Report 6

A complete listing of the proceedings and speakers is available on **the Institute's Web site**

Wednesday, January 7

10:45 a.m. - 12:15 p.m.
Question & Answer Session
Dennis I. Belcher
Carol A. Harrington
Prof. Jeffrey N. Pennell

Reporter: Gene Zuspann Esq.

They received 100+ questions

Impact of HIPPA
Sets privacy standards for medical information _ certain entities (health plans, providers and clearinghouses) may not disclose info to anyone other than patient or POA agent
How does this affect an EP practice
Removal of trustee for incapacity _ medical provider may not longer provide this without a separate authorization signed by that patient
HCPOA still allows agent to make decisions _ should specifically provide that agent should be personal representative under HIPPA (designating specific section of Act which I did not get)
Should execute a separate authorization to holder to get info from doctor and check with Dr and hospitals to see what they require

Strangi was appealed and will go to Fifth Circuit; ACTEC will file an amicus brief

Tax apportionment _ can you apportion tax to an inter vivos donee by a Will?
The issue could apply to the 3 year rule bringing back gift tax into an estate
Jeff only knows of 3 cases dealing with the issue _ 2 allocate the liability to the donees and one does not do so
What is the result under the Uniform Estate Tax Apportionment Act? They did not allocate this in the Act assuming that the gift tax liability was the donor's. Jeff is not sure this is correct. This should be addressed in your tax clause and in the deed of gift.
Jeff also addressed a difference in estate tax rates due to lifetime gifts causing additional tax in the estate but he would not try and draft for this issue
Dennis directed the audience to the Stone decision where the taxpayers tried to address the gift tax.

Question of basis and FLP's
Dennis discussed the difference in inside and outside basis due to a valuation discount and the §754 election.

§643 regulation issues (Carol)
§643 regs address §1001 issue. Although this is not 'clean' it was the best the Service could do given that the §643 project was already open.

The trustee must be consistent on allocation of capital gains to income and observe a duty of impartiality

Sometimes you can use Strangi to your advantage, for instance, if values went down. If you allow 2036 to apply, then all of the tax effects of including the asset in the estate. However, there are a number of issues involved with this.

Defined value clauses. You are looking at a method of limiting the estate tax payment. Consider the possibility of a disclaimer. The trust would provide that the interest would go to the child, but if he/she disclaimed, then it would go to the family foundation. The question submitted asked whether this is good - Dennis said that it depends on the family. Caveat: The person disclaiming must be careful of any problems that the disclaimer could cause for the FF and its operation and the potential excise tax issues.

Can a 5 year old trust with a 25% inclusion ratio be split into a trust with a zero inclusion ratio and a trust with an inclusion ratio of 1? Carol answered in the affirmative. This authority was granted in a 2001 change in the law. See the statute and regs for authority and requirements of the split. You can do this without court approval if your state law allows it. You need to notify the Cincinnati Service Center of the change. If the donor is alive do a gift tax return explaining the change in allocation. If not, mail a document to the IRS showing the change.

Jeff discussed a question on FLP's. He addressed judicial activism (a conclusion of the person submitting the question and adopted by the panel) as the courts have realized that the Service has lost all of its arguments but that the courts feel that the discounts are unsustainable. Jeff feels that the judges are saying that in the bad fact situations, the taxpayer should not succeed. He feels the Fifth Circuit in Strangi may do what they did in Church - exercise the smell test and leave the result alone, regardless of the problems with the lower court decision.

§2036 and the marital deduction (Dennis)
a problem exists if the decedent has used the applicable exclusion amount and a gift comes back under 2036. If there is no ability to get the money from the donees, the gift tax will affect the marital deduction and cause significant additional tax (a circular calculation)
It is wise not to fund your marital share until after you complete your audit

Defenses to Strangi (partially suggested by Stacy Eastland)
Make distributions from entity mandatory
Make power to liquidate in an entity not owned by the transferor
No investment authority in transferor
Reasonably definite external authority

Jeff suggests that you follow the same approach you would take to drafting a trust; Dennis also suggests following the business model (Stone). Jeff does not feel that you should rely on the Byrum defense. He feels this a litigation defense.

2:00 - 3:30 p.m. Special Sessions 1
Session 1-B - Bulletproofing the FLP - Current Issues
John W. Porter
T. Randall Grove

Reporter: Carol Warnick Esq.

