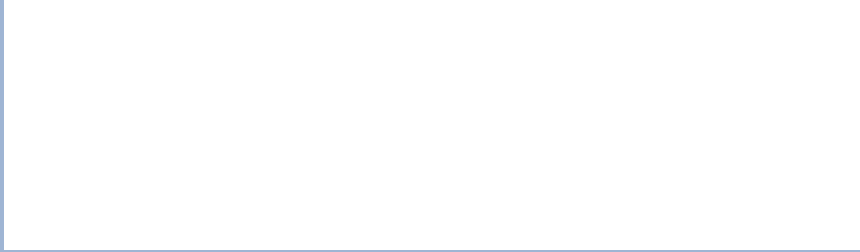




# SCHILLER LAW GROUP

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*Schiller Law Group - A Professional Law Group*

*Planning for the Future Newsletter*

## **GST QUIZ--- DON'T GET ANGRY ...WIN A PRIZE!**

The GST law was written by smart people with little appreciation for the practicalities of complying with the law or impact of creating counter-intuitive rules. Our task of writing an understandable, much less enjoyable article, becomes the more difficult. Therefore, we have decided to write no article on the subject! Instead, those of you who care about this subject are invited to the quiz offered in the insert at page 5. Submit answers by e-mail to [KSchiller@slg4law.com](mailto:KSchiller@slg4law.com) by 2/14/08. Each contestant will receive an answer sheet. The winner will receive a golf hat from the **Masters Golf Tournament**.

## **EXPANDED SOUTHERN CALIFORNIA CONFERENCE CAPACITY**

In recognition of expanding client requests from Southern California, the Schiller Law Group is leasing conference facilities in Southern California from the Barristers Executive Offices. Our main base of Southern California operations remains in Santa Monica, at the Fairmont Miramar Hotel for a third consecutive year. Contact Eleanor Cooper of the Schiller Law Group at 310-394-4LAW(4529) to schedule an appointment.

## **TEACHING SCHEDULE AND UPCOMING SPECIAL EVENTS**

The 2008 teaching schedules for STEPHANNI HEMMI (*GST from A-Z and Form 709 and Gift Tax Law*) and KEITH SCHILLER (*Preparation of Form 706, Estate Planning for the Closely-Held Business Owner and Wealthy Investor*, and the new *Advanced Estate Planning Workshop*, which will feature co-teaching) will be posted on the California CPA Education Foundation web site.

During 2008, Keith will be presenting on behalf of the Tax Section of the California State Bar (February 9, San Francisco), Kess, AICPA Tax Conference (Las Vegas, May 9), Marin County Estate Planning Council (May 14), and Orange County Estate Planning Council (September 23). Check with the sponsoring organization for time and place. STEPHANNI will be speaking at the Cal. CPA Society, Estate Planning Symposium on January 23 (Palo Alto).

# SCHILLER LAW GROUP

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Winter 2008



**future**

C R E A T I V E   D I R E C T I O N S

## TAXPAYERS WIN MAJOR BUILT-IN GAIN DEDUCTION CASE

### Our Vision:

We are the preeminent law firm providing counseling to individuals and businesses in the fields of estate planning, business law, probate and trust law, real estate, 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.

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Imagine. Two identical C Corporations (i.e., regular corporations that are not treated as S Corporations) have the same balance sheets, income statements, clientele, and every other factor conceivable with one exception. Corporation #1 owns assets in which the fair market value is \$10 million greater than basis. Corporation #2 owns the same assets but basis and fair market value are the same. At such time as Corporation #1 sells its assets, it will incur about \$4.2 million in capital gains tax arising from a difference between fair market value and adjusted basis. This value difference is called *built-in gain*. Corporation #2 does not have this problem because there is no difference between fair market value and basis.

The IRS argues that based on the above set of facts, the minimalist deduction, if any, should be allowed for the value of a decedent's minority stock ownership because the occurrence of a sale of the corporate assets is too speculative.

