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

Report #8 (Tuesday, Cont'd)

==

This Report contains some news coverage and additional coverage of the Tuesday sessions on FLPs and GRATS

==

NEWS ITEMS

1) Alaska Trust Company, an exhibitor here at the Institute, has informed us that the Trust forms they used to provide on CD-ROM are now available for viewing and download in PDF format from their Web site at http://www.alaskatrust.com.

2) Apropos the discussion of Circular 230 during the Recent Developments presentation on Monday afternoon, ALI-ABA has just announced the following CLE session:

The New Circular 230 Regulations: What You Need to Know Wednesday, February 9, 2005, 1:00 - 2:30 p.m. Eastern

Join the American Bar Association Section of Taxation for a 90-minute Teleconfernce and Live Audio Webcast on The New Circular 230
Regulations:
What You Need to Know Wednesday, February 9, 2005, 1:00 - 2:30 p.m. Eastern

The long-awaited Circular 230 regulations were issued December 17, 2004, and will become effective in June 2005.

Learn what you need to know to comply with the new rules from Treasury and IRS officials and private practitioners who have played a significant role in the drafting of these much-anticipated regulations.

Our Expert Faculty
DONALD L. KORB, Chief Counsel, Internal Revenue Service, Washington, DC ERIC SOLOMON, Deputy Assistant Secretary (Regulatory Affairs) and Acting Deputy Assistant Secretary for Tax Policy, U.S. Department of Treasury, Washington, DC RONALD M. WIENER, Wolf, Block, Schorr & Solis-Cohen, LLP, Philadelphia, PA WILLIAM M. PAUL, (Moderator), Covington & Burling, Washington, DC

Register:
Phone: 800.285.2221 and Select Option "2", M-F, 8:30 a.m. - 6:30 p.m. Eastern

3) Northern Trust reports that it has update its form book The book includes will, trust agreements for

one settlor, trust agreements for community property, and miscellaneous forms such as irrevocable insurance trusts, CRUT, CRAT, QDOT and gift trust agreements.

The book is available for $250 but includes no disk or CD. An online product is available for $350 for the first year ($100 renewal) or $500 for multiple users ($200 renewal). The product is to be available in February
2005 at www.northerntrust.com. The brochure also indicates that the web version will allow the user to "use a state-of-the-art document assembly program" (not identified) to create documents.

===

Current Valuation Issues Involving FLPs and LLCs
Presenter: John W. Porter Esq.

Reporter: Shelly D. Merritt Esq.

Mr. Porter gave an in depth update on IRS arguments against FLPs and recent cases affecting the IRS's position.

IRS Arguments Regarding Family Limited Partnerships

1. Substance over form argument (Murphy v. Commissioner). Argument that if the primary purpose for creating the partnership is to reduce transfer taxes, it can be ignored for tax purposes. Recent cases have pretty much eliminated this argument. So long as a partnership meets state law formalities, it is a valid entity for tax purposes regardless of motive (Kerr v. Commissioner and Estate of Strangi v. Commissioner)

2. IRC §2703 Argument. Section 2703 provides that any option, agreement, or other right to acquire or use property at a price that is less than fair market value of the property is disregarded when valuing the property unless it is a bona fide business arrangement, it is not a device to transfer the property to family members at less than full and adequate consideration, and its terms are comparable to similar arm's length arrangements. The government has used IRC §2703 to argue that the partnership agreement itself is an agreement under 2703 and therefore is disregarded for valuation purposes. The IRS has lost this argument and the cases have held that 2703 cannot be used to ignore completely the existence of the entity agreement itself. It's purpose is to ignore abusive buy sell agreements.

