Report #13 (Thursday, Cont'd)

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

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This Report contains coverage of the FLIP general session and the Risk Management for Trustees general and special sessions.

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First some Announcements:

First, a special session dealing with Changes for Charities was added to the program after the formal program was printed. This was held on Thursday afternoon. We will try to cover this session at a later date, although we did not have any reporters there due to the late addition of this to the schedule.

Second, when the Institute adjourend at noon on Friday, 1/14/05 , Tina Portuondo, the Institute Director, announced that the official attendance for this year's Institute was 2,618 people, the second largest attendance the Institute has enjoyed since it's inception.

Third, and this is important, the dates for the Institute in January of 2006 were announced. They will be Monday, January 9th, through Friday, January 13th. The location and venue will be the same as this year.

Lastly, while the Institute adjourned on Friday at noon, there are several reports in the pipeline, as there is always a delay between the time the sessions are covered by our reporters and the time that their reports become available for editing and publication. In addition, as this report is being prepared and published, it is already Friday afternoon, and many of our reporters are on their way home from the Institute. They will be able to resume their reporting once they arrive home and have access to e-mail once again. So, please be patient and we will process and publish these reports as soon as we can. Most likely this task will go into the later parts of next week. In due course, all the reports will be posted on the ABA-RPPT Web site. Once that occurs, they will be compiled into one big PDF file with all the extra material edited out. We will announce all this on this list.

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The FLIP side of FLPs: Income Tax Issues
The FLIP Side of FLPs: Income Tax Issues
Thursday Morning, 1/13/05
Presenter: Samuel A. Donaldson, Esq.

Reporter: Shelly D. Merritt, Esq.

Mr. Donaldson's presentation highlighted some of the income tax issues relating to the formation, operation, and liquidation of family limited partnerships. He was quick to point out that the 45 minute presentation was not intended to be a full course on the issues, but more of a refresher on some of the more common issues.

FORMATION OF PARTNERSHIP

Generally, contributions to a partnership are a non recognition event for income tax purposes. There are two primary situations where gain can result when assets are contributed to a partnership:

1. Investment Company (Partnership) Rules under IRC Section 721(b):

Gain (but not loss) must be recognized if the partners create an "investment company partnership" and the partner's contribution of assets results in diversification of the partner's capital account.

A partnership is deemed to be an Investment Company if more than 80% of the assets consist of "portfolio" assets (generally, stocks, securities, cash, notes, options, foreign currency, certain financial instruments, interests in real estate investment trusts, and ownership interests in entities holding such assets) held for investment.

Diversification results where each partner contributes different securities to the partnership so that the end result is that each partner ends up with a share of different securities than those contributed.

A de minimis contribution of non-identical assets is ignored for purposes of these rules. The IRS has ruled that less than 5% of the total value contributed to the partnership qualifies as de minimis.

Ways to avoid Investment Company Rules

Make sure the partnership's assets consist of less than 80% portfolio assets upon formation.

If the partners forming the partnership are unmarried, advise each to contribute substantially identical assets to the partnership.

If the partners are married, have each partner transfer an undivided one-half interest in all of the assets to be transferred to the FLP. Since any transfers between them will qualify for the marital deduction, they can diversify their assets between themselves before contributing them to the partnership.

Have each founding partner contribute an already diversified portfolio to the FLP. A contributing partner's portfolio is diversified if no more than 25% of the portfolioâ€™s value is invested in any one issuer and if no more than half of the value of the portfolio is invested in five or fewer issues.

2. Debt in Excess of Basis IRC Section 752

If a partner contributes property that is subject to recourse debt to the partnership, the partner may recognize gain if the debt exceeds the partner's adjusted basis in the property. The reason for this is that when a partner contributes property to a partnership that is subject to debt, each partner is allocated a share of the debt. As a result, the contributing partner's share of the debt is reduced. Section 752(b) treats this reduction as a cash distribution and Section 731 generally provides that a cash distribution is taxable to the extent it exceeds a partner's basis in his or her partnership interest.

Mr. Donaldson pointed out that this is not generally a problem with FLPs because if the contributing partner is a general partner, then the debt stays with contributing partner because he/she remains liable on the debt. This is not the case for LLCs (and LLPs?).

OPERATION OF FLP

Income and Deduction Allocations

In Mr. Donaldson's opinion, maintaining capital accounts in accordance with 704(b) regulations is only necessary if the partnership has special allocations. If an FLP has special allocations, it may be subject to Section 2701. In addition, Section704(e)(2) requires pro-rata distributions of income from FLPs. As a result, an FLP typically does not have special allocations. In Mr. Donaldson's opinion, it may be better not to follow the capital account rules in the regulations, provided the FLP agreement requires all allocations to be in accordance with the partner's interests in the partnership.

Transfer and Distribution Restrictions

While transfer and distribution restrictions are typically used with FLPs to maximize discounts, Mr. Donaldson pointed out two income tax issues with these types of restrictions.

1. Reg. 1.704(1)(e)(2)(IX) - If a donee of a limited partnership interest is subject to substantial restrictions on transferability of the interest, the income attributable to the interest could be taxed to the donor under the argument that the donor has not given up control and therefore a completed gift has not been made.

2. When a donor gifts a LP interest, basis to the transferee is less than the transferor's basis due to the discounts resulting from the restrictions. Mr. Donaldson pointed out that this may not be bad since parents, who are in a higher tax bracket, will keep more of the basis, reducing their tax liability.