In a major victory for taxpayers, the 11th Circuit Court of Appeals held in *Jelke v. Comr.* 2007-2 USTC Par. 60552 that the decedent's estate would be allowed a dollar-for-dollar reduction in stock value in the estate of the minority shareholder. The Tax Court had limited the deduction to 6%, asserting that a minority shareholder could not control a decision to sell the company.

The Appellate Court, on the other hand, reasoned that the existence of

a significant tax liability would be relevant to a willing buyer and willing seller, that a willing buyer would want an offset; and, that in that setting the appropriate approach is to assume a sale of the company as a whole as of the time of death. Returning to our opening example, that would provide a \$4.2 million reduction in value at the corporate level.

The taxpayer's estate would then share pro-rata the benefit of the reduction, less applicable discounts for minority interest or lack of marketability.

The 11th Circuit opinion follows the taxpayer's success in the 5th Circuit decision of *Estate of Dunn* 301 F.3d 339. In *Dunn*, the decedent's estate owned the controlling stock interest. *Jelke* is more significant because the decedent owned only a small minority interest.

### Service's Approach to Minimize the Built-In Gain Deduction

The approach often taken to minimize the effect of the deduction for the

*Continued on page 2*

### INSIDE:

- Form 706 Instructions (Page 2)
- Funding Living Trusts (Page 3)
- GST Quiz (Page 5)
- And More!!!!

*Continued from page 1*

built-in gains tax is to include the deduction as a part of the lack of marketability discount. This approach makes the discount a part of a variety of factors that enter into a particular discount number. The impact of the built-in gain component may be lost in the shuffle because it is not singled out as a separate deduction item.

The second approach toward minimizing the discount is to apply some type of weighting factor or present discount reduction to the probability of sale. This second approach recognizes that the eventuality of sale is speculative.

The *Jelke* opinion recognizes that eventual sale is unknown. Rather than choosing to err on the side of speculation toward reducing the discount, the Appellate Court focuses on fair market value principles, determines that is a difference, and resolves unknowns for the benefit of the willing buyer (i.e., a value reducer).

### Reviewing Appraisals

It is important for practitioners to review appraisals received, whether from the appraiser engaged by the taxpayer of the report issued by the Service, or its outside appraiser. Are the facts of the business correctly stated? Is the appraisal a cookie-cutter, or reflective of true analysis of the particular business? Have deductions been properly included? (Your author encountered a recent appraisal of a C Corporation in which no deduction in value was taken when LIFO inventory was used. Spotting that issue alone saved the taxpayer a multiple of their investment in our service.) Are the facts and assumptions applied toward conclusions reached? Are the conclusions based on an application of facts presented? Have discounts and deductions been trivialized through a “bunching” technique.

The SCHILLER LAW GROUP advises fiduciaries, tax preparers and attorneys throughout California with the review of estate tax returns, assistance in working with appraisers, estate tax audits, appeals and Tax Court disputes. Contact our office to see how we can be of best service to you.

## HEIGHTENED IRS FOCUS ON PARITAL OWNERSHIP DISCOUNTS

Instructions for the completion of the Federal Estate Tax Return (Form 706) call for the highlighting of discounts in the reporting of partial interests in entities (limited liability companies, limited partnerships, corporations, other associations) and the fractional interest discount reporting with undivided interests in real property. The concern of the Service, particularly with its declining staffing resources, to identify discounts and select returns for audit undoubtedly spurred this change to the Form 706. However, in the process, the Service may also be inadvertently helping taxpayers to *increase* fractional interest discounts and undermining the argument that fractional interests in real property should be valued under a different criteria than minority interests in limited partnerships or other entities.

Question 10a of the Form 706 (revised September, 2007) asks if the decedent owned any interest in a partnership, an unincorporated association, or limited liability company, or owned a fractional interest in real estate. If so, question 10b asks if the value of **any** interest owned with reference to question 10a was discounted. If “Yes”, the taxpayer is directed to the instructions for Schedule F for reporting total accumulated and effective discounts taken on Schedules A, F and G.