3. IRC §2704(b) Argument. Section 2704 provides that certain "applicable restrictions" must be disregarded in determining the value of a transferred ownership interest if certain requirements are met. An "applicable restriction" is a restriction that is more restrictive than state law. In Kerr, the IRS argued that provisions in the partnership agreement limiting a limited partner's right to liquidate was an applicable restriction under
2704(b) which must be disregarded when valuing the interests transferred.
The IRS also argued that a limitation on a partner's right to withdraw from the partnership was an applicable restriction. Fifth Circuit affirmed Tax Court's holding that these restrictions were not "applicable restrictions."
This argument is not being seen anymore in the cases.

4. Gift on Formation Argument. The IRS has argued that a gift occurs when
a partnership is created because the value of the partnership interest received by the person creating the partnership is less than the value he/she put into the partnership (i.e. due to discounts). The IRS

lost on this argument in Estate of Jones v. Comm’r and in Estate of Strangi v.
Comm’r. The Courts have held that so long as a partner’s capital account is properly credited when property is contributed, the partner’s interest in the partnership is based on his/her capital account, and upon liquidation, the partner receives the value of his/her capital account, then there is no gift on formation.

In Senda, the Court found that the parents had actually made a gift of the property contributed to the partnership directly to their children, rather than a gift of limited partnership interests. In this case, the parents made a capital contribution of stock to an existing FLP and on that same day purportedly made gifts of partnership interests to their children (the assignments were not signed until several years later). However, there was no evidence that the contribution was ever actually credited to the parents’ capital accounts.

To avoid gift on formation, contributions to a partnership should be credited to the contributing partners’ capital accounts before any transfers of limited partnership interests are made in order to make it clear that the gift is of the partnership interest and not the capital contribution.

5. IRC §2036(a) Argument

Elements of Section 2036(a):

1) Transfer by decedent

2) Other than a bona fide sale for adequate and full consideration

3) Under which transferor has retained either:

-(a)(1) the possession or enjoyment of, or the right to the income from, the property, or

-(a)(2) the right, either alone or in conjunction with another person, to designate the persons who shall posses or enjoy the property.

IRC 2036(a)(1)

The Service has succeeded using 2036(a)(1) where the facts of the situations are such that the partnership assets are not kept separate from the donor’s assets. Some examples:

Commingling of partnership assets with personal assets

Contributing personal use assets to the partnership (i.e., contributing a house to the partnership) (Estate of Strangi v. Comm’r)

Assets of partnership used to pay personal expenses (Estate of Thompson v.
Comm’r)
Need to make sure that the decedent has enough assets outside partnership to live on - if put everything in, it makes it easier for government to argue that the decedent was using partnership assets to pay personal expenses.

Government has argued that in the case of an elderly person, there needs to be enough assets outside

of the partnership to pay estate taxes (Strangi).
Mr. Porter believes this is irrelevant, however, there is trend toward looking at post death events.

Section 2036(a)(1) can be avoided by taking precautions to make sure entity is respected.

IRC Section 2036(a)(2)

Where a senior family member retains a GP interest, the government has argued that he/she has the ability to make distribution decisions which controls who enjoys the benefit of the partnership.

Estate of Strangi v. Comm'r: In Strangi, the decedent formed an FLP with his children and a corporate GP. Mr. Strangi took back a 99% limited partnership interest and 47% of the 1% corporate GP. His children owned the remaining 53% of the corporate GP. Mr. Stangi's son-in-law managed the day to day affairs of the corporate GP and the partnership. His son-in-law was also his attorney-in-fact under a power of attorney. A host of bad facts supported finding that Section 2036(a)(1) applied. The government also argued that the son-in-law's power to control distributions as a manager of the corporate GP should be imputed to the decedent as his attorney-in-fact.
The taxpayer argued that any power to make distributions as a GP was limited by a fiduciary obligation of the GP to the limited partners (citing United States v. Bynum, 408 U.S, 125 (1972)). The Court disagreed finding that Bynum did not apply because a GP who also owns 99% of the limited partnership assets has no fiduciary obligation to de-minimus partners. In some disturbing dicta, the Court went on to say that even the right as a limited partner to vote on liquidation is a 2036 (a)(2) power since a limited partner can act in conjunction with the other partners to cause the partnership to liquidate. This issue will be addressed on appeal. Oral arguments are set for March 2005.

