

TAX NEWS & COMMENT

© 2009 LAW OFFICES OF DAVID L. SILVERMAN, LAKE SUCCESS, NY

(516) 466-5900

VOL. XVIII NO. 3

OCTOBER 2009

www.nytaxattorney.com

IRS MATTERS

RECENT DEVELOPMENTS

The IRS recently reversed its long-held position that intangibles such as trademarks, trade names, mastheads, and customer-based intangibles could not qualify as like-kind property under Section 1031. CCA 20091106 states that these intangibles may qualify as like-kind property provided they can be separately valued apart from a business's goodwill, and that except in "rare or unusual circumstances" they should be valued apart from goodwill. Even so, the "nature and character" requirements of Treas. Regs. § 1.1031(a)(2)(c)(1) must still be met. Thus, not all trademarks, trade names and mastheads are like-kind property to other trademarks, trade names and

(Please turn to page 2)

FROM THE COURTS

Approving Valuation Discounts, Tax Court Holds Single-Member LLC Not Ignored for Gift Tax Purposes

In *Pierre v. Com'r*, 133 T.C. No. 2 (8/4/09), the Tax Court held that a single member LLC (SMLLC), even though ignored for income tax purposes, must be respected as a separate entity for gift tax purposes.

[Susan J. Pierre formed Pierre Family, LLC, a single-member LLC, on July 13, 2000. On September 15, 2000, she transferred \$4.25 million in cash and securities to the LLC. On September 27, she (i) gave 19 percent of her LLC membership interest to two trusts and (ii) sold 81 percent to those two trusts in exchange for a promissory note. Discounts of 30% were taken for lack of control and lack of marketability. A gift tax return was filed.

(Please turn to page 3)

FROM WASHINGTON

SENATE FINANCE COMMITTEE RELEASES HEALTH CARE BILL

On September 16, Senate Finance Committee Chair Max Baucus (D-MT) released a health care proposal entitled "America's Healthy Future Act of 2009," with the following features:

¶ Beginning in 2013, all U.S. citizens and legal residents would be required to have health coverage, which could be provided by an employer or purchased through a public program or other source that meets the minimum creditable coverage standard. President Obama has likened the mandatory nature of such coverage to the requirement that drivers own auto insurance.

¶ State web-based "exchanges"

(Please turn to page 2)

Tax Analysis

Business Succession Planning Involving Family Members

Business succession planning involving family members presents unique challenges, since liquidity needed to pay estate tax or to fund a legacy for nonparticipating family members may exceed that which the business generates. A buy-sell agreement can establishing the price at which participating family members may purchase the business, or a mechanism in which the interest of nonparticipating family members may be redeemed by the entity. If negotiated at arms-length, the price determined under a buy-sell agreement may control for estate tax purposes.

Estate Planning

(Please turn to page 4)

ASSET PROTECTION: ETHICAL CONSIDERATIONS

Operating a business in corporate form, entering into a prenuptial agreement, executing a disclaimer, or even giving effect to a spendthrift provision in a trust, are common examples of asset protection which few ethical issues, primarily because such transfers do not defeat rights of known creditors. However, transferring assets into a corporation merely to avoid a personal money judgment or utilizing an offshore trust merely to avoid alimony or child support payments would defeat the rights of legitimate creditors, and would thereby constitute fraudulent transfers.

The ABA's Model Code of Professional Conduct, DR 7-102,

(Please turn to page 4)

OCTOBER COMMENT

Amendment of New York Power of Attorney Takes Effect

If a person becomes legally incompetent, a power of attorney authorizes an agent appointed by the principal authority to make legally binding decisions behalf of the principal. Without a power of attorney court involvement may be required to appoint a legal guardian. Effective September 1, 2009, NY General Obligations Law § 5-1501 amended provisions governing both the content and execution of powers of attorney in New York. Powers executed prior to September 1 remain valid, but will be subject to provisions in the new law.

