustee who will be able to withstand Junior's whining and begging so that the funds can be used judiciously over Junior's life. Institutional trustees are used to dealing with trust fund babies. They work fixed hours (they don't have to listen to

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...GIFTS OF FLP INTERESTS: HOLMAN CASE — PART II

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Unresolved Issues.

How long do assets have to age in an FLP before you can make gifts? How long must they age to face a "real economic risk of change in value"? The Court said "We draw no bright lines." Thanks, you could have at least left a light on! If you'll only make annual gifts how can you cost effectively comply with the Holman standards? It's not reasonable to obtain the level and quality of appraisals and analysis the Holman court seeks if you're merely giving a couple of kids $12,000 gifts. The *Holman* Court considered a private market for partnership interests among the FLP's partners. This violates the tax law prescription for determining "fair market value" based on a hypothetical willing buyer and willing seller. There are lots of definitions of "fair value". The highest value is "strategic value", when the business involved fills a unique need of the buyer so that the buyer is willing to pay more than going rate because of the unique value of the asset to them. *Holman* erred in this direction.

Important Points Overlooked.

Formalities: The kids' trust to which the Holman's made gifts was signed by the parents on 11/2, the trustee on 11/4 and made effective 9/10. This is looser than the űber perfection some courts have demanded of FLPs. The partnership agreement was signed 11/2 but the FLP was formed 11/3. The court was silent on this snafu. The 11/8/99 gift was made by a document saying it was effective 11/8/99 but which was undated. When was it signed? It's one thing to forgo a notary, but a date? Count 3 dating goofups! Yet the Court felt that the formalities sufficed! Commentators noted that the appropriate steps were taken. But were they? Was Holman the new version of the Dating Game? While Holman will undoubtedly be cited by taxpayers that have dating errors if challenged, more care is advisable.

Fiduciary Obligations: The general partner of a limited partnership is held, vis-à-vis the limited partners to a fiduciary standard. Could the general partner in Holman have adhered to such a standard if he didn't diversify the Dell holdings as generally required under the Prudent Investor Act (PIA)? Might the IRS argue that a failure to follow the PIA indicates a failure to respect fiduciary obligations? The Court analyzed the *Estate of Amlie v. Commr.*, TC Memo. 2006-76 which involved a conservator entering into a series of agreements while "…seeking to exercise prudent management of decedent's assets…consistent with the conservator's fiduciary obligations to decedent." The Court noted that a fiduciary's efforts to hedge the risk of a ward's holdings and plan for estate liquidity may serve a business purpose under IRC 2703(b)(1). What is the distinction between the fiduciary obligations of a general partner to a limited partner, versus a trustee to a beneficiary, versus a guardian to a ward? Would the result have differed had Holman hired an adviser to create an IPS to hedge the risks of the limited partners to whom the GP owes a fiduciary duty? The *Holman* Court was not convinced by the taxpayer's appraisal expert that a lack of professional management should justify an increased discount. You get no discount benefit from lousy investing, and you undermine your business purpose as a fiduciary.

Fair Market Value: The *Holman* court found a lower discounts because it was swayed by the argument that there was no economic reason why the FLP would not be willing to let somebody be bought out because the remaining partners would be left holding the same assets after the buyout (this ignores the willing buyer/willing seller paradigm). If the FLP held real estate this might not be true. Creditworthiness of the FLP could be adversely impacted. But the *Holman* Court's conclusions are questionable even for an FLP holding securities. If the FLP assets are reduced below the minimum accounts size for the FLP asset manager, a change might be mandated. If FLP assets drop below a certain threshold certain types of investment products may no

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...CHECKLIST: SPENDTRIFT KID

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Juniors whining for money on weekends like Uncle Harry would have to), are a great choice. Delineate in the trust agreement items the trustee should pay for (tuition, technical school), and things the trustee should not pay for (bling, yachts).

