Report #17 (Thursday, Cont'd)

A complete listing of the proceedings and speakers is available on **the Institute's Web site**

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This Report contains coverage of the Thursday main session on Disclaimers plus Special Session III-E on the Reduced Dividend and Capital Gains Dividends and Special Session IV-B on Partnerships

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Disclaimers: When, Why & How To Say No To An Inheritance
Presenter: E. Diane Thompson Esq.

Reporter: Connie T. Eyster Esq.

A disclaimer is a refusal to accept an inheritance or a gift. It provides opportunities to revise the decedent's estate plan post-mortem and can provide income tax planning opportunities.

10 states have adopted the Uniform Disclaimer of Property Interests Act. The terms of that statute are discussed periodically in the presentation.

To be a qualified disclaimer under §2518(b), the disclaimer must:
- Be irrevocable and unqualified
- Be in writing
- Identify the interest being disclaimed
- Be signed by the disclaimant or the disclaimant's legal representative
- Be delivered to the transferor of the interest, the transferor's legal representative, the holder of title to the property, or to the person in possession of the property.

(Note that some states require the filing of the disclaimer in a particular place, such as in the land title records)

- Be made not later than 9 months after the later of the date of the transfer or the date the transferee turns 21. (Note that the UDPIA eliminates time requirements for filing a disclaimer for state law purposes, but you still need to comply with the time requirements for making a tax qualified disclaimer)

In addition, to be a qualified disclaimer, the disclaimant must not have accepted the interest disclaimed or any of its benefits which also prevents the acceptance of consideration for the disclaimer.

Finally, the disclaimer must pass to the spouse of the decedent or to a person other than the disclaimant without any direction on the part of the disclaimant.

§ 2518(c)(3) provides an alternative way of having a tax qualified disclaimer (called a "transfer disclaimer"):

Certain transfers are treated as a disclaimer if the requirements of
§2518(b)(2) and (b)(3) are met and the transfer is made to a person who would have received the property had the transferor made a qualified disclaimer. This provision was enacted for transfers made after 12/31/1981 that may not have met the state law requirements for an effective disclaimer.

Example: PLR9135043 involved a disclaimer of a joint tenancy interest in a state where local law prevented a disclaimer of a joint tenancy interest for which the disclaimant provided any of the consideration.
The consideration issue would not have prevented the disclaimant from making a qualified disclaimer under § 2518. Accordingly, the disclaimant transferred the property by deed to the person who would have received the property had a disclaimer been made and the disclaimant was considered to have made a qualified disclaimer under § 2518.

BUT, the speaker cautions that PLR 200437032 indicates that a transfer disclaimer is only available where the disclaimer was barred under local law but was permitted under federal law. It was not intended to be used instead of local law when state and federal law are consistent. (See pg. 10 of the materials).

In the charitable area, disclaimers can be used to pass property to a charity in order to receive a charitable deduction or effectuate some charitable purpose. Ms. Thompson cautions, however, that there could be problems where the disclaimant is a controlling member of a board of the charity receiving the disclaimed property, or in other instances where the disclaimant might be able to control the use of the disclaimed property.

Another way to use disclaimers in a charitable manner would be to devise property to a family member with similar charitable goals and then say that, if the family member disclaims the interest, the property will pass to a charity. This would give the estate the flexibility to receive a charitable deduction if necessary for estate tax purposes, or if estate tax is not an issue, then the family member could receive the property and obtain an income tax deduction by personally giving the property to the charity.

With regard to use in conjunction with the marital deduction, a disclaimer could be used to increase the marital share where too much property was given to persons for whom no deduction is available. (See p. 13 of the materials)

Another use would be to shape a trust to qualify for the QTIP election by eliminating the power to invade the trust for someone other than the surviving spouse. Usually, the person who would need to make the disclaimer is the person who would otherwise have received a right to a distribution of trust property had the disclaimer not been made.

