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High Net Worth Family TAX REPORT

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Do You Still Have Title and Other Insurance on Your House and Other Real Property?

While not a tax issue per se, the problem discussed here often arises as a result of transfers of real property that were made for income or estate tax planning purposes. People frequently transfer real property to living trusts or to family-owned entities such as partnerships or limited liability companies. In *Kee Kwok v. Transnation Title Insurance Company (2009)*, the California Court of Appeals held that where a husband and wife purchased property in the name of a limited liability company ("LLC") in which they were the sole members, obtained a title insurance policy in the name of the LLC, and then transferred title to the property to themselves in their capacities as trustees of a family trust, they were no longer insureds under the policy and, therefore, were not entitled to coverage. The case has significant implications in the family income and estate tax planning arenas. It emphasizes the point that where parties transfer title to trusts for estate planning purposes, they must be careful to change their insurance policies to reflect the changes in ownership or risk losing their insurance coverage.

In this case, the Kwoks formed Mary Bell, LLC (the "LLC") which purchased real property. The plaintiffs were the only members of the LLC. At the time of purchase, they purchased a CLTA policy that insured title to the property and to an easement over a neighboring property. The LLC was the only named insured under the policy. The policy defined insured as: "the insured named in Schedule A, and, subject to any rights or defenses the Company would have against the named insured, those who succeed to the interest of the named insured by operation of law as distinguished from purchase including, but not limited to, heirs, distributees, devisees, survivors, personal representatives, next of kin, or corporate or fiduciary successors." The policy provided that it would continue in force in favor of an insured only so long as "the insured retains an estate or interest in the land or holds an indebtedness secured by a purchase money mortgage given by a purchaser from the insured, or only so long as the insured shall have liability by reason of covenants of warranty made by the insured or any transfer or conveyance of the estate or interest."

The Kwoks commenced construction of a residence on the property. The neighbors refused to provide access to the easement asserting that the easement was invalid. When construction was delayed, the Kwoks moved into the residence that was already on the property. Subsequently, Mr. Kwok signed a grant deed, transferring the property from the LLC to himself and his wife "as trustees of the Patrick Man Kee Kwok and Maria Oi Yee Kwok Revocable Trust." No documentary transfer tax was paid. They then filed a certificate of cancellation of the LLC.

When they could not resolve the easement dispute, they filed a lawsuit to enforce their rights and tendered a claim to the title insurer, which denied coverage on the grounds that the transfer of the property by the LLC to the Kwoks, as trustees of the trust, did not arise by operation of law and, therefore terminated coverage. The Court agreed. It found that the only insured was the LLC and that coverage did not devolve to the Kwoks as members of the LLC on dissolution of the LLC. Rather, title was transferred by deed from the named insured to the Kwoks as trustees of their family trust, a totally separate entity.

The Kwoks argued that there was no change in the beneficial ownership of the property. The Court held that the issue is "not whether there was a change in the beneficial ownership of the property, but whether appellants, as trustees of their family trust, succeeded as insureds under the terms of the policy." The Court noted that there was nothing in the policy definition of "insured" that identifies "beneficial owners" as insureds. Rather, under the definition, they could only become insureds by operation of law and "the transfer of property by an insured into a family trust is a voluntary act and not one that arises by operation of law."

The policy also provided that insureds included "those who succeed to the interest of the named insured by operation of law as distinguished from purchase, including, but not limited to, . . . distributees." The Kwoks argued that they received the property by operation of law as distributees. They noted that no money changed hands and the grant deed shows that no transfer tax was paid. The Court found that under Corporations Code section 17001(j), a "distribution" is "the transfer of money or property by a limited liability company to its members without consideration." Here, however, the Court noted that title passed to the Kwoks in their capacities as trustees of the trust, and that they were not members of the LLC as trustees. Therefore, they were not distributees under the policy.

The bottom line is that if title to property is transferred from individuals to those individuals as trustees of a trust for estate planning purposes, or to other entities such as partnerships or limited liability companies, the new owner may not be entitled to coverage under existing policies, and may need to obtain either endorsements adding them as insureds or new policies. Some newer policies may cover transfers to trusts but not to other entities. When any such transfer is made, the policy must be reviewed and if the transfer is not covered, the original title insurer must be contacted to obtain an endorsement covering the new owner. In California, most of the common transfers to and from family trusts and other entities can be covered under CLTA Endorsement 107.9 which is not expensive, but you must go to your title insurer and ask for it.

