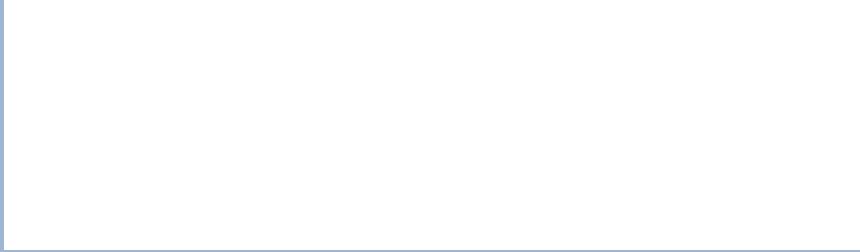


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Planning for the Future Newsletter

Continued from page 3 . . . Estate Planning at the Movies

Tchotchke Can Bring Out the Worst

Tchotchke is Yiddish for baubles, ornaments or little things. In estate planning documents, the tchotchkes are the personal effects. Sometimes these personal effects can have great financial value (jewelry, works of art, automobiles, boats, and the like). Often the personal effects are more modest in financial value, yet rich as keepsakes or mementoes. On other occasions, disputes over the possessions can be more aggravated and tension filled than division of the investments, real estate or brokerage accounts.

Division of the personal effects can bring out all sorts of jealousies, hidden agendas and greed, or decency and empathy.

Zorba the Greek depicts the best and worst of human nature. An elderly French matron, with romance in her heart and a desire for Zorba, lay dying from a brief illness. As word of her pending death spread through town, the locals stormed the home, lying in wait to scavenge her possessions, "so the state will not take them." The village women started picking through the chattel even before the foreigner died. Once the French lady expired, the townspeople ransacked the home to the accompaniment of cawing crows. Ironically, they left only a parrot, a living being, in its cage, alone in this ravaged room.

The women justified their thievery by their plea of poverty. This scene depicts the nadir in the cinematic battle for chattel. Yet, on how many occasions have family members, estate planners and trust/estate administrators witnessed a similarly intended, if more refined execution, of the effort to possess? On how many occasions have loved ones raised questions about their inheritances even before the funeral? Have we not also seen a sharing and problem-solving approach?

It is our hope that the review of motion pictures as they relate to estate planning can provide all of us . . . individuals and professionals . . . an awareness that estate planning is best understood with an appreciation for human nature and a sense of humor.



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Future

Winter 2009

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

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

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RECENT DEVELOPMENTS WITH ESTATE AND GIFT TAX

There have been few significant estate and gift tax developments since *Future* last reported. Legislative changes await the commencement of the new Senate. Since the Senate is not veto proof, debate will likely continue (with the opportunity for the legislators to receive donations from both sides of the argument). See the article *Beware of Valuation Changes* for a warning to a likely attack on small business and family ownership.

The following changes take effect January 1, 2009, under existing inflation-related indices:

- Annual Gift Tax Exclusion- \$13,000 per donor, per donee.
- GST Exemption- \$3,500,000
- Estate Tax Exemption (Tax-Free Allowance)- \$3,500,000
- Estate Tax on Closely-held Business Value payable at 2% rate - \$1,330,000.
- Special Use Value Deduction Limit- \$1,000,000
- Additional exclusion from U.S. citizen to a spouse who is not a U.S. citizen- \$133,000.
- Notice requirement for large gifts from foreign persons- \$14,139

The gift tax lifetime exemption remains unchanged at \$1,000,000.

The Gift Tax decision of *Gross v. Comr.* T.C. Memo. 2008-221 upheld a 35% discount for lack of marketability and minority interest in the valuation of a family limited partnership with substantial marketable securities. The donor-mother preferred a family limited partnership to a trust because she believed it would encourage her daughters to work together and learn from her experience while preserving in the mother control over the partnership's assets. This case applies the *Holman* decision, rejecting the indirect gift of underlying assets, discussed in the Fall issue of *Future*.

Finally, in PLR 200846001, the Service favorably ruled that a power held by the grantor in a GRAT to substitute property at fair market value, when the power was held in a fiduciary capacity, would not cause the GRAT to fail. This ruling can make GRAT planning more effective and flexible.