Death of a Partner

1. Close of Taxable Year. 706(c)(2)(A) provides that upon the death of a partner, the taxable year of the partnership closes with respect to the deceased partner. The deceased partner's final income tax return includes all pass-through items for the short taxable year ending at death, either through an interim closing of the books or through a pro rata allocation based on the number of days in the period. Mr. Donaldson recommended to not provide in the partnership agreement that one approach or the other is required, but instead allow the remaining partners and the deceased partner's fiduciary to decide at the time which approach is better.

2. Adjustment to Basis Under IRC Section 754. Section 754 allows a partnership to step up the inside basis of its assets to equal the outside basis on the death of a partner. Mr. Donaldson pointed out that discounts on the partnership cause the fair market value of the partnership interests (the outside basis) to be less than the value at liquidation resulting in a less than full step up in basis on the assets.

LIQUIDATION OF THE FLP

There are two approaches to liquidation of an FLP:

1. Sell all of the assets owned by the partnership and then liquidate. IRC Section 704(c) requires any gain from the sale of appreciated property contributed to a partnership (built in gain) must generally be allocated to the contributing partner. Any excess gain is then allocated based on the partnership agreement. After this allocation of gain, a distribution of the remaining cash proceeds is taxable only

to the extent that the distributions exceeds a partner's outside basis.

2. In kind distributions of partnership property. Could give every partner a proportionate interest in every asset or cherry pick which assets go to which partners.

IRC Section 704(c)(1)(b) provides that if a partner contributes built in gain property to the partnership and such property is distributed within 7 years to another partner, the contributing partner must recognize the gain. A successor in interest to a contributing partner inherits this liability for the built in gain.

Exceptions:

-If property is distributed back to the contributing partner or his successor in interest.

-If a proportionate distribution of the built in gain property is made.

-Selling built in gain property and then distributing proceeds.

IRC Section 737 provides that if a partner contributes built in gain property to the partnership and within 7 years distributes other property to that partner, effectively this is a sale of the property and the contributing partner must recognize gain.

Exception

-Property distributed to contributing partner. Mr. Donaldson pointed out that a successor in interest is not an exception under IRC Section 737 - it does not have same language as 704(c)(1)(b).

IRC Section 731(c) provides that a distribution of marketable securities is deemed to be a distribution of cash. This gives rise to gain if the distribution exceeds the partner's basis.

4 Exceptions

-Contributing partner exception (no similar rule for successor in interest)

-Form an investment partnership: If 90% or more of the partnership assets are marketable assets, a distribution to a partner who did not contribute marketable securities will not trigger 731(c).

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Risk Management for Trustees
General Session Thursday Morning 1/13/05
Special Session 3-A, Thursday Afternoon 1/13/05
Presenters:
A.M. Session - William C. Weinsheimer Esq.
P.M. Session - William C. Weinsheimer Esq. and John T. Brooks Esq.

Reporter: Eugene Zuspann Esq.

NOTE: Due to limitations on reporting time available to cover these sessions, this report may not provide complete coverage of these sessions. If further coverage is obtained at a later date, we will publish it at that time.

The fact situation involved a typical A-B trust. The family trust provides mandatory income to the spouse and discretionary income between the spouse and the children. The marital trust mainly consists of 1 asset. The Trust provides that the trustee is directed to retain all shares of my beloved company without regard to the usual concern of diversification or otherwise. Later in the instrument is a provision that this stock may only be sold if necessary to prevent calamity to all concerned.

John Brooks started with a summary or the law:

There is an affirmative duty to disclose to the beneficiary. Restatement Trusts, 2nd §173 The duty to inform may be modified by the trust instrument or the state statutes. The fiduciary is obliged to provide complete and accurate information to the beneficiary.

There is a duty to account. To whom must the trustee provide these accounts? See the The instrument and any relevant statutes? Can the instrument override the statute? It depends on the language in the statute.

When does the statute of limitations run? Statutes vary - check your state. Consider providing a form to the beneficiary to sign and return which evidences the beneficiary's approval of the trustee's accounting and receipting for each year. This gives the beneficiary the ability to object on a timely basis rather than much later. The object is to take away the element of surprise (to the fiduciary). An approval of accounts is not a release. Pg 16 You can add language in the release so it specifically covers all actions by the trustee.

In a terminating trust, you may withhold a distribution until the beneficiary provides a release or until the court grants a release. You may not withhold other distributions that the beneficiary is entitled to receive.

There has been an erosion of the attorney-client privilege, and John thinks this will continue. There are exceptions to the attorney client privilege in the materials. The client's state of mind is material. This area is in a state of flux. As a general rule, opinions by counsel that have been paid for out of trust funds are discoverable. John said that he has never lost this argument.

The operating manuals and policy statements will be at the top of the plaintiff's list of things to see. John has kept some of these out as a trade secret. If you have not followed your own policy, you are in a defensive posture.

Communicate clearly with the client. Do not say you will do something and not carry it out - the client will be expecting action and this makes for an unhappy client.

Our on-site local reporters who are present in Miami this year are Gene Zuspann Esq. of Zuspann & Zuspann in Denver, Colorado, Shelly Merritt Esq., a solo practitioner in Boulder, Colorado, Connie T. Eyster Esq. of Hutchinson, Black & Cook LLC in Boulder, Colorado, Jason Havens Esq. of Havens & Miller PLLC in Dustin, Florida, Bruce Stone of Goldman, Felcoski & Stone, PA of Coral Gables, Florida, Herbert L. Braverman Esq. of Walter & Haverfield LLP in Cleveland, Ohio, and Jeffry L. Weiler of Benesch, Friedlander, Coplan & Aronoff LLP of Cleveland, Ohio. The editor again this year will be Joseph G. Hodges Jr. Esq, a solo practitioner in Denver, Colorado who is the Chief Moderator of the ABA-PTL List.

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