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High Net Worth Family
TAX REPORT

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Family Limited Partnership Agreements Need to Be Reviewed

If you created a family limited partnership (or limited liability company) more than one year ago, it would be a good idea to review the operating procedures and to review and possibly amend the partnership agreement (or operating agreement). There has been a continuous stream of court cases on the tax efficacy of these entities. Taxpayers have won some cases and lost other cases, but in the process, the courts have provided some guidance as to the kinds of operating procedures and provisions in partnership and limited liability company agreements that are either helpful or harmful. It is important to make sure that the agreement for your entity contains all the helpful provisions and does not contain any of the harmful provisions, and that the operating procedures are appropriate. We would be happy to review these matters with you.

Last month, the Tax Court decided another family limited partnership case, *Estate of Hilde E. Erickson*, against the taxpayer. This was another "bad facts" case where the partnership was set up by the decedent's daughter, acting under a power of attorney, when the decedent's health was failing. Transfers of assets to the partnership did not occur until later, when the decedent's health was even worse. Some transfers did not occur until two days before she died, and the gifts of partnership interests to other family members were not made until two days before she died. After her death, her estate had to make withdrawals from the partnership to pay expenses. The court had no trouble concluding that the decedent had retained an interest in the assets she transferred to the partnership, which caused all the assets to be included in her estate at full fair market value for estate tax purposes under IRC Section 2036. This is not the way to use a family partnership.

This publication may constitute "attorney advertising" under the New York Code of Professional Responsibility.

We have considerable experience in helping clients confirm the economic substance required to make a family partnership successful. We have also carefully studied all the court decisions and can prepare an updated agreement that contains the helpful provisions while avoiding the problematic provisions.

Deferred Compensation Agreements May Need to Be Amended by December 31, 2007

In 2004, Congress enacted Section 409A of the Internal Revenue Code, which significantly changed the tax rules that apply to nonqualified deferred compensation arrangements. In this context, "nonqualified" means any arrangements other than qualified retirement plans (i.e., pension plans, profit sharing plans, 401(k) plans) that meet all the requirements of the Internal Revenue Code to achieve a preferred tax status.

"The regulations require that every nonqualified deferred compensation plan or agreement be amended by December 31, 2007, if necessary, to comply with the new rules."

The scope of arrangements that can fall within nonqualified deferred compensation arrangements is very broad. It could include something as simple as an employment agreement that requires the employer to make payments to the employee in the years after the employee has performed the services for which he or she is being paid. Some kinds of routine bonus arrangements can even be covered, as can nonqualified stock options, phantom stock plans and stock appreciation rights, sometimes referred to as SARs.

The Internal Revenue Service has just finalized its regulations implementing Section 409A. The regulations require that every nonqualified deferred compensation plan or agreement be amended by December 31, 2007, if necessary, to comply with the new rules. Failure to do so will likely result in unfortunate tax consequences to the service provider, including possible acceleration of taxes and liability for a 20% excise tax on top of regular income taxes.

Please contact us to review any agreements you have, or plans in which you participate, that provide for nonqualified deferred compensation or equity grants. We have assembled a team to review all these agreements and prepare any required amendments. If you are not certain about a particular arrangement, the safest course is to let us take a look at it and tell you if it needs to be amended. Even if compliant, it may still be prudent to amend the arrangement to clarify certain provisions to ensure proper treatment. Please send your documents to us right away so there is plenty of time to complete the necessary amendments. This may be very difficult to accomplish in a timely manner if you do not send your agreement in until sometime in the fall.

What Happened to Estate Tax Reform?

Last summer the Congress came within just a few votes in the Senate of enacting meaningful estate tax reform. Then, when the control of the Congress shifted in the November elections, the prospect of significant reform seemed dim. More recently, there has been some activity in the Senate that provides some basis for guarded optimism. The Senate has been working on its budget resolution. A budget resolution by itself does not make any changes to the tax law. What it can do, however, is to provide room in the budget for tax cuts (or increases) that the particular chamber may be contemplating.