Note that this same problem exists with regard to other forms of insurance such as general liability coverage. If the individuals have general liability coverage in their own names and then transfer title to themselves in their capacities as trustees of a trust, depending on the language of their policies, they may not be entitled to coverage in their new capacities under their existing policies. Thus, any time a property transfer occurs, the transferees must carefully review their policies to determine whether they are entitled to coverage under their existing policies and, if not, take appropriate steps to insure that they do have coverage by either obtaining endorsements adding them as insureds or obtaining new policies.

IRS Reduces Penalties on Qualifying Voluntary Disclosures of Offshore Accounts and Entities Made By September 23, 2009

The IRS has developed a new initiative that may significantly lower the penalties for those who voluntarily disclose their offshore accounts and entities. The IRS's objective is to bring taxpayers that have used undisclosed foreign accounts and undisclosed foreign entities to avoid or evade tax into compliance with U.S. tax laws. A new penalty framework under the initiative is intended to provide taxpayers with the opportunity to calculate, with a reasonable degree of certainty, the civil penalties that may be imposed as a result of the delinquent filings. The framework applies only to those taxpayers who come forward on or before September 23, 2009.

The new penalty framework, publicized in a series of informal press releases and internal IRS memoranda over the last six weeks, is intended to be guidance for IRS examination personnel who are addressing voluntary disclosure requests involving unreported offshore income. The IRS has provided information on the initiative in a piece-meal fashion, and it is not clear whether any additional information is forthcoming. Thus, the following discussion should be read as a general framework that may not necessarily be binding on IRS personnel and that may be further refined.

Under the new penalty framework, for qualifying voluntary disclosures the IRS has indicated that it will asses all taxes and interest due for the past six years, and require the taxpayer to file or amend all returns, including information returns (e.g., Forms 3520 and 3520-A related to foreign trusts and Form 5471 related to foreign corporations) and Form TD F 90-22.1 (Report of Foreign Bank and Financial Accounts), commonly referred to as the "FBAR," for those years. The IRS also will assess either an accuracy or delinquency penalty on all years. In lieu of all other civil tax penalties, including onerous FBAR penalties, that might apply, the IRS will assess a penalty "equal to 20% of the amount in foreign bank accounts/entities in the year with the highest aggregate account/asset value." The 20% penalty could be reduced to 5% in certain circumstances. While the 20% penalty may be a material amount, it still may be significantly lower than the potential draconian civil penalties that the IRS could otherwise assert.

The new penalty framework will apply only to taxpayers who make a qualifying voluntary disclosure and fully cooperate with the IRS, both civilly and criminally. All voluntary disclosures filed under this initiative will be initially screened by IRS Criminal Investigation to determine if the taxpayer is eligible to make a voluntary disclosure. A taxpayer currently under examination by the IRS for any reason is not eligible to make a voluntary disclosure. Nor is a taxpayer for whom the IRS has acquired information from a criminal enforcement action (e.g., grand jury subpoena) directly related to the taxpayer's liability or from a third party (e.g., informant or the media) alerting the IRS to the taxpayer's noncompliance.

The IRS has stated that for those taxpayers eligible to make a voluntary disclosure, doing so generally should reduce, and perhaps even minimize, the chances of criminal prosecution. Because the initial disclosure, including identifying the taxpayer, is made to IRS Criminal Investigation to determine whether the taxpayer is qualified to make a voluntary disclosure, any disclosure should be made with the advice of tax counsel familiar with the issues.

Those taxpayers who have previously filed amended returns and paid any related tax and interest for previously unreported offshore income without first contacting the IRS directly should contact their tax counsel to determine it they should file again under this new initiative.

The IRS has reported that those taxpayers who have properly reported all of their taxable income but have failed to file the FBARs as required should not follow the voluntary disclosure process. Instead, they should file the delinquent FBARs, by September 23, 2009, with the Philadelphia Offshore Identification Unit in accordance with the FBAR instructions, attach a statement explaining why the reports are filed late and include copies of tax returns for all relevant years. The IRS has indicated that it will not impose a penalty for the failure to file those FBARs.