Estate Planning

(Please turn to page 3)

IRS MATTERS, CONT.

(Continued from page 1)

mastheads.

CCA 20091106 opens up new planning possibilities for business owners seeking to swap similar businesses. Business owners may now defer gain not only with like-kind or like-class tangible assets, but also with like-kind non-goodwill intangibles disposed of in an exchange. Utilizing a "reverse exchange," taxpayers may "park" non-goodwill intangibles with an Exchange Accommodation Titleholder (EAT), and use the parked property as part of a like-kind exchange within 180 days.

¶ Rev. Rul. 2009-15 explains that a partnership that converts to a corporation under Treas. Regs. § 301.7701-3(c)(1)(i) or under a state law formless conversion statute may make an S election effective for the corporation's first taxable year, since a conversion of a partnership into a state law corporation under a state law formless conversion statute is treated in the same manner as if the entity had made an election to be treated as an association under §301.7701-3(c)(1)(i).

¶ Section 121 allows taxpayers to exclude up to \$250,000 of gain from the sale of a principal residence (\$500,000 for married couples) provided the residence was the taxpayer's principal residence for 2 out of the preceding 5 years. Section 121(b)(4) now provides that if a residence was at any time during that period **not** used as a principal residence of the taxpayer, the portion of the gain allocable to periods of "nonqualified use" will not be qualify for the exclusion. A period of nonqualified use is any period during which the property is not used as the principal residence of the taxpayer or the taxpayer's spouse or former spouse, excluding the portion of the period preceding January 1, 2009.

To calculate gain attributable to nonqualified use, realized gain is multiplied by a fraction, the numerator of which is the sum of the periods of nonqualified use, and the denominator of which is the period of the taxpayer's ownership. Note that periods of nonqualified use do not include (i) periods of nonqualified use following periods of qualified use; and (ii) periods of temporary absence not to exceed two years due to change of employment, health conditions, or other unforeseen circumstances as may be specified by the Secretary. The new restriction on nonqualified use is intended to discourage taxpayers from buying a dwelling for rental purposes, with the intention of later making it the taxpayer's principal residence, in order to



DAVID L. SILVERMAN, ESQ.

J.D., Columbia Law School, LL.M. (Taxation) NYU Law School. Formerly associated, Pryor Cashman, LLP, Manhattan. Former editor, ABA Taxation Newsletter. Author, "Like Kind Exchanges of Real Estate Under IRC § 1031." (2007). Former Treasurer, NY Virtuosi Symphony Orchestra. Approved sponsor for CPE credits, NYS Board of Public Accountants.

nytaxatty@aol.com

TAX LITIGATION

- ¶ Federal Tax Litigation & Appeals
- ¶ NYS Tax Litigation & Appeals
- ¶ Employment & Sales Tax Litigation
- ¶ Declaratory Tax Judgment Actions
- ¶ Criminal Tax Matters; Liens & Levies

TRUSTS & ESTATES

- ¶ Probate & Estate Administration
- ¶ Estate & Gift Tax Planning; Returns
- ¶ Wills & Trusts, LLCs & FLPs
- ¶ Will Contests; Trust Accountings
- ¶ Elder Law, Guardianships, Medicaid

TAX & BUSINESS PLANNING

- ¶ Opinion Letters & Ruling Requests
- ¶ Like Kind Exchges; Corporate Plann'g
- ¶ Business Succession; Buy-Sell Agree.
- ¶ Marriage & Divorce Planning

REAL ESTATE & CIVIL LITIGATION

- ¶ Commercial & Resident'l Real Estate
- ¶ NYS Tax Appeals Tribunal Litigation
- ¶ NYS Civil & Appellate Tax Litigation
- ¶ Article 78 Tax Appeals; Injunctions

Law Offices of David L. Silverman
2001 Marcus Avenue, Ste. 265A South
Lake Success, NY 11042
Tel. (516) 466-5900 Fax (516) 437-7292
www.nytaxattorney.com



SHIRLEE AMINOFF, ESQ.