### Effective Discounts

The Service would like to see the amount of discounts highlighted on estate tax returns, or at least documents attached to the return (such as within the appraisal). This request is logical in view of the reduced IRS audit staff and its focus on discounts.

However, in the process of requesting reporting of effective discounts, the Service has merged its analysis of fractional interest discount with discounts that apply to minority interests in limited partnerships. However, District Counsel for the IRS argues that minority interest sales of partnership interests are not comparable to sales of undivided interests in real estate.

*Continued on page 3*

**TAX ADVICE DISCLAIMER:** Nothing contained in this communication was intended or written to be used, and it cannot be used, by you for the purpose of (1) avoiding any penalty that may be imposed by the Internal Revenue Service or (2) promoting, marketing or recommending to another party any transaction or matter addressed herein. If you would like advice, please contact us.

**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*

Finally, the instructions to Schedule F include an illustration of a 23.5% fractional interest discount, which is greater than the IRS often (but not uniformly) seeks to allow in audit.

A full discussion of these instructions authored by Keith Schiller was published in the Leimberg Information Services Newsletter (November 27, 2007).

**Likely Amendment to 706 Instructions**

It is our expectation that the Service will clarify the instructions in some manner. The current instructions confuse valuation principles. Also, the Service may or may not want an illustration of a 23.5% fractional interest discount.

Regardless of whether or not the instructions are amended or temporarily fixed in some manner, the new questions emphasize the focus of the Service on a fairly narrow area of concern. In the meantime, and as the *Jelke* case reveals, there may be even greater tax savings achieved with effective appraisal of the underlying entity value than focusing, per se, on the amount of discounts.



**MECHANICS BANK HIRES DANA NOVOTNY**

With a sense of loss, but joy, we are pleased to announce that DANA NOVOTNY (the step-daughter of Keith Schiller), was recently hired away from the Schiller Law Group to serve as a Trust Administrator with the Mechanics Bank. Dana did a wonderful job in our office and should be a great addition for the bank. (She also earned her bank employment with no assistance from us.) Dana received her B.A. Degree in Business and Finance from the University of Nebraska, graduating on the Dean's List. Dana may be reached at (415) 249-8315.

**WOULD YOU PREFER TO NOT RECEIVE THIS NEWSLETTER?**

**If you consider this newsletter "junk mail", we would like to remove you from our mailing list... save your time, help the mailman's back, save us money, and help the environment. We will also send you \$1.00 if you tell us you want off our mailing list. Please, email your request to be removed to [ecooper@slg4law.com](mailto:ecooper@slg4law.com). We remain pleased to provide the newsletter to those who want it.**

**KEEPING LIVING TRUSTS FUNDED**

Living trusts avoid probate when the living trust owns the asset. Generally, a probate is required when the asset is held by an individual. Exceptions to this general rule include life insurance, joint tenancy, and benefits that pass by designation under an agreement (such as an IRA or retirement fund).

Funded living trusts avoid probate because a court order is not needed in order to clear title into the name of the desired recipients. However, when the living trust is not the record owner, a probate may be needed.

The beginning of the new year is a great opportunity to evaluate the following:

- If you do not have a living trust in place, consider updating your estate planning.
- If you have a living trust in place, review the ownership of assets to see if they are in trust title. (While K-1 and 1099 tax reporting forms are not indicators of title, if these forms are issued to an individual and not with a reference to a trust, it is likely the case that the bank, partnership, brokerage firm or other investment source is not recognizing the trust as an owner.)
- See that your Advanced Health Care Directive is in place.
- Review the beneficiary designation of life insurance. (Should a living trust be named as the beneficiary? Should the life insurance be owned by an irrevocable life insurance trust?)
- See that you have current Durable Power of Attorney for Financial Management.
- Inventory assets.
- Provide a list to loved ones of key contacts in the event of death or incapacity and an instruction letter. (Do a *fire drill* to test what happens or should be done in the event of death.)