Ms. Thompson also uses disclaimers to take advantage of the tax on prior transfers credit" ("TPT") which credit is for estate taxes paid when property has been included in the estates of two decedents within a short period of time and estate tax was paid in both estates.
By disclaiming property out of marital deduction in the estate of the first spouse to die, the personal representative could make certain property subject to tax in both estates, which could result in significant estate tax savings for the second estate (see p. 17 of the materials).

With regard to the GSTT, disclaimers can be used to prevent a GSTT transfer or to take advantage of unused GSTT exemption. It can be used to create a reverse QTIP in some instances to "fix" unanticipated issues. Note that to execute a disclaimer on behalf of a minor child, court approval is

often necessary.

Disclaimers can also be used to allow a spouse to roll-over an IRA where persons other than the spouse were named as beneficiaries. A number of PLR's have been issued recently permitting this to happen.

Disclaimers can be used to ensure that the applicable exclusion amount will be used in full on the first spouse's death, or to ensure that a martial deduction is taken when a non-martial share would otherwise have been over funded.

Ms. Thompson's favorite use of disclaimers, is to qualify the estate for the alternate valuation (see p. 26 of the materials). In some instances, the alternate valuation is needed to adjust the threshold for qualifying for another election, such as the ones under §§ 303, 6166, and 2032 of the IRC. If you have situation where values are higher at date of death and lower at the alternate valuation date, but you are dealing with an estate plan where the estate tax has been reduced to zero, then disclaimers can be used to subject the estate to a small amount of tax, take advantage of the alternate valuation date and in turn qualify for other elections.

It is unclear whether use of a disclaimer can affectively bar creditors of the disclaimant. State laws are split on this issue.
Note that under federal law, a disclaimer cannot be used to avoid a federal tax lien. Some states have allowed disclaimers to be used, pre-petition, to avoid bankruptcy creditors. (See p. 37 for cases in Oregon and Oklahoma on this issue)

A disclaimer, generally, cannot change the heirs or next of kin for purposes of a wrongful death suit. But a NY court has held otherwise.
The downside could be that damages will be based on the loss of the person receiving the disclaimer, rather than on the loss of the disclaimant.

Problem areas with disclaimers:

1. Attorneys who fail to consider a disclaimer could be looking at large malpractice damages. In a Florida case an attorney who relied on a CPA's advise that disclaimers would not change the tax treatment ended up paying a large damage award as well as attorneys' fees for the plaintiffs.

2. A critical problem with use of disclaimers is that is not always clear who will receive the disclaimed property yet it is crucial for the practitioner to know this information before the disclaimer is made. Also, consider the collateral consequences of making the disclaimer on the marital deduction, charitable deduction, and additional administrative expenses.

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Special Session 3-E - Planning With Reduced Dividend and Capital Gains Rates
Presenter: Richard B. Robinson Esq.

Reporter: Eugene Zuspann Esq.

Prior to the change in the rates for dividends and capital gains, the normal planning required that the ownership of the corporation be bifurcated due to gifts and death. Except to the extent of basis, the two rates are almost the same (15% maximum).

The possibility of getting out some shareholders was often only possible with intra shareholder purchases because the redeeming shareholder did not want completely out. The result was that the corporation could not do a redemption of some or all of the shareholder's interest and still qualify under the exceptions to dividend treatment in §302. All of the money received would be treated as a dividend subject to the ordinary income tax rates. The reason for the problem exists because of the attribution rules in §318.

Before the 15% dividend rate, getting out and triggering dividend income was an expensive proposition. Now, unless the stock has a high basis, the tax on a dividend and the tax on a capital gain will be the same. If the liquidating stockholder has a high basis, then the redemption is not as attractive. The basis cannot be used against a dividend. The regs have been changed so that the treatment of basis is different. Now the loss of basis is suspended until the other family member sells their stock, which triggers the loss. Also, the loss will be a capital loss limited to capital gains + $3000 while the dividend will all be taxed.