New York and California State 2009-2010 Budgets Raise Taxes and Fees

The 2009-2010 New York State ("NYS") Budget Act, enacted on April 7, 2009, makes numerous changes to New York's Tax Law -- increasing taxes, creating new fees, imposing stricter reporting obligations and increasing penalties. The Budget Act also extends several tax credits, including a one-year extension of the Empire State Film Production Tax Credit. The changes are generally effective for taxable years beginning on or after January 1, 2009. Set forth below is a description of some of the most important changes made by the new legislation. California also raised certain taxes in its budget, enacted in February.

New York

Changes Affecting Individuals

Higher Personal Income Tax Rates

The Budget Act increases the top personal income tax rate for the 2009 through 2011 tax years from 6.85% to 8.97% and adds a new 7.85% rate. The 7.85% rate applies to married individuals filing jointly with NYS taxable income over $300,000 but not over $500,000, heads of households with NYS taxable income over $250,000 but not over $500,000 and unmarried individuals and married individuals filing separately with NYS taxable income over $200,000 but not over $500,000. The 8.97% rate begins for NYS taxable income over $500,000, without regard to filing status. The lower rates phase out as income increases.

Elimination of Itemized Deductions For High Income Taxpayers

The Budget Act eliminates the ability of taxpayers with NYS adjusted gross income over $1 million to claim any itemized deductions (other than 50% of the charitable contribution deduction). Under prior law, a taxpayer with NYS adjusted gross income over $525,000 who itemized deductions for U.S. federal income tax purposes was generally permitted to deduct 50% of her federal itemized deductions for NYS tax purposes. Individuals with NYS adjusted gross income over $1 million now have to choose between the standard deduction or 50% of their U.S. federal charitable contribution. This change also affects the New York City ("NYC") personal income tax on residents of NYC.

Less Favorable NYS Residency Test

Under prior law, an individual domiciled in NYS was not taxed as a resident if within any 548 consecutive day period (1) the individual was in a foreign country for at least 450 days, (2) the individual was not present in NYS for more than 90 days and (3) the individual's spouse or minor children did not reside at the individual's permanent place of abode in NYS for more than 90 days. The Budget Act changes the third prong of this test to provide that the spouse or minor children must not be present anywhere in NYS. This change is intended to combat situations where spouses or children stay in hotels or with relatives in NYS in order to prevent the individual from qualifying as a NYS resident.

Non-Residents Subject to Tax on Sales of Interests in Entities Holding NY Real Property

A nonresident individual will now be subject to NYS personal income tax on gain from the sale of an interest in a partnership (including an LLC), S corporation or closely held C corporation (with 100 or fewer shareholders) if 50% or more of the entity's fair market value on the date the interest is sold is attributable to real property located in NYS. The gain that is subject to NYS tax under this new provision is equal to the individual's pro rata portion of the portion of the gain allocable to the value of the NYS real property held by the entity, determined by dividing the value of NYS real estate held by the entity by the value of all the entity's assets. Without a withholding obligation on the buyer, it is unclear how NYS will enforce this provision.

Changes Affecting Entities

Expansion of Nexus to Certain Sales Tax Collections

NYS previously expanded the scope of NYS's jurisdiction to tax, or "nexus," to presume a seller to have nexus with NYS for sales tax purposes if (1) one or more NYS residents directly or indirectly refer customers to the seller for consideration, and (2) the cumulative gross receipts from sales in NYS pursuant to such referrals exceeds $10,000 during the four preceding sales tax quarters. The new legislation further extends the requirement to collect NYS sales tax to non-NYS vendors who have no physical presence in NYS but who make sales in NYS on the internet or through mail order if the non-NYS vendor has an affiliate in NYS that either (1) uses, in NYS, a trademark, service mark or trade name that is the same as or similar to that of the non-NYS vendor, or (2) engages in activities in NYS that benefit the non-NYS vendor's development or maintenance of a market for its goods or services in NYS. The threshold for "affiliation" under this new provision is exceedingly low – a more than 5% ownership connection will suffice.

Increased Estimated Tax Installment

For tax years beginning on or after January 1, 2010, the first required installment of corporate estimated tax for such year is increased from 30% to 40% of the prior year's tax, if such prior year's tax was more than $100,000. The new legislation also provides that, for purposes of determining estimated tax installments for 2009, the corporation must compute the prior year's tax as if the Budget Act had been in effect throughout 2008.

