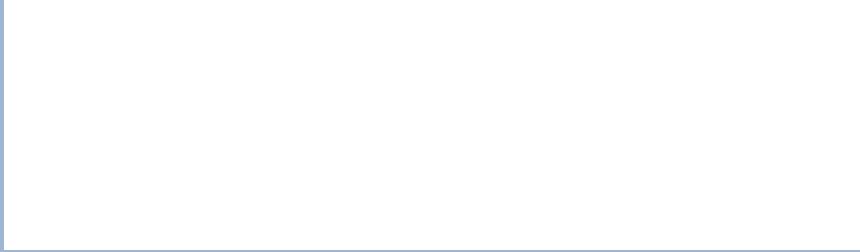


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Planning for the Future Newsletter

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TAX COURT FAVORS TAXPAYER WITH NON-TAX MOTIVE

in harmony, and want to save money, everyone does not have to “lawyer up.” Unfortunately, in the context of family entities, the absence of separate counsel and negotiation is an adverse fact.

In *Mirowski*, the court looked at the forest, not the trees. Did the family LLC make sense from a non-tax standpoint. In this case, the court said it did. Since the types of defects in the case were not fatal to that purpose, the taxpayer prevailed.

The IRS has been successful because it chooses the correct cases to fight. Bad facts make bad law. Strong non-tax purpose is vital, and should be the focus in planning.

Taxpayers still need to focus on the details. Prior editions of this newsletter have discussed these details, and provided a checklist for implementation. Caution is still important. Family limited partnerships and family LLCs are in the middle of the IRS radar screen. *Mirowski* is a positive development in what has been a negative trend.

Continued from page 3 . . . SIGNIFICANT RULING FOR DEFECTIVE TRUSTS

For example, if there is an exchange of life insurance policies, be certain that fair market value is used. If the insured is in poor health, the value may be much greater than the measure normally used. If there is a trust that pays a fixed percentage of asset value and the grantor acquires a high-income asset from a trust (such as a well-secured promissory note or high-interest bond) in exchange for non-income producing assets, will that skew the relative values between the income beneficiary and the remainder beneficiary? If the grantor acquires an interest in an entity, which causes the grantor to be able to control that entity (such as if the grantor owns 49% of the stock before the exchange and acquires 2% in the substitution), the equivalent value should consider the control premium. These are a few examples of sensitive situations. In really sensitive cases, the trustee may want to obtain a Probate Court order to review and approve a sale.

Summary

This ruling is one of several favorable rulings or developments for the taxpayers in the area of defective grantor trusts since 2001. The ruling provides helpful guidance, and some cautionary note.

McCOY WITH GST QUIZ

Congratulations to Christie A. McCoy, CPA of Brown and Adams, LLP, of Menlo Park, CA for achieving the high score in the Winter, 2008 GST tax quiz. For this, Christie won a hat from the Masters Golf Tournament.



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Spring 2008



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C R E A T I V E D I R E C T I O N S

IRS ANNOUNCES BUYING SEASON FOR TAX SAVINGS

Our Vision:

We are the preeminent law firm providing counseling to individuals and businesses in the fields of estate planning, probate and trust law, business succession, taxation and representation before the IRS and other tax compliance agencies.

Our Mission:

To deliver highly effective legal representation to our clients by enhancing the wealth and success of our clients, advancing the interests and transactions of our clients through result-oriented advice, protecting our clients before taxing authorities, securing the legacy and value of family and closely-held business, and assisting the accountancy profession to achieve greater success for its members.

4 ORINDA WAY, SUITE 250B
ORINDA, CA 94563
TELEPHONE 925.258.0123
So. Cal. Tel. 310-394-4LAW(4529)
FAX 925.258.4040
kschiller@slg4law.com
shemmi@slg4law.com
<http://www.slg4law.com>
www.cpas411.com

The Internal Revenue Service requires that family transactions carry a specified minimum interest rate. That minimum rate is called either the applicable federal rate or the Section 7520 rate. These rates are readily accessible on the internet. Just “google” “applicable federal rate.”

The applicable federal rate (or “AFR”) is currently at historic lows. For example, a loan of three years or less to a family member, payable at least interest-only quarterly, must carry interest at the rate of 1.63% per annum. If the loan was for up to 9 years, the interest rate need only be 2.71% with quarterly payments. Even its companion, Section 7520 rate, is very low (3.2% for May, 2008). The Section 7520 rate is 120% of the mid-term applicable federal rate. The mid-term AFR is used for loans of greater than 3 years, but not more than 9 years duration.

The applicable federal rate is used with loans. The Section 7520 rate is used with special estate planning strategies, such as grantor retained annuity trusts and charitable trusts.

