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A PARTNERSHIP OF PROFESSIONAL LAW CORPORATIONS

NEWSLETTER

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CONGRESS DELAYS ESTATE TAX REFORM

TIMOTHY C. POLACEK, ESQ.

While the media has focused on President Obama's efforts to persuade Congress to reform health care, several "blue dog" Democrats in the Senate have raised concerns that the House of Representatives' proposal to fund health care by taxing "wealthy" individuals will delay economic recovery. You may be asking, "What does this mean to estate tax reform?" Possibly nothing. On the other hand, the Democratic led Congress has demonstrated its willingness to increase taxes to fund social welfare programs, while the clock continues to wind down to 2010 when the estate tax is repealed for one year. It will be very interesting politics to see how Congress resolves the estate tax predicament while simultaneously addressing pressing economic and social issues.

In the meantime, 2009 has been a year in which estate and gift tax brackets have reached never before seen levels, as follows:

- The annual gift exclusion amount is now increased to $13,000 per donee.
- The lifetime Applicable Credit Amount (formerly known as the "Unified Credit") exemption is now $3,500,000 per person ($7,000,000 per married couple).

The $3,500,000 Applicable Credit is the result of President Bush's efforts to "repeal" the estate tax in 2001. The tax is "repealed" in 2010, but is scheduled to return in 2011 with an Applicable Credit which covers only $1,000,000 of estate tax.

It is anticipated that Congress will act this year so the scheduled repeal of the estate tax will not occur in 2010 Speculation continues as to what dollar amount Congress will settle upon for the lifetime Applicable Exclusion (the asset value sheltered from tax by the Applicable Credit) if and when Congress makes the estate tax permanent, as many expect. For many individuals, there is a good chance that the current value of their estates will be below the Exclusion amount as finally determined.

A review of the estate tax bills introduced this year shows there could be some significant changes to the law. The following are the bills that are now pending in Congress which address the estate tax.

- The first bill (H.R. 436, known as the Certain Estate Tax Relief Act of 2009) was introduced by Representative Earl Pomeroy (D - ND) on January 9, 2009. The bill seeks to set the Estate Tax Exemption permanently at $3,500,000. *If enacted by Congress*, the new law would apply to the estates of individuals dying after December 31, 2009.
- The second bill (H.R. 498) was introduced by Representative Harry E. Mitchell (D - AZ) on January 14, 2009 and also seeks to reform estate and gift taxes permanently. It would include staged increases in the Applicable Exclusion Amount to $5,000,000, make the gift tax lifetime exemption equal to the Applicable

Exclusion Amount, set the top estate tax rate at the top capital gains tax rate for estates not over $25 million and double the capital gains tax rate for estates over $25 million, repeal the state death tax deduction, and make the first spouse's unused Applicable Exclusion Amount available to the surviving spouse.

- Senator Blanche L. Lincoln (D - AR), for herself, Senators John Kyl (R - AZ), E. Benjamin Nelson (D - NE), Chuck Grassley (R - IA), John Thune (R - SD), Mark L. Pryor (D - AR), Pat Roberts (R - KS), Mary L. Landrieu (D - LA), Michael B. Enzi (R - WY), and Susan M. Collins (R - ME) on April 1, 2009 introduced Senate Amendment 873 (SA 873) to S. Con Res. 13, to create a deficit-neutral reserve fund for estate tax relief.

SA 873 passed in the Senate by Yea-Nay Vote of 51-48. SA 873 includes:

(1) An estate tax exemption level of $5,000,000 (indexed for inflation);

(2) A maximum estate tax rate of 35%;

(3) Reunification of the estate and gift credits, i.e., increasing the lifetime gift exemption to match the estate tax exemption, thereby increasing the amount of lifetime gifts that could be made without having to pay gift tax; and

(4) Permit portability of estate tax exemption between spouses, allowing a surviving spouse to use any unused estate tax exemption of a predeceased spouse.

Of interest to taxpayers affected by the estate tax is the fact that H.R. 436 eliminates the use of valuation discounts applied to “passive” assets held in entities such as family partnerships. Given the IRS’ disdain for such estate planning techniques (see discussion herein regarding the Tax Court’s recent allowance of such discounts in *Miller v. Commissioner*), Congress is likely to pay increased attention to the issue of valuation discounts.

We continue to monitor the estate tax legislation and will announce any changes in upcoming newsletters.

An informal poll among estate planning attorneys suggests there is a good chance that Congress will keep the lifetime Applicable Credit Amount at $3,500,000 per person and the estate tax rate will remain at 45%. It is believed Congress will approve a new Applicable Credit Amount before the new fiscal year starts in October. If no change is made, there will be no (zero) estate taxes for persons dying in 2010.