Certain Partnerships Subject to Filing Fees

For tax years beginning on or after January 1, 2009, the filing fees previously required only from LLCs and LLPs will now also be required of general partnerships and limited partnerships with $1 million or more of NYS source gross income. The fees range from $1,500 if the partnership's NYS source gross income does not exceed $5 million, to $4,500 if the partnership's NYS source gross income exceeds $25 million. The Budget Act also authorizes NYC to impose similar filing fees.

Increased Penalties

The Budget Act contains numerous provisions which impose new penalties or increase the amount of existing penalties. For example, the penalties for failing to file an information return, filing a return with a frivolous position, fraudulently failing to pay tax or willfully failing to pay over withholding tax have all been increased significantly. The new legislation also increases the interest rates applicable to underpayments of tax by 1.5 percentage points (generally from 6% to 7.5%).

More Funds Allocated to NYS Qualified Film Production Credit

One bright spot in the Budget Act is a one-year extension of the Empire State Film Production Tax Credit and an authorization of an additional $350 million to fund the credit. The legislature had previously increased this credit from 10% to 30% of qualified film productions costs in January 1, 2008, and had allocated $685 million to fund the program through 2013, but this amount was exhausted by February of 2009. The Budget Act provides for an increase of $350 million in qualified film production credits, and extends the availability of the credit itself for one year.

For more information on the changes made to New York Tax Law by the Budget Act, please contact either Alan J. Tarr, atarr@loeb.com, (212-407-4900) or Steven C. Gove, sgove@loeb.com, (212-407-4191).

California

Our California readers have no doubt noticed that taxes have gone up as well. The California budget, enacted in February, contained several tax provisions which primarily were tax increases:

i) The sales tax rate was increased by 1% beginning April 1, 2009.

ii) Vehicle license fees were increased from 0.65% to 1.15% beginning May 19, 2009.

iii) Personal income tax rates were increased by 0.25%. The income tax rate increase would have been limited to .125% if California had been entitled to receive $10 Billion of federal stimulus funds through 2010; however the State Treasurer recently determined that only $8.17 Billion will be received.

iv) Beginning in 2011, California will also provide a credit for motion picture production within the state. Taxpayers will apply to the Film Commission for the credit.

v) Beginning in 2011, multi-state taxpayers will be permitted to elect to apportion their business income using only the sales factor in lieu of the current three factors of property, payroll and sales.

Proper Timing is Critical to a Deduction for Worthlessness

A sign of the times is that many people are holding a variety of investments that have become worthless, or may become worthless in the not too distant future. A recent decision by the United States Court of Appeals for the Seventh Circuit reminds us that timing is critical when claiming a deduction for an investment that has become worthless. The taxpayers in *Bilthouse v. United States (January, 2009)* owned stock in an S Corporation called S & E Contractors, Inc. The company performed public works construction projects and suffered heavy losses in 1994 and 1995. It filed a lawsuit in 1995 against the City of Jacksonville, Florida to recover certain losses it had incurred in connection with a project it had worked on for the City. The litigation was settled in 1997 without S & E receiving any payment. The taxpayers concluded that their shares of S & E were worthless at that time and claimed a deduction for worthlessness on their 1997 federal income tax return.

The IRS disallowed the deduction on the basis that the shares had become worthless in 1995. IRC Section 165(g) allows a deduction for the year in which a security becomes worthless. In general, cases have said that stock is worthless where the company has no current liquidating value and no potential value. A company has no current liquidating value if its liabilities exceed the current fair market value of its assets. This is probably true of many companies, but the stock is not considered worthless if it is reasonable to expect that the value of the assets will exceed the liabilities in the future. The court concluded that the mere fact that a lawsuit was pending in 1995 did not provide reasonable expectation that the company would have value in the future. The taxpayers presented no evidence to suggest the lawsuit would be successful.

The case illustrates the difficult situation a taxpayer is in with respect to a worthlessness loss. It can certainly claim the deduction too early, but as this case shows, it can also wait too long. The loss must be claimed in precisely the right year. When possible, it is better to find an arm's length party that will purchase the investment from you, even if its value is nominal. Then you have a closed and completed transaction that establishes your loss. If you cannot do that, you need to claim the loss in the earliest possible year and then consider filing protective refund claims to protect subsequent years until you find out whether the IRS accepts your claimed deduction in the earlier year.