INSIDE:

- **Congress hurting small business?** (page 2)
- ***Tchotchke* in Estate Planning** (page 3)

BEWARE OF ENACTMENT OF VALUATION CHANGES

A specter haunts family small business. No, it is not communism. Rather, it is the prospect for change in valuation rules that apply under federal estate and gift tax law. Since the mid-1990's, the IRS has sought to eliminate or reduce valuation discounts for fractional interests in real property, and lack of marketability and minority interest discounts that apply to family ownership of corporations, LLCs and partnerships.

These changes have been proposed in any of three forms: (1) flat-out elimination of discounts on transfers among family members (President Clinton's proposals of 1998 and 1999); (2) elimination of discounts on fractional interests and on the valuation of liquid assets held in business entities (Republican proposal though the Joint Committee on Taxation); and, (3) setting discounts at low amounts (i.e., less than court decisions generally allow).

Each of these proposals has its own approach, but the effect is the same... that being, to value identical interests held in a family business at a higher value than an identical interest in the same business owned by non-family members, or to have closely-held businesses valued in a disadvantaged manner when compared to stock or partnership interests owned in publicly traded entities.

Why the Change is Desired by Treasury

Treasury has felt over-worked and losing revenue as a result of the allowance of discounts in estate and gift planning. After hundreds of court decisions from every corner of the nation have upheld valuation discounts, Treasury would like to change the rules. In this case, Treasury wants to change the definition of "fair market value."

The current definition of fair market value does not consider the personality of the buyer and seller. Rather, it is a time-honored, objective standard. This is the same standard used in general appraisal work. This standard recognizes that partial interests are difficult to sell, or may

have limited management rights.

Also, the estate tax law looks at what a decedent owns, not at what each beneficiary receives. For example, if a decedent owns 100% of a building, there is no fractional interest discount to the surviving family, even if each family member receives only a partial interest. Similarly, if a decedent owns a partial interest in a real estate, there is a fractional interest, even if the surviving beneficiary owns most, or all, of the property.

The gift tax law, on the other hand, considers the interest that passes to the donee. Thus, if a donor owns 100% of a property and leaves 20% to a child, the gift tax law values the 20% interest as a partial interest.

These rules have existed in the law for decades.

The proposals want to eliminate these discounts or reduce them to low limits – whether for fractional interests or interests in a business. Thus, if Cain and Abel each receive one-half of a property, the IRS wants no discounts to apply, even though the brothers loathe each other and could not co-manage a sheep, much less rental realty.

Limited Partnerships and LLCs

The Service has been particularly concerned about discounts being manipulated through the use of limited partnerships and LLCs that own liquid assets, for which discounts are applied when valuing the partial interest in the entity. However, the IRS has won significant court victories that require the existence of a legitimate and material non-tax or business purpose for the creation of these entities if discounts are to be honored. If the requisite purpose does not exist, the underlying assets are valued, not the partial interest in the entity.

The Service's success with the existence of the substantial and legitimate non-tax purpose has arisen since the Clinton and Joint Committee proposals were made. Nevertheless, the Service

persists in its battle against discounts for family enterprise.

Essentially, the IRS is arguing, "Even if your family enterprise makes sense from the business perspective, we believe discounts should either be eliminated or reduced below amounts allowed for non-family members." Does that make sense? Is the argument based on logic, sloth, fairness, or what?

Also, if the IRS persuades Congress and the President to disallow discounts with closely-held or family co-ownerships or businesses, then the owners of closely-held or family enterprise will have their interest valued for a higher amount, with greater tax, than will be valued for the interest in an identical public company. This results because the public markets consider the impact of lack of marketability and minority interest discounts as part of the stock pricing.

Why Doesn't the IRS Just Audit More?

Congress allocates funding for the IRS. Normally, when a business has an opportunity to increase sales, it hires staff. In the situation of the IRS, revenue is the sale, and estate tax attorneys are the sales staff. The IRS has recently expanded hiring in the estate and gift tax area, with a new group in Northern California, and anticipates added hires in Southern California. Since California generates about 20% of all estate tax returns, this hiring is significant.

Moreover, estate filings are down almost 65% since 2004. In that year, there were approximately 74,000 estate tax returns. The projected filing for 2009 is only 26,700 returns. There were 37,031 estate tax returns filed in 2007, of which 17,416 were taxable. For taxable estates with a gross value in excess of \$3.5 million (the 2009 exemption amount), 1,703 returns included a non-farm limited partnership or LLC interest. Even assuming that every one of these partnerships was solely among family members (an assumption that would be much inflated), the IRS has ample staff to audit every one of these returns to route out abuse, and do so without harming closely-held or family

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Continued from page 2...Beware of enactment of Valuation Changes

business or fractional ownership.