> "Given the ongoing uncertainty of where the rates and exemption amounts will ultimately end up, any planning done now must be sufficiently flexible to accommodate a range of possible outcomes."

In March, an amendment to the Senate budget resolution proposed by Senator Max Baucus of Montana to extend the 2009 exemption of $3,500,000 and the top rate of 45% through 2012 passed the Senate by a vote of ninety-seven to one. Then, in May, the Senate passed by a vote of fifty-four to forty-one a motion by Senator John Kyl of Arizona to instruct the conferees to plan the budget around a top rate of 35%. Remember, it takes sixty votes to pass this kind of legislation in the Senate. The Senate budget resolution needs to be reconciled with the House resolution, but there does still appear to be some interest in estate tax reform.

Unless further estate tax legislation is enacted, here is where things stand through 2010, as of today:

Lifetime Exemption:	
Gift tax:	$1,000,000
Estate and generationskipping tax:	$2,000,000 for 2007 and 2008
Maximum Tax Rates:	
Estate, gift and generation-skipping	45% through 2009

In 2010, the estate and generation-skipping tax are repealed for that year only. The maximum gift tax rate is 35%. In 2011, the estate, gift and generation-skipping taxes will again be as they were in effect prior to 2001. There will be a $1,000,000 lifetime exemption and the maximum rate will be 55%. For 2007, the gift tax annual exclusion amount is $12,000. Given the ongoing uncertainty of where the rates and exemption amounts will ultimately end up, any planning done now must be sufficiently flexible to accommodate a range of possible outcomes.

California Liberalizes Rules for Withholding on Sales of Real Property

California requires tax to be withheld from the proceeds of the sale of any California real property. Prior to 2007, the amount required to be withheld was 3 1/3% of the total sales price. In many instances, this resulted in withholding more than the seller would actually owe in California income taxes when he prepared his return. About 42% of the total amount collected through the withholding program ended up being refunded to taxpayers. For example, if an individual sells a parcel of California real property for $1,000,000 in which he has an adjusted basis of $800,000, his gain of $200,000 would result in California income taxes of $18,660, at the 9.3% individual income tax rate. However, at the closing of the sale he would have had $33,333 withheld (3 1/3% of $1,000,000) and paid over to the state. He could not get this back until he filed his California income tax return for the year of the sale.

Since January 1, 2007, sellers can elect to have their withholding determined by applying their maximum tax rate to the gain they will realize from the sale. The seller determines his gain by completing Form 593-E and then makes the election to withhold on the actual gain on Form 593-B. It is the buyer's responsibility to withhold the appropriate amount, but he may delegate this responsibility to the escrow company, which is what typically happens. Each time you sell real property in California, you should calculate the withholding under both methods and use the one that results in the lower amount being withheld.

IRS Cannot Automatically Require a Bond When Taxpayer Elects to Pay Estate Tax in Installments

One of the most important estate tax provisions for the owners of closely held businesses is IRC Section 6166, which allows estate tax to be paid in up to ten installments beginning five years after the tax would be otherwise due. This is often a critical provision for the estate of a business owner where the business would otherwise have to be sold in order to fund the payment of the estate tax. Given that estate tax is due nine months after death, a sale could easily result in fire-sale pricing. In order to qualify for the deferral, the decedent must have owned an interest in a closely held business that is included in his gross estate for estate tax purposes and comprises at least 35% of his adjusted gross estate.

> "Ideally, since the Section 6166 election is often critical for high net worth families, the IRS should publish specific guidelines about when a bond or special lien will be required."