Kimbell v. United States, 244 F.Supp.2d 700 (N.D. Tex 2003). IRS successfully argued at the district court level that an FLP should be ignored under §2036(a)(2), but was reversed on appeal by the 5th Circuit.
In this case, the decedent's revocable trust formed an FLP with the bulk of its assets and took back a 99% limited partnership interest and 50% interest in an LLC GP. The 5th Circuit found that a 50% interest in the GP was not enough to control the beneficial enjoyment of the property.

To avoid 2036 (a)(2):

1) the partnership agreement should not provide that the GP has no fiduciary obligations.
2) the partnership agreement should require mandatory distributions of available cash to the partners to avoid the argument that the GP has control over the distributions.

Both 2036(a)(1) and (a)(2) can be avoided by satisfying the bona fide sale exception.

Kimbell

Bona fide sale. The 5th Circuit looked at objective facts to determine if the partnership was treated as separate entity, including non tax reasons for creating the entity. The Court seemed to focus on fact that in Kimbell, the decedent owned an 11% working interest which required active management. Therefore a valid non-tax reason existed for the partnership.

Adequate and full consideration test. The Court found that so long as the value of assets transferred to a partnership are properly credited to the capital account of the contributing partner, the partner's interest in the partnership is based on his/her capital account, and the partner receives his/her capital account upon liquidation of the partnership, then this test is met.

Estate of Thompson

3rd Circuit affirmed Tax Court's finding that §2036(a) applied and that bona fide sale exception was not met.

Bona fide sale. Court found that there was no non-tax reason for the creation of the partnership and therefore there was no "bona fide sale."
The 3rd Circuit noted that the fact that the partnership consisted mostly of marketable securities and that the investment strategy did not change once contributed to partnership was a significant factor in finding that there was no "business" purpose to the partnership. This is very disturbing since there can be many non-tax reasons for contributing marketable securities to an FLP, such as protection from partners' creditors or a divorcing spouse.

==
Care and Feeding of GRATS

Presenter: Carlyn S. McCaffrey Esq.

Reporter: Herbert L. Braverman Esq.

Carlyn S. McCaffrey, who is as well known as any estate planning attorney in this country, discussed "The Care and Feeding of GRATs--Enhancing GRAT Performance Through Careful Structuring, Investing and Monitoring". The "grantor retained annuity trust" is one of the most powerful, currently available estate planning techniques. It is a trust that pays an annuity to its grantor for a specific period of time and then shifts the beneficial interest to another beneficiary or beneficiaries. It is a "qualified annuity interest" if its terms satisfy the requirements set forth in Treas. Reg. 25.2702.3 There are 8 governing instrument requirements, including: 1. annuity amount must be payable at least once in every 12 month period to the appropriate payee.
2. the funding of annuity payments by notes or certain other financial arrangements must be prohibited. 3. the annuity amount must be a fixed amount in dollar terms or percentage. The regs. Do allow modifications to the amount from time to time. 4. If a formula approach is used, there must be an adjustment provision to correct any errors in determining values. See Treas. Reg. 1.664-2(a)(1)(iii) discussing charitable remainder annuity trusts. 5. Additional contributions must be prohibited in the trust instrument. 6. Commutation must be expressly prohibited in the trust instrument. 7. The trust instrument must prohibit payments to or for the benefit of any other than the annuitant until the expiration of the qualified interest. 8. The term of the qualified annuity must be fixed in the trust instrument for (i) the life of the annuitant, (ii) a specified term of years or (iii) the shorter of those 2 periods.

The grantor will pay all of the income taxes on earned income of the GRAT; it is a grantor trust when properly prepared. Upon termination, the property of the GRAT is transferred to the remainder beneficiary(s) free of gift tax.