√ Incentive Trust: Make distributions from Junior's trust in part based on Junior's performance and conduct. If Junior earns $50,000, let the trust match it plus pay certain other expenses. If Junior earns nothing limit the trust to cover just basic needs and expenses. These trusts have been touted as a great technique to motivate underachieving heirs. In reality, these are not simple documents. How is "income" to be defined? If Junior joins the Peace Corp. or something equivalent he might earn little while accomplishing a lot. You may want a greater incentive for such altruistic conduct. The problem with incentive trusts is that it is difficult, if not impossible, to address the myriad of circumstances that might arise. It might be just as effective, perhaps more so, to have a discretionary trust and give the trustee the flexibility to react to the beneficiary's circumstances, rather than endeavoring to embody the range of behaviors in an incentive formula.

√ Charitable Lead Trust: Put some portion of Junior's money in a charitable lead trust ("CLT"). A CLT is a "split interest" trust. Charities receive a specified amount during the trust term, and thereafter a non-charitable beneficiary, such as Junior, receive the trust assets. It is a "split interest" since both charitable and non-charitable beneficiaries share. A CLT can be structured as a grantor trust (taxable to the parent) or a non-grantor trust (the CLT itself pays tax, but most of the tax liability will be offset by charitable contribution deductions). For example, a specific charity could receive a unitrust, or an annuity, payment for some stated period, say 20 years. That payment could be made to a donor advised fund so Junior can appoint the money to charities he selects. This can help teach Junior about philanthropy in addition to Gucci. At the end of 20 years Junior will get the money in the trust (or it can be paid into a further trust to continue to protect him). This approach delays Junior's access to this portion of the inheritance, provides something analogous to a retirement plan in case he burns through everything else, and hopefully improves his values during the interim. The IRS recently issued new sample forms to be used for CLTs Rev. Proc. 2008-45 and 2008-46, 2008-30 IRB.

√ FLP/LLC: Convince Junior to contribute his assets to a family limited partnership or limited liability company for which you (or someone else trustworthy and stern) are the general partner or manager to control Junior's access to the assets. As a limited partner Junior has no say in FLP management, including distributions. If Junior is still a minor, evaluate transferring custodian accounts to an FLP/LLC. While many people are cavalier about doing this, it raises issues as to Junior's rights upon attaining the age of majority. See "Custodial Account into FLP", Practical Planner May 2008, page 4.

√ Go Skiing: Hey, if all else fails, do like the popular car bumper stickers in Boca Raton say, SKI! Spend Kids

RECENT DEVELOPMENTS

Summary: Palimony is an equitable type of support awarded when a long term non-marital, but spousal-type relationship between unmarried parties terminates. This remedy is intended to achieve substantial justice in light of the realities of the relationship. It is significant for all non-married partners to consider.

"You've Come A Long Way Baby". That is not only a great slogan for Virginia Slims, but it also aptly describes the evolution of palimony. In the landmark 1976 California case, *Marvin v. Marvin,* 18 Cal. 3d 660, Lee Marvin, star of the film "The Dirty Dozen", had his laundry washed in public when he broke off his relationship with ex-dancer Michelle Triola. The two had lived together in Marvin's Malibu pad from 1964 - 1970. Triola won a settlement based on a theory of implied contract. She provided homemaking and other services to Marvin, and he impliedly agreed to provide for her. In a recent New Jersey case, *Devaney v. L'Esperance*, A-20-07, the court found that palimony could be awarded even if the couple didn't live together. Palimony has come a long way baby! Now your paramour doesn't even have to live with you to fleece you! Up until recently you would know if you were in the mix for a palimony claim if your lover moved in. But this recent New Jersey court decision has broken the precedent set in almost every other jurisdiction by holding that a palimony claim might succeed even if your paramour never resided in your secret pied-a-Terre. Cohabitation is, according to the court in *Devaney v. L'Esperance*, only one of the many factors to consider. To win such a palimony claim, your ex-paramour still has to prove that the two of you maintained a marital type of relationship, and that there were promises of support. That promise, however, can be express, or implied. The moral of this tale is if you have a relationship you need a living together agreement that documents your understandings, including the payment or absence of palimony. PP