Attempted End Run Around Related Party Like-Kind Exchange Limitations Fails

In *Ocmulgee Fields, Inc. v. Commissioner, (March, 2009)* the Tax Court rebuffed a taxpayer's attempt to use an exchange intermediary to avoid certain related party restrictions on like-kind exchanges. IRC Section 1031generally provides that if business or investment property is exchanged for property of a "like-kind," the exchanging taxpayer is allowed to defer recognizing his gain until he disposes of the property he received in the exchange. These exchanges are commonly used to dispose of income producing real property and acquire other income producing real property. However, IRC Section 1031(f) provides that a taxpayer's gain is recognized if it does a Section 1031 exchange with a related party and either party then disposes of the property it acquired in the exchange within two years.

To try to avoid these rules, the taxpayer completed an exchange through a "qualified intermediary." This is an independent party, often owned by a bank, escrow or title insurance company, which enables unrelated parties to complete deferred exchanges without having to trust each other. The taxpayer who wants to complete the exchange transfers his property to the intermediary who sells it to the third party that wants to buy it. The intermediary holds the cash from that sale until the exchanging taxpayer identifies his replacement property, at which time the intermediary purchases that property and transfers it to the exchanging taxpayer to complete his exchange. Recently, some of these intermediary companies have gone bankrupt or absconded with funds, but more on that later.

The taxpayer here transferred his property to an intermediary which then sold it to an unrelated party. However, the property that the taxpayer identified to complete the exchange was owned by a related party as defined in IRC Section 1031(f). The court held that this exchange ran afoul of IRC Section 1031(f)(4) which provides transactions structured to avoid the purpose of Section 1031(f) do not qualify as tax deferred exchanges. The court concluded that this provision allowed the transaction to be viewed as a direct exchange between the taxpayer and the related party, in effect ignoring the intermediary. Since the taxpayer's original property was sold by the intermediary, it was deemed to have been sold by the related party, thus running afoul of the 2 year rule.

All like-kind exchanges are tricky and should be done with guidance from qualified advisors. This is especially true of deferred exchanges accomplished through the use of a qualified intermediary.

While on this subject, we must warn you to do your due diligence on any qualified intermediary you are considering using to complete a deferred like-kind exchange. People tend to think of these as "tax transactions" so they do not seem to worry about the money. It is just stunning how many people who would not loan their best friend $10 without a letter of credit will allow an intermediary they have never heard of to hold millions of dollars of their money without making any effort to determine the intermediary's creditworthiness. Most of these firms are highly reputable but recent events have shown that is not uniformly so. Please do appropriate due diligence before selecting one of these firms to hold exchange proceeds. If one of them does steal your money, you should at least get a loss deduction to offset the gain you will now have to recognize because you did not complete your exchange.

Discount for Fractional Interest in Art Limited to 5%

In *Stone v. United States (March, 2009)* the United States Court of Appeals for the Ninth Circuit (which includes California) upheld an earlier decision by the District Court that an estate was allowed a fractional interest discount of only 5% on the 50% interest it owned in a collection of nineteen paintings. The appellate court held that the District Court properly disregarded evidence the taxpayer had presented through its expert witness of fractional interest discounts typical for real estate assets.

A problem the taxpayer had was that in the real world, fractional interests in art are not usually sold so there is no good empirical data. This is in stark contrast to real estate where fractional interests are commonly sold either directly or through entities like limited liability companies or limited partnerships. At the original trial, the government's expert had testified he was familiar with some fractional interest sales of artworks where the seller did not suffer any discount attributable to its fractional interest. The court had also reasoned that the owner of fractional interest in art would likely seek the cooperation of the other owners to sell the entire work.

Unless future taxpayers can come up with better data, it does not appear that fractional interests in art will yield much by way of a valuation discount. Nonetheless, all may not be lost. Taxpayers often make charitable gifts of fractional interests in art to museums where physical possession of the art is shared between the donor and the museum in accordance with their percentages of ownership. The *Stone* case also suggests that these donors will not suffer major discounts for purposes of determining the amount of their charitable contribution deduction (and the IRS's public position is that no such discount will apply). However, IRC Section 170(o) enacted in 2006, contains certain restrictions for fractional interest gifts so you should consult a qualified tax advisor before making such a gift.