IRC Section 6165 authorizes the IRS to require the taxpayer to post a bond to secure the payment of any tax where an extension of time to pay the tax has been granted. IRC Section 6324A allows the estate to agree to a special lien against the property in lieu of posting the bond. In 2002, the IRS decided that it was going to require either a bond or special lien for all estates electing deferred payment under Section 6166. In *Estate of Edward P. Roski*, decided by the Tax Court in April, the estate challenged the right of the IRS to make a bond or special lien mandatory in all cases. Further, it said that it had investigated getting a bond and was unable to obtain one for the period required. The estate also argued that the special lien would create undue interference with the operation of its business. The IRS already had a general lien on all of the estate's assets, and the executor, who was the decedent's son and a very substantial person, remained personally liable for the payment of the estate tax. The IRS attempted to disallow the election under Section 6166 because the estate did not post a bond or agree to a special lien.

The Tax Court ruled in favor of the estate. It said that the Internal Revenue Code does not permit the IRS to adopt a policy of requiring a bond or special lien for all electing estates. Rather, the IRS must review the circumstances of each case and then make a good-faith determination of whether a bond or special lien is necessary. The ruling did not totally end the case, as the estate will now have to prove that requiring a bond or special lien is not necessary to protect the government.

While the case is a victory for the taxpayer, it remains to be seen how this issue will ultimately be resolved. Ideally, since the Section 6166 election is often critical for high net worth families, the IRS should publish specific guidelines about when a bond or special lien will be required.

IRS Permits Donation to a Private Foundation of Stock Traded over the Counter

In order to donate appreciated stock to a private foundation and receive an income tax deduction for the full fair market value of the stock, market quotations for the stock must be readily available on an established securities market. This includes the NYSE and the NASDAQ, but what about the over-the-counter markets? Do shares traded on such markets qualify? In *PLR 200702031*, the IRS explained the requirements. It found that the Over-the-Counter Bulletin Board ("OTCBB"), established by the SEC in 1990 pursuant to the Penny Stock Reform Act of 1990, is in fact "an established securities market." Unfortunately, the IRS added another requirement, which it pulled out of other parts of the Treasury

Regulations dealing with charitable contributions. That is, the stock must also be "regularly traded" on the established securities market. Based upon trading volume information supplied by the taxpayer, the IRS also ruled that the particular stock was "readily traded." Unfortunately, the trading volume information was redacted when the ruling was made public, so the ruling does not provide helpful guidance to other taxpayers.

If you contemplate donating OTCBB shares to a private foundation, the safest course is to obtain your own private letter ruling from the IRS with respect to the specific stock you plan to donate. Also, keep in mind that if there are other restrictions, such as securities law restrictions, a fair market value deduction will generally not be available.

IRS Allows Life Insurance Policy to Be Transferred between Two Revocable Trusts

Life insurance proceeds paid by reason of the death of the insured are normally exempt from federal income tax under IRC Section 101. However, if the policy has been "transferred for value," then only the amount paid by the transferee plus additional premiums paid by the transferee are exempt from tax. The balance of the proceeds are taxable. There are a few exceptions to this rule, one of which is for transfers of policies to the insured.

> **"Any transfers of life insurance policies must be handled with care to avoid inadvertently running afoul of the transfer-for-value rules."**

In *Rev. Rul. 2007-13*, the IRS considered a situation where a life insurance policy was owned by a trust that was a grantor trust with respect to the insured. A grantor trust is a trust where the person who transferred property to the trust has retained certain rights or powers over the trust. The ruling does not say which right or power the insured had over the trust to make it a grantor trust. If a trust is a grantor trust, it is essentially ignored for income tax purposes. The trust property is considered to be owned by the grantor, who reports all income and deductible expenses related to the trust property on his own income tax return. Irrevocable life insurance trusts designed to exclude the policy proceeds from the estate of the insured can also be structured as income tax grantor trusts.

The grantor trust that owned the life insurance policy sold the policy to a second trust that was also a grantor trust with respect to the insured. Since the grantor was considered to own the property of both trusts, the IRS ruled that no transfer had occurred that could be treated as a transfer for the value. Thus, upon the death of the insured, the policy proceeds would still be exempt from income tax.

