Report #7 (Tuesday, 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 additional coverage of the Tuesday sessions.

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Death, Estate Taxes, and Liquidity Needs - Three Strikes for the Family Business Dennis I. Belcher Esq.

Report by Connie T. Eyster Esq.

Mr. Belcher first discussed material not in his materials concerning a Graegin promissory note transaction used in the case of Klein v.
Hughes, 2004 WL 838198, an unpublished California opinion reported at p. 87 of the Recent Developments material.

The decedent in Klein died in 2000 with an estate worth $300 million.
The estate tax liability was approximately $200 million. Most of the trust assets were interest in limited liability companies from which the estate could not compel distributions and which companies severely
limited the rights of the estate to transfer its interest. To pay
the estate tax, the estate negotiated with the IRS to borrow $50 million from an unrelated third party, which was an LLC formed by a tax attorney. The LLC would borrow the funds from the decedent's company and then loan the money to the estate. To give the loan substance, the LLC stood to earn over $12 million in fees through this transaction. All of the principal and interest on the note at a date 25 years later with no interim interest due. Prepayment of the loan was prohibited, and thus the estate would incur $309 million of
deductible interest expense by the due date of the loan. Section
2053 of the IRC would permit a current estate tax deduction for all interest payable throughout the term of the 25-year loan, with no present interest discount, reducing the estate's liability for estate tax by $166.5 million. As stated in the materials, when you have estate liquidity issues, this case indicates the desirability of negotiating with the IRS over the payment of estate taxes. A hidden downside to this favorable result, however, is the income tax that would need to be paid on the interest earned on the loan.

Turning to the materials for this program, the speaker began by emphasizing that when speaking with a private business owner about estate planning, often the method for paying the estate tax burden is to purchase life insurance. However, in some instances the client is adverse to purchasing life insurance, life insurance might be prohibitively expensive for the client in light of all circumstances, or the life insurance currently held by the client will not cover all the estate liquidity needs. In those circumstances, the client might consider other alternatives to prepare for payment of the estate tax such as making a § 6166 election.

In order to make a § 6166 election, the following requirements must be met:

(a) the decedent must have been a citizen or a resident of the U.S.,

(b) more than 35% of the decedent's adjusted gross estate must consist of an interest in a trade or business, and

(c) the personal representative of the decedent's estate must make an election on a timely filed estate tax return.

If the estate qualifies for the election, it will be able to defer payment of the estate tax on the closely held business interests for
14 years. In the first five years of the deferral period, the estate can elect to make interest only payments. In addition, the estate receives a favorable, 2% interest rate on the first $540,000 of estate tax deferred and a rate of 45% of the federal underpayment rate for the balance of the deferred tax. However, the estate can no longer get income or estate tax deductions for the interest payments. Also, practitioners should be aware that IRC § 2035 adds a complication in that gifts made within 3 years of death are brought back into the estate to determine the 35% closely held business interest eligibility requirement.

Determining whether the decedent held interest in a trade or business can be a difficult determination, especially where the decedent held interest in rental real estate. The IRS takes the position that passive rental of real property does not qualify for the benefits of § 6166. However, the private letter rulings are all over the board on this issue. A net cash lease arrangement where the owner has no duties will not qualify for the § 6166 election. The more duties the owner has, the greater likelihood that the asset will qualify. Where the decedent is an owner of real estate that is leased to a company in which the decedent is a primary stock holder, again, the amount of duties of the landowner under the lease will determine whether the asset will qualify for the § 6166 election. The speaker suggests that duties of the landlord must be in the lease or the real estate must be conveyed to the corporation itself in order to assert the election.

An estate tax audit of the §6166 election will ask very fact specific questions such as:

What was the schedule of rental payments?

How active was the decedent's management of the property?

Who prepares and maintains the property?

Who takes care of utilities, gardening and other such responsibilities?

Who pays the bills?

Who inspects the property?

Who makes bank deposits?

Clients often have holding companies and those rules should be reviewed carefully (see p. 5-22 of the materials) if the client

expects to qualify for the §6166 election. Generally, the IRS takes
the position that if the sole asset of a company is stock in another company, it will not qualify for the § 6166 election. However, if a parent company owns 20% or more in value of the voting stock of another corporation or the corporation has 45 or fewer shareholders, and 80% or more in value of the subsidiary corporation is attributable to assets used in carrying on a trade or business, then the holding company and subsidiary will be treated as one company for the purposes of making the § 6166 election.

Note that the deferral of unpaid tax is accelerated if the business on which the election was made is sold during the deferral period.

One area that the IRS has really started to change its position on is the lien and bonding requirements (see pages 5-33 and 5-34 of the materials). In March of 2000 the Treasury Inspector General for Tax Administration issued a final audit report entitled, "The IRS Can Improve the Estate Tax Collection Process." The report stated that a vast majority of the § 6166 deferrals were not subject to liens and many of those not subject to liens were in default.

In addition to seeking liens on deferred assets, the IRS is now also seeking liens on the property held by the companies in which the estate owns interest. This is to protect against cases like that of IRS v. Skiba. In that case, the decedent had owned a car dealership and the estate made a § 6166 election for the business interest held by the estate. The car dealership started to do badly and the estate sold the underlying assets. When the business went bankrupt, the IRS was given the status of a general, unsecured creditor because, while it had an interest in the business itself, it did not have a lien on the underlying assets.