Ms. Aminoff earned her J.D. from Benjamin N. Cardozo School of Law, with a concentration in property and real estate. Ms. Aminoff is admitted to the New York State Bar. Ms. Aminoff practices tax, trusts & estates, estate administration, real estate, tax litigation, trademarks, and estate planning.

aminoffs@gmail.com

FROM WASHINGTON, CONT.

(Continued from page 1)

would direct consumers to health plans available in their zip code, and would offer standardized health insurance applications.

¶ Low income families would receive a tax credit to make health care more affordable.

¶ Employers would not be required to provide health insurance to employees. However, beginning in 2013, employers with more than 50 employees who do not provide coverage would be required to pay a fee for each employee receiving a tax credit for insurance.

¶ Beginning in 2011, small businesses (fewer than 25 employees and average wages of less than \$40,000) that offer health care would receive tax credits.

¶ Beginning in 2013, a 35 percent excise tax would be imposed on insurance companies and insurance administrators for insurance plans costing more than \$8,000 for single plans and more than \$21,000 for family plans.

¶ Beginning in 2010, employers would be required to disclose on Form W-2 the value of the benefit provided for each employee's health insurance.

¶ Annual contributions to Flexible Savings Accounts would be limited to \$2,000 beginning in 2013; and the additional tax for Health Savings Account withdrawals before age 65 not used for qualified medical expenses would be increased from 10 percent to 20 percent.

¶ Businesses paying more than \$600 annually to corporate providers would be required to file an information report with each

FROM THE COURTS, CONT.

(Continued from page 1)

On examination, the IRS disallowed the discount and asserted a deficiency, asserting that the LLC should be ignored for gift tax purposes, and that the LLC interests gifted and sold should be treated as transfers of cash and marketable securities. The IRS argued that the promissory notes evidencing the sale of LLC interests were insufficient in amount, since no discounts were available. Accordingly, the IRS asserted that sale was in part a gift. Since the discounts were inapplicable, the gifts to the trust were also undervalued.

The taxpayer argued that state law rather than federal law determines the nature of a taxpayer's transferred ownership. Under NY LLC Law 601, a membership interest in an LLC is personal property, and a member has no interest in specific property of the LLC. The Tax Court agreed, observing that "a fundamental premise of transfer taxation is that State law creates property rights and interests, and Federal tax law then defines the tax treatment of those property rights." Under New York law, the taxpayer did not possess a property interest in the underlying assets of Pierre, LLC. Consequently, gift tax liability was properly determined by the value of the transferred interests in the LLC, rather than by the value of the underlying assets.

The Tax Court then disposed of the IRS argument that the LLC should be ignored for gift, as well as income, tax purposes:

"If the check-the-box regulations are interpreted and applied as respondent contends, they go far beyond *classifying* the LLC for tax purposes. The regulation would require that Federal law, and not State law, apply to determine property rights and interests transferred by a donor for valuation purposes under the Federal gift tax regime. . . . To conclude that because an entity elected the *classification* rules . . . the long-established Federal gift tax valuation regime is overturned as to single-member LLCs would be 'manifestly incompatible with the Federal estate and gift tax statutes as interpreted by the Supreme Court.'"

Although *Pierre* reinforced the proposition that single-member LLCs are indeed entitled to valuation discounts, those entities, while useful for income tax purposes, are sometimes less than perfect for other legal purposes, since there is a temptation to ignore the LLC for other legal purposes as well. The problem encountered in *Pierre* would not have arisen had a multi-member LLC been utilized. Of particular interest is that in other respects, the taxpayer was astute: an independent valuation appraiser was retained to compute the appropriate discounts, and LLC formalities were observed.