IRS staffing has not declined by 65% since 2004. Then one might ask... With the additional hiring, fewer returns and the requirement for a substantial non-tax purpose for the formation of family partnerships and entities, why not simply use the resources and law at hand, rather than punishing family business, in general, or closely-held business (when compared to large corporate ownership)?

If 20% of these partnerships and LLCs are in California, there would be 340 returns to audit with such entities. If 25 estate tax attorneys in California audited 1 such return each month, 88% of all such returns would be audited.

One concern experienced by your author is the slowness with which IRS valuation engineers (in-house consultants) do their work. After all, value is the key consideration to fair market value. Recently, it took the IRS valuation employee about 10 months to conduct an appraisal on farmland in the Salinas Valley. What's worse, the engineer thought that amount of time was normal!

Heck, 10 months is about the time it took the Allied Armies to battle from the Normandy Beaches to Berlin. If the comparison to that successful government operation seems excessive, consider that it took my son, Jordan, five months to walk from Mexico to Canada on the Pacific Crest Trail, including five mountain passes in the snow.

Why the Anti-Family Bias?

Under the proposals referenced above, a business owned by a husband and wife in a traditional marriage, or transferred from a parent to a child will be valued at a higher amount than will the identical business owned by friends, non-family owners, domestic partners, or others in a committed relationship but whose marriages are not recognized under federal law.

That fact should make great fodder for Fox and CNN pundits.

Stupid Government Formulas

Smart people often go to Washington, D.C. to do good service. Then, for whatever reason, some get caught up in an academic or formula driven world in which they believe algebra can be applied to life and achieve sanity. Well, it may be logical, but it ain't right.

The Treasury Joint Committee proposal would value the liquid assets of a business (i.e., publicly traded stock and cash) without discount if greater than 1/3rd of asset value of a business). For example, if an auto dealership is owned by father and son and the company with a \$10M asset value, of which \$4M is cash or liquid assets, there is no discount on the \$4M when valuing the decedent's interest in the company. The cash and liquid assets are treated as though owned outside of the company, notwithstanding the fact that they are part of the company, and ownership in the business is subject to lack of marketability or minority ownership discounts.

However, the build-up of cash reserves in the dealership may be totally logical by enabling the dealership to internally finance some or all of its flooring. Why therefore, should the owners be penalized for thrift and forward planning? In fact, our firm is aware of several auto dealerships that are surviving because of their internal financing, while others have closed their doors due to heavy outside debt. Had our successful and far-seeing clients been hamstrung by the Treasury Proposal (or pay more estate tax) they would have gone out of business, or faced a competitive disadvantage when compared to a public company to which the "special" valuation rules do not apply.

Precisely, the family auto dealership would be valued for more than the identical dealership owned by the publicly-trade Lithia Motors.

Should the owners of the family dealership be made to pay more estate tax than the owners of an identical company not owned by family members, or which is publicly traded? Hopefully, the new President and Congress will not tolerate further harm to closely-held business.

Call to Action

Space considerations compel us to stop this discussion. If you want a copy of nationally published articles in Leimberg Information Services written by Keith Schiller on this subject, please e-mail your request to the Schiller Law Group. In any event, stay alert to changes that may arise to the definition of fair market value or other limitations on valuation discounts for family business or closely-held enterprise. Make your industry group aware of this issue.

The effect of these changes can mean a lot more in added estate tax than is saved through the increase in the estate tax exemption to \$3.5 million. Also, a change in the definition will cause estate tax to be payable with more estates and families that are otherwise outside of the estate tax system.

ESTATE PLANNING AT THE MOVIES™ --- FOR ALL

The Fall, 2008, edition of *Future* included a review of the Cinderella® in the context of family business succession and the sports world, which review was an excerpt from Keith Schiller's article, *Estate Planning at the Movies™*, originally published in BNA. Today, we look at personal effects as seen through the camera's lens. Keith is presenting *Estate Planning at the Movies™* complete with film clips, to professional and business groups throughout California.

Continued on page 4

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