Here's The Deal

A loan with a family member can be created so that the lender (parent or senior generation) sells an asset to a family member, or simply makes a loan wherein the borrower (child or younger generation) invests the borrowed money, or purchased asset, and

receives a greater return than interest rate incurred on the borrowing.

Wouldn't it be nice if the bank lent you money at a 1.84% interest rate and allowed you to invest that money in a certificate of deposit that earned 4%?! That loan is not available at Wells Fargo Bank or Mechanics Bank, but it can be offered at the Bank of Parents or the Bank of Child-Helping Parents. Moreover, case law supports the proposition that a gift does not arise when the loan carries interest at the applicable federal rate.

Consider the following simple example: Parents loan child \$1 million on a bona fide loan. Security may be a good idea, even a deed of trust on the child's home. The loan provides for quarterly payments of \$28,400. The child is able to invest the money at 4%, safely \$40,000 a year interest without compounding. The child keeps the \$11,600 spread and may avoid gift treatment. Check with the CPA regarding interest deductibility.

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- Defective Trust Love (Page 2)
- Helpful Family LLC Case (Page 3)

SIGNIFICANT RULING FOR DEFECTIVE TRUSTS

The Service recently issued Rev. Rul. 2008-22, which provides that the existence of a power in a non-fiduciary capacity to substitute property of equivalent value will not cause the holder of that power to be considered the equivalent of an owner for estate tax purposes. The ruling is significant because the power to substitute assets for equivalent value is one of the main approaches, and for some practitioners the preferred approach, for making a trust defective for income tax purposes.

A “defective trust” is one that is income taxed to the creator of the trust (i.e., the grantor) but is outside of the grantor’s estate for income tax purposes. Defective trusts are widely used with life insurance planning and in connection with the installment sale of assets. For example, the wealthy family member could sell an asset to a trust, wherein the asset sold is outside of the grantor’s estate on death, but the grantor pays the income tax on income and gains that the trust receives. The payment of the income tax by the grantor further benefits the younger generation by allowing property to pass without reduction for income tax against the younger generation. This double-win is further enhanced when low interest rates apply on the loan for the deferred purchase price.

Making a Trust Defective

The income tax law provides that a grantor will be considered the taxpayer when the grantor retains certain powers. When the powers extend to the trust as a whole, then the recognition of gain can be avoided when the asset is sold to the defective trust. This conclusion arises because there is not a taxable sale when a person sells an asset to himself.

One popular way for making a trust defective is to allow a third party to add beneficiaries. However, that power runs the risk that a beneficiary will be added contrary to wishes. The other popular approach is to allow the grantor to hold a power, in a non-fiduciary capacity (i.e., not as a trustee) to exchange property for equivalent value. Many practitioners believe this approach has less practical risk (i.e., un-loved ones do not become beneficiaries).

Impact of the Ruling

The Service ruled that a grantor’s retained power, exercisable in a non-fiduciary capacity, to acquire property held in trust by substituting property of equivalent value will not, by itself, cause the value of the trust corpus to be includible in the grantor’s gross estate under either Code Section 2036 or 2038.

In the facts of the ruling, a third party served as the trustee. (This would be normal with life insurance trusts so the insured does not have an incident of ownership.)

Continued on page 3

TAX COURT FAVORS TAXPAYER WITH NON-TAX MOTIVE

Mirowski v. Comr. T.C. Memo. 2008-72 reflects a realistic approach in the Tax Court to focus on the importance of the existence of a significant and legitimate non-tax purpose in the determination of whether or not to recognize a limited partnership or LLC interest for estate tax purposes.

Tax Court Judge Chiechi determined that the existence of substantial non-tax purposes for the formation and continuation of a family limited partnership (FLP) were sufficiently strong that the underlying assets of the FLP should not be included in the gross estate of the decedent, notwithstanding the fact that some of the particular operational facts or post-death use of funds could have led another judge to a different result. The Court rejected the inclusion of the assets under IRC Section 2036.

Several facts did not dissuade the outcome, including, gifts made by pre-arrangement shortly after formation of the LLC; the LLC was formed as part of the estate plan; the value of assets placed in the LLC was much greater than the assets retained outside of the LLC (although significant assets were held outside of the LLC); the decedent’s health was poor, but not fatal; funds were used from the LLC post-death to pay estate tax; and one attorney handled the deal (i.e., no separate representation).