The 5th Circuit recently held that the transfer of assets owned by Linda Evans and the Estate Robert C. Evans, Jr., to a limited partnership following a Tax Court judgment constituted a fraudulent transfer under the Texas Fraudulent Transfer Act. Since the United States was not bound by state statutes of limitations in

fraudulent conveyance actions, the statute's four-year limitations period was inapplicable. *U.S. v. Evans*, No. 08-51054, (August 18, 2009).

In *Estate of McCoy*, TCP Memo, 2009-61, the decedent's will and trust provided that specific bequests were to be paid from the residuary estate. Different definitions of "residuary" in the governing instruments created ambiguity over the tax clause. The estate apportioned all taxes to the specific bequests, rather than to the marital bequest. Although the IRS argued that the marital share was the proper source of payment, the Tax Court ruled that unless the will clearly provides otherwise, the state apportionment statute controls. Since Utah's apportionment statute equitably apportions taxes to property that generates the tax, no estate tax was imposed on the marital bequest.

In *Bennett v. Com'r*, TC Memo 2008-251, the IRS rejected the taxpayer's offer in compromise even though the amount offered was ten times that which the IRS determined it could currently collect. The taxpayer, who had failed to file for five years, and had rejected an IRS counteroffer, argued that the IRS abused its discretion, since IRS guidance provides that an offer should be accepted when "it reasonably reflects collection potential." Noting that the regulations do not compel the IRS to accept any particular offer, the Tax Court concluded that "guidelines are in the end just that."

It is well settled that a settlor's interest in a domestic asset protection trust ("APT") is excluded from the bankruptcy estate under §§541(c)(2) and 548(e) of the Bankruptcy Code. Will distributions of income or principal from the trust become part of the bankruptcy estate? The answer appears to be no. To be included in the bankruptcy estate, a domestic APT distribution must satisfy two requirements under §541(a)(5)(A): First, the debtor's receipt or entitlement to receipt must occur within 180 days after the filing of the bankruptcy petition. Second, the receipt must arise from a "bequest, devise, or inheritance." Since an APT is an *inter vivos* trust, it is doubtful that any distribution would satisfy these requirements. Therefore, a trustee in bankruptcy could not likely reach assets distributed from an APT.

Since the IRS imposes greater scrutiny on transfers and discounts involving family entities, the lack of substantial nontax reasons for forming these entities may predispose these transfers later examination. *Estate of Jorgensen*, T.C. Memo, 2009-66, illustrates the danger of ignoring case law, formalities, and proper maintenance when utilizing family entities for estate planning. Discounts of 35% were taken on gifts without obtaining an independent discount appraisal. The partnership bank account was used to make cash gifts to family members and to pay personal expenses. Partnership formalities were not followed, since a requirement that distributions be pro rata was ignored. The son borrowed money for personal expenses. Non-tax reasons for forming the limited partnerships were lacking. The Tax Court concluded that the use of a significant portion of partnership assets to dis-

NEW YORK'S POWER OF ATTORNEY, CONT.

(Continued from page 1)

The POA must now be signed, dated and acknowledged not only by the principal, but also by the agent. Under the new law, a POA is durable (*i.e.*, not affected by later incapacity) unless it otherwise specifically provides. If a guardian is later appointed, the agent will account to the guardian rather than the principal. The new POA contains an optional provision whereby the principal can appoint a "monitor" who may request records of transactions by the agent. The statute also provides for a special proceeding to compel an agent to produce records of receipts. Provisions relating to health care billing should allow the agent access to health care records in accordance with HIPPA privacy requirements.

A "Statutory Major Gifts Rider" (SMGR), if executed simultaneously with the power of attorney, authorizes the agent to make legally binding major gifts on behalf of the principal. The SMGR must be executed simultaneously with the power of attorney, and with the same formalities as the execution of will requires. The SMOG may also authorize the agent to "create, amend, revoke, or terminate an inter vivos trust." The authority of the agent to create joint accounts, or to modify a "Totten trust" may also be included in the MSGR. Small gifts (\$500 or less) in a calendar year may be made by the agent without a MSGR. The SMOG may be modified to supplement or eliminate the default provisions provided by law, provided they are not inconsistent with other provisions in the MSGR.