The Schiller Law Group assists clients throughout California with their estate planning needs. Contact STEPHANNI HEMMI or KEITH SCHILLER to update your estate plan.



## GST MASTERS QUIZ

(No grades. See how you do. The best result wins a golf hat from the Masters. Contest closes 2/14/08.)

1. T gifted \$100K in trust for the benefit of T's son (S) in 1999 and allocated no GST exemption. Income and principal is payable to S for need in the discretion of the trustee. There was no Crummey withdrawal power. On S's death, the remainder of the trust goes to G (grandchild). S died on July 8, 2007, at which time the trust had a value of \$900,000. Which of the following is the best, legal course of action for T to take:

(A) Include the allocation of \$900,000 of GST exemption on the estate tax return of S; (B) T should file a gift tax return within nine months of the death of S allocating \$900,000 of GST exemption by T; (C) T should timely file a gift tax return and allocate \$100,000 of GST exemption; or (D) T should timely file a gift tax return and allocate \$90,000 of GST exemption.

2. In 2007, T makes a gift of \$12K, in trust, for G, in which G receives income and principal for need. G has a right, exercisable within 30 days of the making of the gift, to withdraw the gift up to the annual exclusion amount (a Crummey power). On G's death, the balance of the trust goes to G's issue then living. Which of one the following applies:

(A) The gift is an annual exclusion gift for gift tax purposes and a non-taxable transfer for GST purposes; (B) The gift is an annual exclusion gift for gift tax purposes and a taxable transfer of \$5K by T to G (direct skip), to which \$5K of T's GST exemption is automatically allocated unless T elects out of automatic allocation. G is treated as the transferor on the \$7K excess; (C) The gift is an annual exclusion gift for gift tax purposes and a taxable transfer of \$12K by T to G (direct skip), to which \$12K of T's GST exemption is automatically allocated unless T elects out of automatic allocation; or (D) The gift is a taxable gift of \$12K for both gift tax and GST tax purposes.

3. In 2007, T makes a gift of \$12K, in trust, for S, in which S receives income and principal for need. S has a right, exercisable within 30 days of the making of the gift, to withdraw the gift up to the annual exclusion amount (a Crummey power). On S's death, the balance of the trust goes to S's issue then living. Which of one the following applies:

(A) The gift is an annual exclusion gift for gift tax purposes and a non-taxable transfer for GST purposes; (B) The gift is an annual exclusion gift for gift tax purposes and a taxable transfer of \$5K by T to G (direct skip), to which \$5K of T's GST exemption is automatically allocated unless T elects out of automatic allocation. S is treated as the transferor on the \$7K excess; (C) The gift is an annual exclusion gift for gift tax purposes and a taxable transfer of \$12K by T to G (direct skip), to which \$12K of T's GST exemption is automatically allocated unless T elects out of automatic allocation; or (D) The gift is a taxable gift of \$12K for both gift tax and GST tax purposes.

4. T established a trust in 1999 with \$500,000 for the benefit of T's three children and seven grandchildren. The trust has a current value of \$750,000. Under the terms of the trust principal and income may be paid to or applied for the benefit of these 10 beneficiaries, or the survivors of them, for health, education and support. No GST exemption has been allocated to this trust. T's children are ages 40-50. The grandchildren range in ages 6-20. Which of the following is the most prudent general advice:

(A) While any children are living, make distribution on behalf of grandchildren by having payments go directly to health care providers or educational institutions for tuition; (B) While any children are living, avoid making any distributions to grandchildren in order to avoid any taxable distribution; (C) Divide the trust into separate trusts, allocated one equal share to each beneficiary; or (D) While any children are living, make distribution on behalf of children for their health needs by making the payments directly to health care providers.

5. T bequeaths \$3 million to C. C disclaims \$2 million of the gift as a qualified disclaimer, as a result of which the \$2 million goes to G. Which of the following is true:

(A) The transfer goes from T to C and is not a direct skip as a result of the qualified disclaimer; (B) G is treated as a person in the same generation of C for GST purposes as a result of the qualified disclaimer; (C) T made a direct skip transfer to G of \$2 million; (D) The automatic allocation of GST exemption applies unless there is an opt-out of T's estate tax return; (E) A and B apply; (F) A, B and D apply; (G) C and D apply; (H) All of the above; or (I) None of the above.