John Porter and T. Randall Grove did most of the talking, although they noted that their Special Session Materials contained two relevant articles, which are listed below. They announced that they were providing microphones for the authors of those articles to make comments at any time during the presentation. They asked that all other comments or questions be put in writing and submitted to them in that fashion.

The articles were:

Strangi; A Critical Analysis and Planning Suggestions, BY Mitchell M. Gans and Jonathan G. Blattmachr, 2003 Mitchell M. Gans and Jonathan G. Blattmachr, Published in Tax Notes, September 1, 2003, pg 1153.

New Tax Court Cases: Developments in Planning with Family Limited Partnerships, by S. Stacy Eastland, 2003, Stacy Eastland, Published in ACTEC Journal, Fall 2003 Vol 29. No. 2, p. 69.

John Porter started out going over what he talked about yesterday. He again emphasized that we should work to make these entities commercially reasonable. Many things we like to include in partnerships, such a prohibiting withdrawal, only allowing withdrawal with a penalty, requiring a high number of affirmative votes before liquidation, etc. are also common in commercial deals.

He feels that 2703 was specifically set up to deal with abusive buy-sell arrangements. The Service has lost many of the other arguments against FLPs.

As he discussed yesterday, the gift on formation argument is really dropping out. In Strangi, they based the argument on the partnership's own appraisal. The Service felt that something had happened to the values, they disappeared somehow in the process therefore there must have been a gift on formation. The Tax Court threw that argument out and said that what Mr. Strangi received was worth about the same as what he put in, in spite of the valuation appraisal showing discounts.

The Jones case put the gift on formation argument to bed with the same analysis. If the capital accounts are properly credited and this is a pro rata partnership, there is no gift on formation. Contrast this with the Shepherd case, where 50% of what he contributed was credited to his two sons' capital accounts (25% to each son). Make sure that when the partnership is created and when a partner contributes property to the partnership, that the value of the property is appropriately credited to his or her capital account.

Strangi II T. Randall Grove says it is a testamentary devise case. He thinks that comment right out of the box in the opinion had a very significant impact on the rest of the opinion. Mr. Strangi retained the right to enjoyment of the assets in Strings. How did they get there? Mr. Gulig had power of attorney. This looks more like one man's estate plan than a joint enterprise. The fiduciary duty Mr. Gulig owed to Mr. Strangi allowed to court to come up with the retained right issue.

He discussed how Mr. Strangi continued to use his personal residence, how he did not have sufficient assets in his own name to continue to live the way he had been accustomed, and the most critical factor, which was that nothing really changed in the management, etc. of the assets. Mr. Gulig continued to manage afterwards, just as he did before. Grove thinks the court was greatly influenced by the fact that the whole arrangement looked like one man's testamentary devise.

2036(a)(2) issue Court said it distinguished Strangi from Byrum because Byrum had an independent trustee. Court also said they were ignoring the identity of the other shareholders. (Family members, with only a sliver of interest going to charity.) There was a high unlikelihood of the shareholders bringing any accountability into the mix, both terms of who they are but also in how small their interest was.

Porter This upsets him because the courts seem to think that family members will not enforce fiduciary obligations. We as practitioners know that family members do sue other family members. We see it all the time. Will this be a battleground in the appeal of Strangi II? Also make sure that the partnership agreement does not negate fiduciary duties as in Kimbell.

Question: What impact did Mr. Gulig's role as attorney in fact have on the court, given the other issues as well?

Answer: The Court never got beyond the fact that Mr. Gulig was the attorney in fact for Mr. Strangi, even though he had fiduciary duties to others under the FLP agreement.

Very broad discretionary powers to Gulig in partnership agreement. Maybe better off with ascertainable standards regarding distributions, which should avoid the 2036(a)(2) problem. We won't see that in Strangi because there are no ascertainable standards in the agreement.

Mitchell Gans asked whether or not ascertainable standards are really necessary? It was not in Byrum. It was a corporate fiduciary standard. Does Byrum stand for the proposition that corporate fiduciary duties are the same as what we term ascertainable standards?

Porter: He thinks you need both the fiduciary duties and ascertainable standards to avoid the (a)(2) problem.

Mitchell: Thinks that corporate fiduciary duty is analogous to the ascertainable standards in trust law.

Porter: In a partnership, if income is not distributed, it must be credited to the partner's capital accounts. The general partner may control when they get it, but can not decide to give it to some other partner's capital account.

Mitchell: Timing still an issue, even though it is in the capital account.

