High Net Worth Family

TAX REPORT

LOEB & LOEB adds Knowledge.

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Welcome to the first edition of the *High Net Worth Family Tax Report*, published by Loeb & Loeb's High Net Worth Family Practice Group. We plan to publish this report approximately quarterly. Our purpose is not to publish a newsletter that simply discusses recent developments in the tax law. Instead, we will highlight developments that illustrate either planning opportunities that may be of interest or pitfalls to be avoided. Sometimes even the pitfalls reveal what could have been a good planning opportunity, if properly structured. The report will focus only on issues that are likely to be of interest to high net worth taxpayers. If you find that our report is useful, please feel free to share it with other family members, friends and colleagues. Also, feel free to contact any member of our high net worth Family Practice Group if you would like to obtain more information about anything discussed in this or future reports.

Loeb & Loeb Adds Prominent Trusts and Estates Team

Two Partners and Five Associates Join the Los Angeles Office

We are delighted to announce that Stuart Tobisman and Leah Bishop joined the firm on March 31 as partners in the Los Angeles office. They were previously partners at O'Melveny & Myers LLP, and brought their entire team of five associates, four paralegals and other staff with them. The addition of this outstanding team evidences Loeb & Loeb's continuing commitment to the representation of high net worth families.

Mr. Tobisman's and Ms. Bishop's clients include high net worth individuals and many of the largest and most prominent public charities and private foundations, both in Southern California as well as nationally.

Mr. Tobisman has extensive experience in all aspects of estate and tax planning for individual clients and in the administration of estates and trusts. His clients include prominent individuals in industry, commerce, and entertainment, as well as individuals, banks, and trust companies acting in fiduciary capacities. Mr. Tobisman advises owners of closely held businesses in connection with estate and tax planning matters.

Mr. Tobisman has been named in The *American Lawyer* magazine's "Best Lawyers in America" and as a Southern California Super Lawyer by *Los Angeles* magazine, and he is a lifetime member of the national *Who's Who* registry.

Leah Bishop focuses on estate and gift tax planning for high net worth individuals and closely held businesses and in the administration of estates and trusts. Ms. Bishop also has extensive experience in the areas of charitable giving and exempt organizations.

Ms. Bishop's estate planning experience includes all aspects of legal matters pertaining to high net worth individuals, including probate court procedures, living trusts, gift and insurance trusts, and sophisticated transfer tax techniques. Her charitable giving and exempt organizations representation involves all aspects of tax and corporate nonprofit law. She represents many leading southern California private foundations, museums, and other public charities. She is a Fellow of the American College of Trust and Estate Counsel and Vice President and Trustee of the Jewish Community Foundation. Ms. Bishop has received numerous awards and distinctions, among them her inclusion in The *American Lawyer* magazine's Best Lawyers In America. She is also a lifetime member of the national *Who's Who* registry and has been identified by *Town & Country* magazine as a "tax and estate planning partner par excellence" in an article entitled "The Touchiest Subject." In 2002 she was nominated for The *Los Angeles Business Journal*'s "Women Who Make A Difference Award." Most recently, Ms. Bishop was named as a Southern California Super Lawyer by *Los Angeles* magazine.

California Limited Liability Company Fee Held Unconstitutional

The California Superior Court for the County of San Francisco has held that the fee California imposes on limited liability companies violates the United States Constitution. In *Northwest Energetic Services, LLC v. California Franchise Tax Board*, the court ruled that the fee imposed by California Revenue & Taxation Code Section 17942 (ranging from $900 up to $11,790 annually) violates both the Due Process and Commerce clauses of the Constitution because it is based upon the limited liability company's gross income without apportionment. The $800 annual fee paid by all California limited liability companies is not affected by this decision.

While the case will probably be appealed, it is a good idea to file protective refund claims right away to prevent the statute of limitations from barring a claim later. The applicable statute of limitations is normally four years from the return's due date or, if later, the actual filing date if an extension was obtained. The Franchise Tax Board has established a dedicated fax line (916-845-9796) that taxpayers can use to file claims.

The refund claim should include: i) the LLC name and state identification number; ii) a statement indicating this is a protective claim; iii) the tax years involved; iv) the amount of the claim; v) a statement that the LLC fee is unconstitutional; vi) name, phone, and fax numbers for the contact person.

Please feel free to contact us if you have questions about filing refund claims.