6. T establishes a life insurance trust in 2007, which acquires \$3M of life insurance on the life of T. Annual premiums are \$35K for a term life insurance policy. While T is living, net income, if any, accumulates in the trust. On T's death, distribution of income and principal is distributed among the children and grandchildren as the trustee determines appropriate. Which of the following is the most prudent general advice:

(A) Be certain that GST exemption is timely allocated to the minimum extent necessary each year to keep the inclusion ratio at zero (i.e., GST tax exempt); (B) Allow the automatic exemption allocation rules to apply and save the cost for preparing a gift tax return; (C) Allocate GST late each year since the trust will go down in value each year, since term insurance generally has minimal if any value; or (D) Communicate with clients regarding the pros and cons of timely versus late GST exemption allocation to determine what approach the client prefers.

7. During life, H made taxable gifts of \$500K to his children and no taxable gifts to grandchildren, other skip beneficiaries, or anyone else. Under the terms of the living trust between H and W, the trust estate of the first spouse to die (H in this case) is divided between a credit shelter trust (also referred to as a by-pass trust) and a marital deduction QTIP trust. At death, H has a taxable estate of \$5 million, before the marital deduction. Which of the following is the most prudent general advice:

(A) Establish the marital trust and credit shelter trust, each as separate trusts; (B) When filing the estate tax return, it is not necessary to allocate GST exemption on Schedule R because the credit shelter trust will automatically be fully GST exempt; (C) Make a reverse QTIP election on Schedule R to use \$500K of H's GST exemption to a GST exempt marital trust, dividing the marital trust between separate GST exempt and non-exempt trust; or (D) Make a reverse QTIP election on Schedule R to use \$500K of H's GST exemption to the marital trust, establishing the marital trust as one trust, enabling the client to save on legal and accounting fees for the administration of too many trusts.

8. Trustee is administering a long-term trust for the benefit of the children, grandchildren and great-grandchildren of T. As each beneficiary dies, distribution is divided among the issue of that deceased beneficiary. The trust has a value of \$10 million and an inclusion ratio of .30. (In other words, the trust is 70% exempt and an effective GST tax rate of 13.5% applies to taxable transfers). Which of the following should the Trustee generally consider:

(A) Divide the trust between GST exempt and non-exempt shares; (B) Allocate the growth assets to the exempt share; (C) Make distributions to the extent feasible to non-skip beneficiaries from the non-exempt share; or (D) All of the above.

9. T makes a gift in 2007 of \$100K, in trust for the benefit of daughter (D), age 35, for life. D receives all net income and principal for need. On the death of D, the balance of the trust goes to D's estate or issue as D appoints. If D does not appoint, the balance goes to D's issue. Which of the following is/are true:

(A) T has made a taxable gift of \$100K because D has no Crummey withdrawal power; (B) T has made a taxable gift of \$88K; (C) On the death of D, a taxable termination will occur; or (D) If T allocates no GST exemption, there will be an automatic allocation of GST exemption to this trust.

10. T makes an outright gift in 2007 of \$100K to GGGC (the great-great-great-grandchild of T). Each ancestor of GGC who is a descendant of T is living at the time of the gift. Which of the following is/are true:

(A) T has made a taxable gift of \$100K for gift tax purposes; (B) T has made one direct skip transfer. (C) T has made more than one direct skip transfer; or (D) The automatic allocation of GST exemption does not apply.

11. Tie breaking question. In 1992, the Reds of the Farm League of the San Ramon Valley Little League came from behind to win a playoff game against the Mets. As of the bottom of the third inning:

A. First tie breaker: By how many runs were the Reds trailing the Mets? \_\_\_\_\_

B. Second tie breaker: What was the final score (total number of runs)? \_\_\_\_\_