Stacy Eastland: 2036(a)(2) should not be applied. O'Malley case is wrong with all of its progeny. You cannot shift the income to another partner in a partnership. He agrees with Porter. Partners have the benefit of the past, present, and future income. This is language from the Harrison case.

Look at his article (Special Session Materials) He cites authority from Jennings v. Smith. He suggests putting in the partnership agreement specific amounts to be distributed with no discretion. They have used this in almost every single partnership. It never hurt them in getting discounts. Also helpful if you want annual exclusions. Solves the Hackl problem. Also helps on the 2036(a)(1) problem. Now there is a distribution that would be inconsistent with the retained interest argument. We have three years to amend partnership agreements and put Little Suzy or Little Bobby in charge. Now maybe defined value clauses may have an even greater importance. (He commented he will talk about defined value clauses in his special session tomorrow.)

Mitchell: Is not persuaded by idea that the value is in the capital account. He cited an Alexander case. Here, the interest could either go to the daughter or her estate. She could sell her interest as a vested remainder. The Tax Court held that the father's ability to move it between the daughter or her estate was all it took to bring the interest back to his estate.

Porter: He likes to see fiduciary duty PLUS ascertainable standards on distributions in the partnership agreement.

Mitchell: How does that avoid a 2036(a)(1) argument?

Eastland: It just needs to be a standard that can be defined.

Grove: What about transfer issues?

Eastland: A transfer must be the same thing for 2036 as it does for 25ll. He does not think the initial transfer to a partnership is a taxable transfer.

Mitchell: He agrees that you have to have a taxable transfer to get into 2036(a)(1). Thinks that in the recycling argument the courts have ignored the cases. Prior cases talked about bona fide sale did you really get the consideration not was it a family transfer? Cannot be a transfer for 2036 purposes if it is not a transfer for gift tax purposes. He thinks that the Tax Court got it wrong on both issues. He thinks the gift on formation issue is much more troubling. Is there a connection between gift on formation and bona fide sale? We say that there is. He things you should fund the partnerships in such a way as to avoid that argument. What are the appeals courts going to do?

Jones issue Is there a gift on formation when a child purchases or obtains general partnership interests and the father only gets limited partnership interests? The government argued a gift on formation. Despite the disproportionate control rights, the Tax Court found no gift on formation because the capital accounts were property accounting for the interests contributed. To avoid the issue completely, provide proportionate interests in both the general and limited partnership interests upon formation.

Grove: We need to talk about constraints on rights to designate, 2036(a)(2) planning issues. There was not an independent trustee in Strangi as in Byrum. There were also corporate realities on Byrum. Also the fiduciary duty in Strangi was owed to himself since he had 99.9% ownership, whereas in Byrum there was the possibility of enforcement from others. Byrum refers to the independent trustee who has the right and the duty to hold Mr. Byrum responsible. He thinks the idea of an irrevocable trust with an independent trustee is a powerful tool we can use for planning.

Looks at his materials, Exhibit 6-B. Three circles surrounding the designation of donees. First ring is the GPs fiduciary duty. Second ring is business objectives and economic realities. The partners should monitor the economic results of the partnership on an ongoing basis. If the family has had a business plan and evaluated performance based on the business plan, he thinks it would have helped in litigation.

Porter: The more it looks like a going concern, the better and the more likely it is to be respected by the Service. In the bad cases, the courts have felt like it was not a real deal. In Stone, the court found there was real business purpose.

Third circle: Distribution authority restrictions. Is the family lawyer or family accountant an independent trustee that would help? He thinks the family lawyer or accountant is more of a subordinate than an independent trustee. He also thinks expertise is critical as well. Also the facts are important. Look at the reality of the situation.

Porter: Looks at things backwards because he does not plan...he litigates. He likes the idea of someone more independent rather than anyone who could be considered subordinate.

Grove: In Byrum, the decedent had the power to remove the trustee but the court still liked it. The court said that if the successor trustee is going to succeed to the rights of the one removed, then it seems to be OK that you can remove the independent trustee.

Discussed what the IRS is alleging in its notice of deficiency on a 2036(a)(1) case. If they argue that you have a retained right, then the asset that corresponds to your percentage interest should go back to your estate. If they argue that an implied agreement exists with regard to all of the assets, (Harper, Thompson, Strangi), then everything is going to be included. in the estate. For a 2036(a)(2) argument, if there is the right to designate, then all assets are going to be includable.