Avoiding Double Taxation with Respect to Corporations

Taxpayer loses in court, but the case highlights planning opportunities

In the recent Tax Court case of *Chickie's and Pete's, Inc. v. Commissioner*, T.C. Memo 2005-243, the taxpayer lost, at least in part. Nevertheless, the case serves to illustrate a couple of valuable tax planning concepts. At issue in the case was whether a corporation could deduct royalties paid to its shareholder for the use of a trademark owned by the shareholder. The corporation paid its shareholder royalties in excess of $900,000 during the year at issue. The IRS determined, and the Tax Court agreed, that only $440,000 was a reasonable amount. Consequently, the corporation's deduction was so limited.

Although the taxpayer lost, the case illustrates a valuable tax planning concept. Businesses operated in corporate form are subject to tax at two levels. The corporation pays tax on its income, and the shareholders must pay additional tax when they take dividends from the corporation, unless the shareholders can find ways to pay out amounts for which the corporation receives a tax deduction. Compensation for services rendered is one such way. Another, as illustrated here, is for the shareholders to own assets used by the corporation and lease or license those assets to the corporation.

Reasonable payments for the use of property may be deducted. The owner of Chickie's and Pete's did extract $440,000 from the corporation with only one level of tax.

The second important point illustrated is that assets that may appreciate substantially in value should not be owned by corporations if such ownership can be avoided. If the corporation owns appreciating assets, double tax will result if they are sold and proceeds are distributed to the shareholder. If the shareholder owns the assets, only one level of tax results. In addition, if the asset gives rise to long-term capital gain, the federal tax rate is only 15% if sold by an individual, but 35% if sold by a corporation.

A better way to avoid these tax problems is to conduct your business through a form of "pass-through" entity, such as a limited liability company, which does not itself have to pay federal income tax. If your business must be conducted in corporate form, then consider owning appreciating assets like real estate and intellectual property outside of the corporation. This must be done at start-up. Once the corporation owns these assets, you cannot take them out without creating adverse tax consequences. Similarly, a corporation cannot be converted to a partnership or limited liability company without a tax impact.

We have a variety of techniques available to mitigate the double tax aspects of corporations. Please feel free to contact us to assist you with these issues.

Estate Tax Value of Closely Held Business Can Be Fixed by a "Buy-Sell" Agreement, But Only If It Is Properly Structured among Parties Dealing At Arm's Length

A common source of controversy between taxpayers and the IRS is the valuation for estate tax purposes of a decedent's interest in a closely held business. Different valuation approaches can yield widely disparate results. The IRS always favors the approach that yields the highest value, while taxpayers usually find the approach giving the lowest value the most logical.

A series of court cases over the years has established that if properly structured, owners of closely held businesses can enter into agreements that will fix the value of the business for estate tax purposes. Such agreements are typically called "buy-sell" agreements and are entered into among all the business owners and sometimes the business entity as well. They usually provide that upon the death of one of the owners, his or her estate must sell the decedent's interest either to the other owners or to the entity itself. The other owners and/or the entity are also required to purchase the interest. The price is usually determined by a formula contained in the agreement.

For such an agreement to be effective to fix the value of the interest for estate tax purposes, courts have required (i) the price must be fixed and determinable under the agreement; (ii) the agreement must bind the parties during life and at death; and (iii) the agreement must have been entered into for bona fide business reasons and not just as a way to pass the business to family members at a low valuation. Section 2703 of the Internal Revenue Code added an additional requirement that the terms of the agreement be comparable to similar arrangements that would be entered into by people dealing at arm's length.

The United States Court of Appeals for the Eleventh Circuit recently agreed with the Tax Court that a buy-sell agreement did not live up to these standards. In *Estate of Blount v. Commissioner*, the court found that the agreement did not bind the decedent during his lifetime. The agreement was between the decedent and a closely held corporation of which he owned 83 percent of the stock, with the balance being owned by an employee stock ownership plan (ESOP) that was not a party to the agreement. Although the agreement by its terms was binding during the decedent's lifetime, the court pointed out that the decedent could change it at will, since he owned 83 percent of the stock of the corporation which was the only other party to the agreement. The court ignored the value set by the agreement and determined a higher value for estate tax purposes.

Could the taxpayer have avoided this problem? If the ESOP or another shareholder had been a party to the agreement, the court may have upheld the agreement because the taxpayer would not have been able to change the agreement on his whim. A sole shareholder will not be able to enter into an agreement with his corporation that fixes value, because he can always change it unilaterally. Estate tax value can only be fixed by agreement where you have at least two shareholders or owners dealing with each other at arm's length.