Carlyn's primary focus in the presentation was upon enhancing GRAT performance through careful structuring, investment selection and monitoring of GRAT performance over time.

She indicated the following structural issues in this regard:

1. Create a GRAT with no taxable gift(s); make the actuarial value of the annuity payments=the value of the property transferred to the GRAT.
A GRAT created without a taxable gift is known as a "zeroed-out" GRAT, as in the Walton case. I believe Carlyn prefers a small taxable gift to be properly reported, causing the applicable statute of limitations to begin running.

2. Short term GRAT versus long term GRAT. A shorter term minimizes the number of years of poor performance by GRAT assets and reduces the likelihood of grantor's early death during the term of the GRAT. On the other hand, the 7520 rate could increase dramatically and hamper the re-GRATTING plan and a change in tax laws could adversely effect the plan. Longer term GRATs lock in a low interest rate over a longer term and work well for non-marketable assets without cashflow . Nevertheless, a series of short term GRATs seemed to be her favorite approach.

3. Amount of each annuity payment was considered and it was suggested that a formula approach might prove best in many cases. Also keep in mind the use of graduated payments (see her table 5 on page 6-17).
Formula clause approach in GRATs is ok, unlike the IRS stance toward the use of these clauses in other planning devices.

4. Use single asset GRAT. This prevents poor performing assets from diluting good performance of other assets.

5. Use of income tax payment reimbursement clause. Best to make it discretionary for the trustee and to avoid it altogether if local law is a problem.

6. Marital deduction planning. Give grantor the power of appointment to do marital deduction for that portion of the GRAT that would be otherwise includable in her/his estate.

7. Avoid use of spendthrift clause.

8. Identify the remainder beneficiaries, either individual(s) and /or a free standing trust(s).

9. Use a power allowing an independent trustee to amend the trust as necessary.

10. Plan profit level carefully so that remainder beneficiary(s) gets the amount grantor desires as precisely as possible, as long as the property in the GRAT appreciates sufficiently.

Selecting investments for the GRAT carefully may enhance the probability of success. Assets mentioned by Carlyn included those with restrictions that provide a basis for discounting the value of the property transferred into the GRAT, assets with limited marketability like fractional shares or non-controlling interests in a family business, certain stock options and derivatives.

Monitoring the GRAT plan is also very important. Who will do this?
When to get out of an underperforming GRAT and start over with new arrangement? Protecting gains obtained in the GRAT and assessing mortality risk (how is the grantor feeling these days?) When and how to buy out the remainder of a GRAT. In short, planning is a dynamic process--don't neglect the follow up!

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.

GENERAL INFORMATION ABOUT INSTITUTE
Inquiries/Registration
Philip E. Heckerling Institute on Estate Planning University of Miami School of Law Center for Continuing Legal Education P.O. Box 248087 Coral Gables, FL 33124-8087
Telephone305-284-4762 / FAX305-284-6752
Web site www.law.miami.edu/heckerling
E-mail heckerling@law.miami.edu
==
Headquarters Hotel - Fontainebleau Hilton
4441 Collins Avenue
Miami Beach, FL 33140
Telephone (305) 538-2000, FAX (305) 674-4607
===
NOTICE: Although audio tapes of all of the substantive session at the Miami Institute currently are only made available to Institute registrants for purchase, the entire proceeding of the Institute are published annually by Lexis/Nexis. For further information, go to their Web site at http//lexisnexis.com/productsandservices. The text of these proceedings is also available on CD ROM from Authority On-Demand by LexisNexis Matthew Bender. For further information, contact your sales representative, or call (800) 833- 9844, or fax (518) 487-3584, or go to http//www.bender.com, or write to Matthew Bender & Co., Inc., Attn. Order Fulfillment Dept.,
1275 Broadway, Albany, NY 12204. Note that Special Session, workshop and fundamentals program materials are not published.