Federal Audit Adjustments Must Be Timely Reported to California

A recent decision by the California State Board of Equalization ("SBE") reminds us that when an IRS audit results in the payment of additional income tax, the adjustments must be reported to the California Franchise Tax Board ("FTB"). In *Appeal of LSI Logic Corporation (2009)*, the taxpayer settled an IRS audit by signing IRS Form 870, which is a consent to the immediate assessment of tax, on September 30, 2002. The IRS posted the audit adjustments to the taxpayer's Business Master File ("BMF") account on November 12, 2002. On December 6, 2002, the taxpayer entered into a Closing Agreement on Form 906 with the IRS for all years included in the audit. On December 23, 2002, the IRS posted another entry in the taxpayer's BMF account reflecting the Closing Agreement but without further assessments.

The taxpayer reported the federal adjustments to the FTB on June 4, 2003, by filing amended California returns. On June 30, 2006, the FTB issued a Notice of Proposed Assessment based on the federal adjustment. It is not clear whether the taxpayer had not paid additional tax with its amended returns or the FTB was just assessing some additional amount.

California Revenue & Taxation Code ("R&T") Section 18622 requires taxpayers to report federal audit changes within six months of the final federal determination. If the taxpayer reports such changes within six months, R & T Code Section 19059 allows the FTB two years from such reporting to assess additional California tax. If the taxpayer reports such changes after six months, R & T Code Section 19060(b) allows the FTB four years to make the assessment. If the taxpayer never notifies the FTB of the federal changes, R & T Code Section 19060(a) allows the FTB to assess additional tax any time.

Thus it was critical to determine the date of the final federal determination. R & T Code Section 18622(d) provides this is the date on which the adjustment is assessed pursuant to Section 6203 of the Internal Revenue Code. That section in turn provides that the assessment is made by recording the liability of the taxpayer in accordance with rules and regulations prescribed by the Secretary of the Treasury. Based on this, the SBE concluded that the assessment was made on November 12, 2002, the date of the first BMF posting. The NPA was timely because the taxpayer's amended returns had been filed more than six months after the federal assessment so the FTB had four years to make its assessment. The taxpayer had argued that the federal assessment was not made until December 6, 2002, when the Closing Agreement was signed. Their amended returns would have been filed within six months if this had been the relevant date and the FTB would only have had two years to make its assessment.

The problem this presents for taxpayers is that in the normal course, they do not necessarily know when the IRS has recorded the assessment. Most settled audits are concluded without Closing Agreements and the IRS cannot make an assessment until the taxpayer signs the Form 870. In such a case, if the taxpayer files its California amended returns within six months of the date on which it signs the Form 870, it should be safe.

Ruling Permits Employer to Deduct Deferred Compensation Paid to a Charity

In *PLR 200905016*, an employee of a corporation was entitled to a benefit under a non-qualified deferred compensation plan. The employee designated his spouse as his beneficiary under the plan in the event of his death, provided she survives him for 45 days and does not disclaim the compensation. If she does not survive for 45 days or disclaims the compensation, it was to be paid to a charity.

The corporation sought a ruling that it could deduct the compensation even if it ended up being paid to the charity as a result of the spouse's prior death or disclaimer. IRC Section 404(a)(5) provides that nonqualified deferred compensation is deductible by the payor only in the tax year in which it is included in the gross income of the employee/recipient. The employer probably sought the ruling because where the compensation was received by a charity, the charity would not pay tax on it. The IRS agreed the employer could deduct the compensation based on its interpretation of Treas. Reg. Section 1.404(a)-12(b) as saying the compensation is considered to have been included in the taxable income of the employee even if it is received by a beneficiary that does not have to include it in gross income. It is not clear to us that the regulation is as broad as the IRS apparently reads it, but we take no issue with the result they reached.

The ruling does not address the tax consequences to the employee but there should not be an adverse tax result. This unpaid compensation is an item of "income in respect of a decedent" under IRC Section 691. It would be ordinary taxable income if received by the decedent's estate after his death. However, where someone else becomes entitled to receive the compensation as a result of the decedent's death, IRC Section 691(a)(1)(B) provides that party is subject to tax; however, in this case that party is a tax exempt entity.