One thing is clear, 2010 is fast approaching and estate tax reform should regain substantial momentum at the end of the summer.

NEW REASONS TO REVIEW YOUR “OLD” ESTATE PLAN

MARY J. PESHEL, ESQ.

Estate taxes are a consideration in many estate plans and the idea of not owing any estate tax is certainly a welcome thought. However, an estate plan addresses not only the *value* of the assets, but also the *manner* in which the assets are transferred to one’s heirs.

For decades, our firm has worked with clients to create estate plans that permitted assets to be managed by a child as trustee of a generation skipping trust. The trust assets remain in place for the benefit of the child and avoid estate tax at the child’s death. For inheritances received over a decade ago, this strategy has generally proven to be quite successful due to the appreciation in asset values.

However, many of our clients have created generation skipping trusts that have not yet been funded as the surviving spouse is still living. In these cases it is appropriate to re-examine the basic terms of these generation skipping trusts and determine whether they are still appropriate for the child. Parents might consider changes to their plans to reflect the following:

- Increased age and maturity of the children;
- Possibility that a child has received retirement plan funds and/or other payments that decrease the need for income;
- Changed attitude toward spending and investments; and

- Financial circumstances which may make it unlikely that the child (and spouse) will accumulate assets of his/her own in excess of the current $3,500,000 estate tax exemption.

Estate plans that were drafted over five years ago should be reviewed and/or revised to consider the amounts that can now pass free of estate tax, as well as the estate tax changes we believe are coming.

Perhaps more importantly, we find that many adult children wish to participate in their parents' estate planning, including how the children will receive their inheritance. Many clients are no longer concerned with keeping their estate plan private, especially when adult children are assisting the parent(s) in managing the family wealth.

Also, a growing number of adult children desire to better understand how to keep their inheritance separate from the assets they have accumulated with their spouse.

For these reasons, it is very important that estate plans be reviewed in the near future to assess the effect of the pending estate tax law changes. Often this will include the estate plan for the surviving spouse who likely has powers to alter the disposition of the trust.

VALUE OF SECURITIES HELD BY FAMILY LIMITED PARTNERSHIP WERE DISCOUNTED FOR ESTATE TAX PURPOSES

TIMOTHY C. POLACEK, ESQ.

The Tax Court has again allowed valuation discounts to the estate tax value of a properly structured and operated Family Limited Partnership ("FLP") whose sole business involved the management of marketable securities. In *Miller v. Commissioner (May 27, 2009),* the court found that the purpose for creating a FLP was to enable a mother and son to continue executing her husband's investment strategies in managing the family's securities portfolio after the parents' death.

The facts of the case are familiar. Valeria Miller was married to a successful architect who retired in 1974 and spent the next 26 years managing an investment portfolio and applying his own unique method of charting stocks. Upon his death in 2000, the portfolio was worth $7 million. Under Mr. Miller's estate plan, a portion of the securities passed to a Qualified Terminable Interest Property ("QTIP") Trust for Valeria, with the balance transferred to her revocable trust.

In 2001, Valeria sought legal advice about forming a family partnership. She was 86 and in good health. The next year, she funded the partnership by contributing 77% of her assets. She transferred 8% of the FLP to her children, and kept the remaining 92% interest. Valeria's son, Virgil, managed the stock portfolio using his father's charting method. He worked full-time each week in managing the portfolio.

Later, in May 2003, after Valeria recovered from surgery from a broken hip and heart failure, the balance of the securities were transferred to the FLP.

The IRS rejected the application of a 35% discount to the FLP interest held by Valeria on the basis that IRC Section 2036 applied. Upon review by the Tax Court, it ruled that the son's continued, full-time, implementation of his father's investing strategies made the FLP an active business. Additionally, the fact that Valeria kept sufficient assets outside the FLP at the time of formation, indicated she did not then "retain" the beneficial use of the transferred securities. Therefore, the 35% discount was permitted.

Although the deathbed additions were disregarded as a tax avoidance device with "no significant non-tax purpose," the case presents a good example of how FLPs can demonstrate active business management for securities portfolios. The Tax Court's decision is consistent with *Bongard v. Commissioner*, wherein a decedent formed trusts and a partnership to carry out his long-term investment goals. A review of this case is recommended for those practitioners whose clients have similar circumstances.

For those families that hold securities in a business entity, the benefits of documenting the active management of an investment portfolio are illustrated by this case. Alternatively, the failure to devote time, effort and strategy to a FLP owning marketable securities can prove fatal if the primary objective of the partners is to obtain valuation discounts.

If you would like to receive further information regarding the topics in this or past newsletter, or if you would like to let us know any issues or topics you would like to see addressed in future newsletters, please contact us at (619) 239-7777 or newsletter@mmpph.com.

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