Under GO §5-1504, acceptance of the statutory "short form" OP by banks and other third parties is mandatory. A third party may not refuse to honor the power or SMOG without reasonable cause. The statute provides that it is unreasonable for a third party or bank to require its own form, or to object to the form because of the lapse of time between execution and acknowledgment. (Banks had sometimes insisted that their own powers be used, which created a problem where the principal had become incapacitated.) An attorney may certify that a photocopy of a duly executed power is a true copy, which banks must now accept.

The statute requires that the agent, a fiduciary, observe a "prudent person standard of care," and imposes liability for breaches of fiduciary duty. Fiduciary duties are imposed on agents appointed under all powers of attorney, including those executed prior to the effective date of the new law. The agent must maintain records and must make those records available within 15 days to a monitor, co-agent, certain governmental entities, a court evaluator, a guardian, or a representative of the principal's estate. The statute expressly provides that the agent is entitled to compensation for his work. A mechanism is provided by which the agent may resign.

ASSET PROTECTION: ETHICAL CONSID., CONT.*(Continued from page 1)*

“Representing a Client Within the Bounds of the Law,” provides that “[a] lawyer shall not . . . [c]ounsel or assist his client in conduct that the lawyer knows to be illegal or fraudulent.” Although the Model Code does not define “fraud”, New York, a Model Code jurisdiction, has provided that the term “does not include conduct, although characterized as fraudulent by statute or administrative rule, which lacks an element of scienter, deceit, intent to mislead, or knowing failure to correct misrepresentations which can be reasonably expected to induce detrimental reliance by another.” Therefore, in New York, the prohibition against counseling a client in perpetrating a “fraud” would not prohibit an attorney from assisting a client in transferring property because of the possibility that the transfer might, in hindsight, be determined to have constituted a “fraudulent conveyance”.

Model Rule 8.4 of the ABA’s Model Rule of Professional Conduct provides that it is professional misconduct for a lawyer to “engage in conduct involving dishonesty, fraud, deceit or misrepresentation.” Model Rule 4.4 provides that “a

lawyer shall not use means that have no substantial purpose other than to embarrass, delay, or burden a third person.” Conduct involving dishonesty or an attempt to deceive appears to be a readily determinable question of fact. However, conduct engaging means having no substantial purpose other than to delay or burden third parties may be a more difficult factual determination.

Connecticut Informal Opinion 91-23 states that “[f]raudulent transfers delay and burden those creditors who would be inclined to try and satisfy their unpaid debts from property of the debtor. It forces them to choose either not to challenge the transfer and suffer the loss of an uncollected debt or to file an action to set aside the transfer. . . . If there is no other substantial purpose, Rule 4.4 applies. Where there is another substantial purpose, Rule 4.4 does not apply. For example, where there is a demonstrable and lawful estate planning purpose to the transfer Rule 4.4 would not, in our view apply.”

To minimize risk, the attorney should be careful in performing due diligence prior to engaging in asset protection. Specifically, the attorney should determine (i) the source of the client’s

wealth; (ii) the client’s reason for seeking advice concerning asset protection; and (iii) whether the client has any current creditor issues or is merely insuring against as yet unknown future creditor risks. The attorney should also obtain a statement affirming that the client (i) has no pending or threatened claims; (ii) is not under investigation by the government; (iii) will remain solvent following any intended transfers; and that (iv) the client has not derived from unlawful activities any of the assets to be transferred. Since most prohibitions on attorneys involve the attorney having acted “knowingly”, due diligence is the best insurance against future ethical or legal problems.