Passive Investments May Not Be Appropriate for Family Limited Partnerships

The stream of family limited partnership litigation continues. After early taxpayer successes, the IRS has recently become smarter about the cases they pursue and this has resulted in a more recent string of IRS victories, which continues here. The recent Tax Court case of *Estate of Jorgensen v. Commissioner (March, 2009)*, shows that bad things can happen to seemingly good people. Colonel Gerald and Erma Jorgensen seemed to be a quintessential American success story. Colonel Jorgensen was a thirty-year career Air Force officer who had served as a highly decorated bomber pilot in both World War II and the Korean War. After retiring from the Air Force, he served as an aide to a United States Congressman. The Jorgensen's lived frugally and continually saved money from Colonel Jorgenson's government salaries and pensions. Colonel Jorgensen astutely invested their savings and by the early 1990's had accumulated over $2 million in marketable securities. Enter the estate planner.

The Jorgensen's formed a family limited partnership in 1995 and transferred marketable securities to it. Colonel Jorgensen and his two adult children were the general partners. The Jorgensen's had six grandchildren who became limited partners. None of the children or grandchildren made any contribution to the partnership and received their interests as gifts. Colonel Jorgensen passed away in 1996, and Mrs. Jorgensen subsequently formed a second limited partnership to which she transferred marketable securities and additional marketable securities from her husband's estate. Mrs. Jorgensen died in 2002, and the IRS sought to include the assets Mrs. Jorgensen had transferred to the partnership in her estate under IRC Section 2036(a). To be so includible Mrs. Jorgensen must have: i) transferred assets during her life; ii) the transfer must not have been a bona fide sale for full and adequate consideration; and, iii) she must have retained the right to receive income from or the right to possess or enjoy the assets that she transferred. As the law has developed, for a sale to be bona fide the taxpayer must have had a significant non-tax reason for making the transfer.

Where taxpayers have prevailed in these cases, they have usually been able to demonstrate that the partnership facilitated the centralized management of the assets and enabled the family to introduce younger generation members to the management process. This did not work for Mrs. Jorgensen because the court found that the securities portfolios did not require active management. Colonel Jorgensen had been a "buy and hold" investor and sold positions infrequently. Following Colonel Jorgensen's death, the general partners were the children who, unlike Colonel Jorgensen, were not sophisticated investors but relied instead on financial advisors and did not even want to hear from them very often.

The court noted other problems as well. The partnerships did not keep accounting records, loaned money to one of the children, and Mrs. Jorgensen used partnership funds to make gifts. Also, after Mrs. Jorgensen died, one of the partnerships made distributions to enable her estate to pay taxes, legal fees and other estate obligations. This enabled the court to conclude that Mrs. Jorgensen had retained the prohibited interest in the property she had transferred. The court therefore found that IRC Section 2036(a) did apply to include the assets in her estate.

Further cases will be necessary to see where the Tax Court goes with its distinction between assets that require active management and those that do not. More troublesome is the court's apparent equating of active management to trading. It would be unfortunate if day traders and speculators can use family partnerships but the Warren Buffets of the world cannot. We suspect that while Warren Buffet may not trade often, he nevertheless spends enormous amounts of time monitoring the financial health of the companies in which he holds large positions. Why should that not count as active management? It seems nonsensical to conclude that you have to be trading to be managing. It seems more likely that a flurry of trading activity may reflect an absence of any real management. Hopefully, the right set of facts will come before the court and this clarification can be made.

It is possible that even where assets do not require active management, the taxpayer may still defeat Section 2036 by avoiding the kind of conduct that allows the court to conclude the taxpayer retained an interest in the assets. This requires that partnership formalities be rigidly followed, and all distributions must be proportional to all partners in accordance with their interests. The taxpayer also must have enough assets outside of the partnership to pay all of their expenses, including apparently expenses that result from their death.

The *Jorgensen* case is a reminder that success with a family partnership is not guaranteed. You cannot just sign the papers and get a discount. It must be treated as a family business entity and managed as such.

A Private Annuity Sale Transaction Fails

Estate of Hurford v. Commissioner (2008), decided by the Tax Court in late December, 2008, is a case that makes estate planning attorneys cringe. In an 85 page opinion, there is virtually not a page where the court does not level criticism at the attorney who set up the estate planning at issue.

Mrs. Hurford's husband had passed away in 1999 and she was diagnosed with cancer that had spread to her liver in early 2000. She fired the estate planning attorney she and her husband had previously used, and hired the new (and later sharply criticized) estate planning attorney, who proceeded to plan away. The new estate planning attorney had Mrs. Hurford set up three family limited partnerships to which she transferred her assets. He then had her sell most of her partnership interests to two of her three children for a private annuity. The third child was left out of the private annuity sale due to personal problems, yet it was clear from the record that Mrs. Hurford ultimately wanted him to receive one-third of the value of her estate.