In a variation of the facts, the policy was owned by an irrevocable trust that was not a grantor trust. It sold the policy to a second trust that was a grantor trust with respect to the insured. In this case, a transfer for consideration was found to have occurred, but since the insured was treated as owning the assets of the purchasing grantor trust, the IRS ruled that the sale was a transfer to the insured and thus not subject to the transfer-for-value rule.

Any transfers of life insurance policies must be handled with care to avoid inadvertently running afoul of the transfer-for-value rules. It is a good idea to review any contemplated transfers with your tax adviser before completing them.

The Statute of Limitations Protects Taxpayers, but Not against Everything

In general, the IRS cannot assess additional income tax for a year more than three years after the taxpayer files his return for that year. There are some exceptions that can result in a longer assessment period. The protection afforded taxpayers by the statute of limitations is not well understood. It does

not protect against everything that happened in old tax years, as was recently illustrated in the case of *Fernandez v. United States*, decided by the United States Court of Federal Claims.

In 1999, a year closed by the statute of limitations, the taxpayer participated in the "Son of Boss" tax shelter transaction, which he believed created a high tax basis in certain stock he owned. The taxpayer sold the stock in his tax years 2000–2003. The IRS audited these years in time to keep the statute of limitations open. The IRS took the position that because the claimed basis arose in an abusive tax shelter transaction, the correct basis of the stock sold was zero, and it sought to tax the taxpayer on the entire amount he received for selling the stock in 2000–2003.

Before the court, the taxpayer argued that since the claimed basis arose in 1999 and that year was closed by the statute of limitations, the IRS was precluded from denying him the basis that he claimed. The court held in favor of the IRS, saying that although the IRS could not assess any tax for 1999, it nevertheless could consider facts arising in 1999 to determine the taxpayer's correct liability for tax years 2000-20003, which were not closed by the statute of limitations.

"There are numerous circumstances where you could be called upon to produce very old records to support a tax position you took in a more recent year."

This case brings up a very important point. People are frequently told that tax records only need to be maintained for some fixed period, typically six or seven years. In fact, any records that could be relevant to the determination of your tax liability in a later year need to be retained indefinitely. The example in this case was the correct basis for an asset the taxpayer sold. The IRS can challenge the basis you claim in the sale year no matter how many years ago the basis arose. The same would be true for a depreciation deduction for a shopping center or an apartment building you may have purchased ten years ago.

An area where taxpayers are often caught off guard is with respect to net operating losses. Let's say your business incurred a loss in 2000 that you did not carry back. In general, you may carry that loss forward for twenty years. Suppose you used part of that loss as a deduction from business income in 2005 and that return is now being audited by the IRS. The IRS cannot assess any taxes against you for 2000, as that year is closed. However, if it believes the net operating loss that you claim arose in 2000 is not good, it can deny your deduction of the loss carryover for the 2005 year. In effect, you can be required to prove the bona fides of the 2000 loss in any year where you claim a deduction for part of that loss. All this should serve to emphasize the importance of keeping good records and retaining them. There are numerous circumstances where you could be called upon to produce very old records to support a tax position you took in a more recent year.

Supreme Court Decides to Hear Case on State Taxation of Bonds Issued by Other States

In a special alert we circulated in February, we pointed out that the United States Supreme Court had been asked to hear the case of *Kentucky v. Davis*, dealing with whether a state that does not impose income tax on its own bonds, and bonds issued by its subdivisions, can nevertheless impose income tax on bonds issued by other states and their subdivisions. The Kentucky Court of Appeals held that this pattern of taxation, followed by most states that impose an income tax, violated the Commerce Clause of the United States Constitution.

The State of Kentucky asked the United States Supreme Court to hear the case, and on May 21,

the Supreme Court indicated that it would indeed hear the case. In our February alert, we suggested that individuals with significant interest income from bonds of other states consider filing protective claims for refund. Please refer to that alert for specific information about the applicable statute of limitations for such claims. A copy is available on our website.