Porter: Tried two cases recently (November 2003), Vassler and Bonguard. The Service tried to bring all the assets back to the estate. They backed out all the gifts made during life and backed out of the notice of deficiency the fair market value of the partnership interest. They looked at it as though no partnership was ever created and no gifts were ever made.

In essence, when 2036 is asserted, the value of the assets contributed by decedent are brought back in, gifts and partnership interest are backed out.

Porter: Look at the situation where the general partner has discretionary authority to distribute, but he is clean with regard to 2036(a)(1). First go to argument that there was no transfer, then get to full and adequate consideration, fully created capital accounts, the partners have received appropriate interests in the partnership, and satisfy the bona fide sale rule. With 2036(a)(2) he would take the position that they are subject to fiduciary duties and that those obligations are enforceable. They are real obligations because the capital accounts are required to be credited with partnership funds that are accrued but not distributed. Given a choice, he prefers to see some type of mandatory distribution if Mom or Dad is the general partner. He cannot go along with the Idea that just because Mom or Day can vote with others to liquidate the entity, they have a 2036 issue. He does not really think that can be the law of the land. If so, Bill Gates would have a 2036 problem with his Microsoft stock because he can vote with all the other owners of Microsoft stock regarding liquidation.

Grove: What about not making any changes to the way you are doing anything with respect to the 2036(a)(2) issues. There are very knowledgeable attorneys who are taking this position.

We do not want to be Chicken Little or the Ostrich with its head in the sand. Look at everything and make your best call.

2036(a)(2) issue assessment. Exhibit 7 from his materials. Helps you assess various factors from weak to strong in your situation. He goes through this analysis with clients and then makes a mutual decision as to what steps to take. Client may want to risk the 2036 issue rather than give something up.

Exhibit 8(a). Strangi II issues where 2036(a)(2) now seems to apply. Most of the interests have been gifted to already to the children. His next exhibit adds an independent trustee to the situation which arguably can take it out of the 2036(a)(2) problem. If the donor is old, worry about the three year rule because of possible lapsed or relinquished rights and donor dies within 3 years. His next exhibit is a different variation when kids enter into a transaction can either sell a significant interest or gift a significant interest to charity.

Recommends a Journal of Taxation article by Joe Kirpix where he discusses the issue of what is a de minimus amount? It is all relative.

Porter: From a litigation perspective, he likes to see more rather than less. A legitimate pooling of both assets and services is the best. In Stone, the children contributed much more in services. The more it looks like a real deal, a real pooling of assets and services, the better chance you have of surviving a 2036 attack. He likes to see children involved in the process regarding how the partnership is going to be structured. He has seen the government questioning witnesses in the Bonguard case right after Stone, and their questions went to the issue of negotiation in the partnership agreement. He thinks it does not have to be a fight, just give everyone the opportunity provide input.

Grove: References to other planning ideas in the Gans Blattmachr Article. It goes into some detail on an approach where there can be a restructuring of the FLP when all rights regarding distribution and liquidation are in the GP interest, and then there is a gift to an incomplete gift trust.

Porter: Wants to mention some of the IRS attacks on the sale to a defective trust. The Service ignores the promissory notes and argues 2701 and 2702. The Service has sought to ignore the transaction and ignore the notes. A recent case he is aware of settled nicely. The Service dropped most of their arguments. But the same things apply. The sales and promissory notes need to be structured as real deals. Page 51 of his outline discusses the facts and circumstances the Service will look at to see if they respect these deals for tr5ansfer tax purposes. He discusses some tips there as well.

Question: The entity is an LLC, and Mom or Dad gave most or all of their interest away already but want to stay on in an investment advisor capacity, but not with regard to distributions. Will that work?

Grove: Thinks that can be workable. It is only the right to designate income or property that is hooked by 2036(a)(2). One of the main arguments in Byrum was that Byrum's right to control the Board by virtue of his majority interest was tantamount to his right to retain or distribute income. The court said no, just because you have impact on investments, just because you can say do not sell the stock out of the trust, and just because indirectly you could affect the amount of income that came to the trust, since you do not have the right to make the distribution decision, you do not have a 2036(a)(2) issue.

Grove: 2038 issue right to amend or revoke. Also cannot not have the right to amend or revoke, but investment power is fine. Cannot have the right to amend or revoke, or to distribute or liquidate.

Grove read a note from Willamette Management Associates that said that having a minimum distribution right in the partnership agreement does not hurt your discount. This right is similar to rights contained in the commercial entities which are being used as comparables in the discount appraisals.

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