The attorney no doubt seized upon the private annuity sale because of Mrs. Hurford's poor health. In a private annuity sale, the seller transfers property to a buyer (usually a family member) for a specified stream of payments that typically ends with the seller's death. The payment stream is valued using current discount rates and a standard mortality table. Even if the seller is very ill, as long as he or she has a 50% chance of surviving for one year, the standard mortality table can be used. In this case, even though it was clear the Mrs. Hurford's condition was terminal, it was determined that she had at least a 50% chance to survive for one year. In fact, she died in February of 2001 which was less than one year after the annuity sale was completed.

The potential benefit of the annuity can be significant in these situations. Assume the seller has a normal life expectancy under the mortality tables of 15 years but, due to the seller's actual health condition, is likely only to survive for 3. The tables compute a payment stream to last for 15 years. If the seller dies after 3 years, the succeeding 12 years of payments are not made and no value attributable to those payments is included in the taxable estate of the deceased seller. The buyer gets a windfall not subject to estate tax, which is fine because the buyer is typically a family member.

Private annuities have been successfully used by taxpayers for a very long time. Here the annuity failed for two main reasons. The court found that while the sale was to two of the three children, there was nevertheless an implied agreement that the two children would share equally with the third sibling. Thus, the court concluded the annuity was not a bona fide transfer but rather a will substitute. Second, the children made the annuity payments by having the partnerships write checks and make asset transfers back to Mrs. Hurford, rather than paying her from their own funds or earnings from the partnerships. This allowed the court to conclude that Mrs. Hurford had retained a prohibited interest in the transferred assets under IRC Section 2036.

The family partnerships failed as well, due to sloppy formation and funding mechanics by the attorney. The management business purpose also failed as it did in the case we discussed in the previous section. The family generally failed to follow partnership formalities and Mrs. Hurford dipped into partnership assets to pay her expenses before she began receiving her annuity payments.

There was one bright spot for the Hurford family. The court declined to impose the negligence penalty, concluding they had reasonably relied on professional advice, poor though it may have been.

The teachable point here is that where you use a private annuity sale, the buyer should not make the payments by transferring back to the seller the very assets that were purchased. Ideally the assets purchased should produce sufficient income to enable the buyer to make the annuity payment, or if not, the buyer should be able to make up the difference out of his own assets.

Required Minimum Distribution May Be Skipped in 2009

Normally a participant in an individual account type of retirement plan must begin taking annual distributions when he or she reaches age 70 ½. Following the decimation of the financial markets last fall, a concern arose that people would have to liquidate investments at depressed prices to pay their 2009 distributions. In December, 2008, Congress passed and the President signed the Worker, Retiree and Employer Recovery Act of 2008. Under the Act, the minimum required distribution amount does not have to be distributed in 2009 in these types of plans, which include IRAs. The 2009 required distribution may also be suspended where a participant is taking distributions over a fixed period. In *Notice 2009-9*, the IRS said that if someone had elected distributions over five years, he or she can skip the 2009 distribution and effectively receive the distribution over six rather than five years.

Finally, if someone turned 70 ½ during 2008 and elected to defer taking his or her first distribution until

April 1, 2009, this distribution must still have been made. The suspension does not apply to it, because it is considered to be a 2008 distribution.

Section 529 Plan Investment Options May Be Changed Twice During 2009

In a Section 529 tuition program, the person who sets up the account is not permitted to manage the investment of the assets in the plan. He or she must choose one of the investment options provided by the state in which the account is set up, and can only change the investment option for the account once each calendar year, or upon a change of the designated beneficiary of the account. Again due to the recent turmoil in the financial markets, the IRS issued *Notice 2009-1* which provides that for calendar year 2009, the investment option may be changed twice.

Estate and Gift Tax Reform

A variety of estate and gift tax proposals have been introduced in the new Congress. It seems virtually certain that something will pass this year in order to prevent the currently scheduled elimination of the estate tax for the year 2010. The proposals to date have generally provided exemption amounts between $2.0 million and $3.5 million and maximum rates between 35% and 45%. The fates of the $1,000,000 gift tax exemption and the step-up in basis remain uncertain. We will notify you as soon as new law is enacted.

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.

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