Substantial Non-Tax Purposes

The court noted the following legitimate and significant non-tax reasons: (1) joint management of the family’s assets by Mrs. Mirowski and her daughters, and eventually her grandchildren, with the objective of fostering family cohesiveness; (2) maintenance of the bulk of the family’s assets in a single pool to take advantage of lower investment management fees and to allow for investment opportunities that would otherwise not be available; and (3) providing for each of her daughters and eventually each of her grandchildren on an equal basis.

Realism of the Case

Judge Chiechi sought to focus on the fundamental principles of the leading cases, Bongard and Bigelow, which emphasize the existence of substantial, legitimate non-tax purposes. For example, in the real world, when individuals go to form a partnership or new company, they may go to one attorney to handle the deal. The attorney will need to proceed with a conflict waiver. However, when parties are

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Continued from page 1...

IRS ANNOUNCES BUYING SEASON FOR TAX SAVINGS

Leveraging the Cash Flow Even More

The foregoing example can be enhanced when the child purchases an interest in an entity, such as stock or partnership interests. Let's assume that a limited partnership owns investment real estate, cash and securities, and that the partnership as a whole has a value of \$10M; and net income of \$600,000. The amounts to a 6% capitalization rate (i.e., the value of the investment in relationship to its income return). Assume that the minority interest in the sale receives a moderate discount of 35% when compared to net asset value. In this instance, a 10% interest would have a net-discounted value of \$650,000 (\$1M less \$350,000).

In this example, the amount of the required sales price to avoid a gift is less than the pro-rated value of a 10% interest to the entire partnership. However, the net income on the 10% interest is still \$60,000 (10% of \$600,000). When compared to the discounted value, the return for the child is \$60,000 income over a \$650,000 value, or a return of 9.2%.

While there is normally some down payment on a sale of this nature with a child, to simplify the math, consider the following result. The child pays interest at the rate of 2.84% (April, 2008 rate) on the promissory note of \$650,000 (i.e., \$18,460 a year) but receives income from the partnership of \$60,000. Assuming the partnership distributes its net income, the child enjoys a positive cash flow of \$41,540 a year, less any principal paid. Again, that deal can be structured to avoid a gift.

Gift Tax Filing

Even though no gift may arise, or arguably not arise, a gift tax return should be filed. Adequate disclosure should be made of the non-gift transaction. This allows the IRS only three years to then challenge the value of the transfer as a gift. The IRS audits fewer Gift Tax Returns than Estate Tax Returns. Also, issues can be raised on an Estate Tax Return as part of a trade-off, which negotiation may otherwise be avoided with the cleaner Gift Tax Return.

The SCHILLER LAW GROUP works extensively with clients and professionals with estate planning approaches that can substantially reduce, or avoid, estate tax, income tax, and gift tax while transferring significant wealth to the younger generation.

GENERAL DISCLAIMER: While we hope our newsletter assists your planning, please note that it does not advise on a particular matter or outcome. This newsletter does not predict or guarantee the outcome or result in any situation. No attorney-client relationship exists or is established as a result of this newsletter or its receipt.

Continued from page 2...

SIGNIFICANT RULING FOR DEFECTIVE TRUSTS

Furthermore, the power was exercisable by the grantor in a non-fiduciary capacity, without the approval or consent of any person acting in a fiduciary capacity. However, to exercise the power of substitution, the grantor must certify in writing that the substituted property and the trust property for which it is substituted are of equivalent value.

The Service noted that under state law (which would be the situation in California), the trustee had the duty to see that the values were equivalent and the trustee would also have to have the power to sell, acquire, exchange, control, and manage trust assets (which is also normal).

A key portion of the trust is that the grantor was prohibited from serving as a trustee. This element of the ruling differs from Estate of Jordahl, wherein the decedent held the power to substitute for equivalent value as a trustee.

Caution under the Ruling

The following action steps should be considered to avoid estate tax inclusion with the right to substitute assets of equivalent value:

- (1) include express statement that the power to substitute is held in a non-fiduciary capacity, and that the Probate Code Section 16081 shall not be construed or applied to impose or create a fiduciary duty to the grantor with respect to the exercise or non-exercise of that power;
- (2) prohibit the grantor from becoming a trustee;
- (3) require the trustee to ensure that the assets exchanged are of equivalent value, so that the exercise of the power of substitution by the grantor will not reduce the value of the trust, increase the grantor's wealth, or shift benefits between or among beneficiaries of the trust as a result of the substitution of assets;
- (4) the nature of the trust's investments or level of income produced should not impact the respective rights of beneficiaries.

Practical Considerations

With most defective trusts, the power to substitute assets of equivalent value is not exercised, it merely exists with its attendant tax effect. However, the trustee should be mindful to ensure compliance with the above-noted cautions.

Continued on page 4

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