We are not optimistic that the result in the Kentucky Court of Appeals will be upheld by this Supreme Court, but nobody knows for sure until the Court hears the case and renders its decision. We will issue another special alert on the Court's decision as soon as it is announced.

For more information about any of the techniques and strategies discussed in this newsletter, or any other income or estate tax planning assistance, please feel free to contact any member of our High Net Worth Family Practice Group.

If you received this alert from someone else and would like to be added to the distribution list, please send an email to alerts@loeb.com and we will be happy to include you in the distribution of future reports.

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High Net Worth Families Group

Los Angeles

C. DAVID ANDERSON	DANDERSON@LOEB.COM	310.282.2128
JOHN ARAO	JARAO@LOEB.COM	310.282.2231
MARLA ASPINWALL	MASPINWALL@LOEB.COM	310.282.2377
LAURA B. BERGER	LBERGER@LOEB.COM	310.282.2274
LEAH M. BISHOP	LBISHOP@LOEB.COM	310.282.2353
TARIN G. BROSS	TBROSS@LOEB.COM	310.282.2267
REGINA I. COVITT	GCOVITT@LOEB.COM	310.282.2344
TERENCE F. CUFF	TCUFF@LOEB.COM	310.282.2181
LINDA N. DEITCH	LDEITCH@LOEB.COM	310.282.2296
PAMELA J. DRUCKER	PDRUCKER@LOEB.COM	310.282.2234
ANDREW S. GARB	AGARB@LOEB.COM	310.282.2302
STEVEN C. GOVE	SGOVE@LOEB.COM	310.282.2207
LILLIAN C. HENRY	LHENRY@LOEB.COM	310.282.2247
NEAL B. JANNOL	NJANNOL@LOEB.COM	310.282.2358
DEBORAH J. KORNEY	DKORNEY@LOEB.COM	310.282.2245
THOMAS N. LAWSON	TLAWSON@LOEB.COM	310.282.2289
JEFFREY M. LOEB	JLOEB@LOEB.COM	310.282.2266
DAVID C. NELSON	DNELSON@LOEB.COM	310.282.2346
RONALD C. PEARSON	RPEARSON@LOEB.COM	310.282.2230
ALYSE N. PELAVIN	APELAVIN@LOEB.COM	310.282.2298
STANFORD K. RUBIN	SRUBIN@LOEB.COM	310.282.2090
PAUL A. SCZUDLO	PSCZUDLO@LOEB.COM	310.282.2290
ADAM F. STREISAND	ASTREISAND@LOEB.COM	310.282.2354
STUART P. TOBISMAN	STOBISMAN@LOEB.COM	310.282.2323
NICHOLAS J. VAN BRUNT	NVANBRUNT@LOEB.COM	310.282.2109
GABRIELLE A. VIDAL	GVIDAL@LOEB.COM	310.282.2362
JOHN S. WARREN	JWARREN@LOEB.COM	310.282.2208

New York

PATRICIA J. DIAZ	PDIAZ@LOEB.COM	212.407.4984
ELIOT P. GREEN	EGREEN@LOEB.COM	212.407.4908
H. SUJIN KIM	SKIM@LOEB.COM	212.407.4116
LAURA LAVIE	LLAVIE@LOEB.COM	212.407.4165
JEROME L. LEVINE	JLEVINE@LOEB.COM	212.407.4950
JENNIE E. MOONEY	JMOONEY@LOEB.COM	212.407.4181
LANNY A. OPPENHEIM	LOPPENHEIM@LOEB.COM	212.407.4115
LAURIE S. RUCKEL	LRUCKEL@LOEB.COM	212.407.4836
JOHN SETTINERI	JSETTINERI@LOEB.COM	212.407.4851
C. MICHAEL SPERO	CMSPERO@LOEB.COM	212.407.4045
ALAN J. TARR	ATARR@LOEB.COM	212.407.4900
BRUCE J. WEXLER	BWEXLER@LOEB.COM	212.407.4081