New York County Surrogates Court, in *In re Joseph Heller Inter Vivos Trust*, 613 N.Y.S.2d 809 (1994), in approving a trustee’s application to sever an *inter vivos* trust to “insulate[] the trust’s substantial cash and securities from potential creditor’s claims that could arise from the trust’s real property, observed that “New York law recognizes the right of individuals to arrange their affairs so as to limited their liability to creditors, including the holding of assets in corporate form . . . making irrevocable transfers of their assets, outright or in trust, as long as such transfers are not in fraud of existing creditors.”

BUSINESS SUCCESS PLANNING, CONT.*(Continued from page 1)*

Permissible transferees under a buy-sell agreement may also include other owners of the entity. If a “cross-purchase” agreement is used, the continuing owners will acquire the withdrawing owner’s interest at a price determined under the agreement. An advantage to a cross-purchase agreement is that under IRC § 1012, the basis of the surviving owner’s interest is increased by the price paid. Under a “redemption agreement,” the entity itself redeems the owner’s interest at a price determined under the agreement. A management agreement, which defines the rights, powers and responsibilities of each equity owner, often supplements a buy-sell agreement.

Business equity may pass equally to all children, or only to children active in the business, with equalizing transfers of non-business assets to nonactive children. Determining the amount of the equalizing transfer may be difficult, as nonactive children may feel that dividing assets based upon values as finally determined for estate tax purposes may be unfair. Even if fair equalizing values can be determined, nonbusiness assets may be insufficient to provide equal shares to nonactive children. In this case, all or part of the business could be sold to active children, or business equity could pass equally to all children with built-in redemption provisions enabling nonactive children to “put” their business interest to the company at a future time. The put right could be triggered upon a change in ownership or a change in control.

The owner may wish to cede management of the business during his lifetime to family members without disposing of his equity in the company. Future economic benefits could be retained by establishing a mandatory dividend or distribution policy with respect to a retained membership interest or stock ownership. Corporations other than S corporations could have two classes of stock with the class retained by the retiring owner possessing preferential dividend and distribution rights. An S corporation could engage in a tax-free recapitalization creating voting and non-voting interests without violating the single-class-of-stock rule. By selling non-voting interests, the retiring owner could continue to exercise control over dividends and distributions. IRC § 2036 would not apply to a bona fide sale for adequate and full consideration.

An owner with business expertise could enter into a consulting or non-compete agreement with the business which would provide income to the retiring partner. Payments under a consulting agreement are deductible by the business. Unless the retiring owner were an independent contractor, compensation received would be subject to self-employment tax. If employment tax liability arises, the IRS is likely to be indifferent to the level of compensation. Therefore, an owner willing to provide continued services can be divested of ownership interest in the company for legal and estate tax purposes while continuing to receive a steady stream of income. Payments under a non-compete agreement are amortizable by the business over 15 years under IRC § 197 and are not subject to employment tax.

An executive bonus plan could be used to fund a nonqualified private pension, such as a life insurance policy. The plan could discriminate in favor of any employee since it is not tax-advantaged. For income tax purposes, the premium payments would be treated as bonuses (or guaranteed payments in the case of a partnership or LLC). Such payments would be deductible by the business and includable as compensation by the owner.

Various trust arrangements may facilitate a plan of business succession. By selling an ownership in the business to a grantor trust, the retiring owner can remove the value of the business as well as its appreciation from his estate with no adverse gift or income tax consequences. The promissory note issued by the trust as consideration for the business interest purchased could provide for a low rate of interest at the applicable federal rate. If a self-canceling feature is employed, nothing will be included in the seller’s gross estate at his death; however, the rate of interest used would have to be higher to compensate for the self-canceling feature.

To appease family members who continue to participate in the business and want no interference from nonparticipating family members, the equity of nonparticipating family members may be transferred to a voting trust, which would issue new trust certificates representing the transferred interest. Voting rights would become vested in the trustee. Other *inter vivos* trust arrangements may be used to hold and pass equity in among family members in precise manner. For example, a revocable trust agreement may specify how the business equity will be distributed in the event the event the owner becomes incapacitated.