More on Family Limited Partnerships

Discount Allowed where Partnership Held Only Cash

Family limited partnerships (and limited liability companies) have been popular vehicles to discount the value of property for estate and gift tax purposes. The concept is that an interest in a limited partnership is worth less than its proportionate share of the underlying partnership assets because it would be difficult to sell and does not enable its holder to exert control over the management of the partnership. This phenomenon can be observed with respect to closed-end mutual funds, which normally trade at a discount to their net asset value. The IRS has aggressively challenged these entities, and the cases have gone

both ways. In a recent surprising case, *Kelley v. Commissioner*, T.C. Memo 2005-235, the Tax Court allowed a discount of 32 percent for an interest in a partnership that held only cash and certificates of deposit.

> *"Family partnerships remain a viable estate and gift tax planning tool."*

Many experts have thought that discounts were appropriate for partnerships that own assets such as real estate but were not so sure that discounts should be allowed for cash and marketable securities. The partnership here had nothing but cash. The only issue the court had to decide was the amount of the discount. Before the trial, the IRS surprisingly dropped all the legal arguments it had made against the discount. The IRS had even been willing to grant a 25 percent discount, but the taxpayer wanted more and got a little bit more from the court.

Family partnerships remain a viable estate and gift tax planning tool. However, they are very complex and fraught with pitfalls. We routinely structure these entities for our clients and would be glad to assist you in exploring the feasibility of a family partnership or limited liability company.

Grandparent's Lump Sum Tuition Prepayment Not Subject to Gift or Generation Skipping Taxes

We should all have grandparents like the one described in recently issued Private Letter Ruling 200602002. The donor had six grandchildren not yet in school. He entered into a contract with a private school to prepay the tuition for all six of his grandchildren all the way through the 12th grade. The contract provided that the grandchildren were not guaranteed admission to the school and no part of the payment was refundable if they were not admitted or if they were admitted but left before completing the 12th grade. The contract even said they would not be given any preference over other children applying to the school.

The IRS ruled that the payment qualified for exclusion from gift tax under IRC Section 2503(e), which excludes amounts paid directly to an educational organization for tuition on behalf of an individual. Because the amount was excluded from gift tax under Section 2503(e), it was also excluded from the generation-skipping tax by virtue of Section 2611(b)(1), which excludes from generation-skipping tax any transfers excluded from gift tax by Section 2503(e).

If you are highly confident that your grandchildren will be admitted to a particular school, this can be a means to remove assets from your taxable estate without using any of your annual or lifetime exemptions. Our guess is that Grandpa had also made numerous and substantial gifts to the school!

Contact Us

Los Angeles

Name	Email	Phone
Leah M. Bishop	lbishop@loeb.com	310.282.2353
Thomas N. Lawson	tlawson@loeb.com	310.282.2289
Jeffrey M. Loeb	jloeb@loeb.com	310.282.2266
Ronald C. Pearson	rpearson@loeb.com	310.282.2230
Stanford K. Rubin	srubin@loeb.com	310.282.2090
Paul A. Sczudlo	psczudlo@loeb.com	310.282.2290
Stuart P. Tobisman	stobisman@loeb.com	310.282.2323
Laura B. Berger	lberger@loeb.com	310.282.2274
Tarin G. Bross	tbross@loeb.com	310.282.2267
Linda N. Deitch	ldeitch@loeb.com	310.282.2296
Neil B. Jannol	njannol@loeb.com	310.282.2358
Deborah J. Korney	dkorney@loeb.com	310.282.2245
Alyse N. Pelavin	apelavin@loeb.com	310.282.2298
Jonathan D. Petrus	jpetrus@loeb.com	310.282.2101

New York

Name	Email	Phone
Jerome L. Levine	jlevine@loeb.com	212.407.4950
Lanny A. Oppenheim	loppenheim@loeb.com	212.407.4115
Laurie S. Ruckel	lruckel@loeb.com	212.407.4836
C. Michael Spero	mspero@loeb.com	212.407.4877
Bruce J. Wexler	bwexler@loeb.com	212.407.4081
H. Sujin Kim	skim@loeb.com	212.407.4116
Jennie E. Mooney	jmooney@loeb.com	212.407.4181

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