Now, the IRS is filing liens on underlying assets rather than on the trade or business interests that are reported on the estate tax return. Mr. Belcher cautions that negotiating with individual agents regarding these liens is a tricky business and practitioners should be wary that they may see some abuses by the IRS in this regard.

When doing estate planning, be aware that use of a sale to a defective grantor trust can disqualify the owner's estate for the benefits of §6166. The promissory note issued by the grantor trust will be the asset of the owner's estate, not the underlying business interest and the owner may not meet the 35% eligibility requirement.

An alternative strategy to relying on § 6166 when there are estate liquidity issues is to borrow money from a third party with a deduction for interest payments made on the loan, often referred to as
a Graegin note. In Estate of Graegin v. Comm'r, T.C. Memo 1988-477,
the issue involved the estate borrowed money from a company in which the decedent held an interest in order to pay the estate tax. The loan was structured with a balloon payment of principal and interest upon maturity of the note (15-year term). The estate, however, took an upfront deduction of the interest due on the note and the tax court allowed the deduction as an expense of administration. The IRS issued a litigation Guideline Memorandum in response to the Graegin decision stating that, in order for the interest to be deductible, the interest must be certain to be paid, and the amount must be subject to reasonable estimation. In addition, the loan must have substance and have commercially reasonable terms. (See p. 5-52 of the materials).
PLR's since the Graegin decision have blessed the Graegin note: PLR
199903038 and PLR 199952039 (see also PLR 200449031 not in materials).

Final words of advice:

If considering one of the Graegin notes, RUN THE NUMBERS. The income tax on the interest earned by the note may make the transaction less favorable than it may appear at first blush.

The IRS lien requirements make the §6166 election a more burdensome and more costly alternative.

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I Fell and My HIPAA is Broken
Michael L. Graham Esq.

Report by Eugene Zuspann Esq.

For Mike's Powerpoint presentation, go to http://www.ilsdocs.com:

HIPAA = Health Insurance Portability and Accountability Act of 1996

Although not defined in the HIPAA regs, there are two rules:
The Agency Rule addresses the situation in which a 3rd party is authorized to request a patient's Protected Health Information (PHI). This is the form that the client signs for the agent.
The Release Rule dictates the form and requirements for a request for the release of PHI. These requirements dictate the requirements for the form required by the hospital.

What do we have clients sign in order to obtain their PHI? - a form that meets the requirements of the Agency Rule.

Note that the term 'Authorization' is used in two different contexts.
- the form provided to the medical provider is very specific (the hospital form)
- the form provided to an agent allowing the agent to sign the hospital form is not as specific

The Release Rule sets out a number of elements that must be included in the release provided to the medical provider. Pg 15-16. Mike believes that you are not going to get all of this in your power of attorney or your trust agreement.

There are no magic rules describing the requirements of the Agency Rule. The document must include an authorization to make decisions relating to health care. His outline (pg 13) provides language for a power of attorney.

There is a problem with a springing power of attorney. This probably requires a physician to certify that the HCPOA is now effective. HIPAA does have the key to the springing power in §164.510(b)(3). If the individual cannot agree, the hospital may, in its professional judgement, determine that the disclosure is in the best interests of the patient and then the hospital may release the information. This is discretionary with the doctor or hospital and there is no requirement that the recipient be the health care agent that the individual has picked.

Will and trust drafting issues.

The client still need to sign
a medical power of attorney
a durable power of attorney
If possible, still sign one of the HIPAA release in Mike's exhibits. He adds language to the form

authorizing anyone appointed under a medical power of attorney.

The problem with documents arise when disqualifying an individual as executor/trustee if such individual is lacking competency. The executor/trustee has generally not given an agency document. You could seek an authorization from the person at the time of appointment but this is a bad way to start a relationship. You are also unlikely to put all required information in the will or trust agreement.

Mike's materials contain two alternative provisions that can be added to the instrument to deal with the incompetency of the trustee. The first provides that the fiduciary's continued service is conditioned upon the fiduciary's voluntary release of his/her PHI. The obligation to provide the release is purely discretionary with the fiduciary, but failure to provide a release is considered an automatic resignation. His language is in the materials at page 34. The issues in these provisions are harassment and the dependability of getting a certificate from physician.

An alternative provision (pg 33) requires that the fiduciary is required to maintain a currently effective release. Mike finds this very troubling. There can be an inadvertent termination of fiduciary status. There are also waiver of right issues and privacy issues for the fiduciary.

Another alternative is the appointment of a trust protector to make trustee decisions independently of proof (without cause). A fourth alternative is to appoint a family member to decide competency issues.

Summary
1. Add suggested language to the DPOA
2. Execute a medical power of attorney
3. Execute an actual HIPAA release form 4. Add specific language to your will and trust agreements

Q&A Session:

Q: Must a release be a single purpose release?
A: The one to the hospital does have a single purpose and must contain all of the language required by the Release Rules, but the one for the agent does not. However, you must have a separate document for psycho-therapy notes.

Q: Will releases that satisfy state law satisfy HIPAA? The release must satisfy HIPAA. However, the agency authorization for someone to sign the release will satisfy the HIPAA requirement because state law will govern the power of an agent.

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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