You also need to get an appraisal before you do the redemption to avoid making an unintentional gift between the family members.

Rich spent some time discussing the relationship between §336 and §1239. Section 339 treats a redemption in which the assets are distributed to the stockholders as a deemed sale of the assets to the stockholders at the fair market value. §1239 reclassifies a sale of depreciable property to a related party as ordinary income. The result is that any gain recognized on the distribution of depreciable property will be ordinary income. The result if the property is not depreciable is that the gain is capital gain.

He discussed the illusion that there is no gain on liquidation of an S-Corp after the death of the stockholder (as the stockholder's stock). People are often advised that the gain in the corporation assets will go away after the death of the stockholder due to the step-up in basis. However, if the gain is ordinary income, this is not correct with potentially disastrous results. The gain is ordinary income, passed through to the new stockholders and the loss is a capital loss, limited to $3000 + capital gains. In Rich's example, the beneficiaries had $5mm ordinary income and a $5mm capital loss. Assuming no other capital gains, they had ordinary income of $5mm less $3,000 capital loss on this transaction.

He also discussed a way to avoid this effect. The attribution rules under
§267 govern the definition of related persons. If the stock is inherited by the decedent's 3 children, they are related persons and §1239 applies. However, if the stock goes to 3 ESBT's, the result is that the gain is capital gain and is offset by the capital loss. This is because there is no attribution between the 3 ESBTs under §267. See materals pg 21.

He evaluated the possibility of triggering gain at 15% to step up basis so that goodwill is depreciable at the stockholder's rate (35% in this example). Rich says this usually works on a present value basis. There are instances that this is not good planning. If the stockholder has a life expectancy less than 15 years, he would not get to use all of the depreciation before his death and it would go away. Also, remember that the change to the law several years ago makes the goodwill an intangible depreciable over 15 years. If the corporation has purchased goodwill that it is depreciating, then the gain on this asset is ordinary income under §1239.

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Special Session 4-B - Come Into My Partnership, Said the Spider to the Fly
Presenter: Samuel A. Donaldson Esq.

Reporter: Shelly D. Merritt Esq.

In this break out session, Mr. Donaldson expanded on some of the income tax issues relating to partnerships which he covered in the morning session. He went over four problems during the working session. The first two problems concentrated on the application of the built in gain rules under the Code which provide that when the partnership has built-in-gain property and property is distributed to the contribution partner within 7 years of its contribution to the partnership.

IRC Section 752 involves an analysis under three code sections:

1. IRC Section 704(c)(1)(b) provides that if a partner contributes built in gain property to the partnership and such property is distributed within 7 years to another partner, the contributing partner must recognize the gain.
A successor in interest to a contributing partner inherits this liability for the built in gain.

Exceptions:

-If property is distributed back to the contributing partner or his successor in interest.

-If a proportionate distribution of the built in gain property is made.

-Selling built in gain property and then distributing proceeds.

2. IRC Section 731(c) provides that a distribution of marketable securities is deemed to be a distribution of cash. This gives rise to gain if the distribution exceeds the partner's basis.

4 Exceptions

-Contributing partner exception (no similar rule for successor in interest)

-Form an investment partnership: If 90% or more of the partnership assets are marketable assets, a distribution to a partner who did not contribute marketable securities will not trigger 731(c).

3. IRC Section 737 provides that if a partner contributes built in gain property to the partnership and within 7 years distributes other property to that partner, effectively this is a sale of the property and the contributing partner must recognize gain.

Exception

-Property distributed to contributing partner. Mr. Donaldson pointed out that a successor in interest is not an exception under IRC Section 737 - it does not have same language as 704(c)(1)(b).

The amount recognized under these rules is the amount of gain that would be recognized by a partner if all built in gain property contributed by the partner to the partnership were sold.

Treas. Reg. 1.731-2(g)(1)(i) provides the order which the above sections are applied. First 704(c)(1)(B), then 731(c)(3)(b), and then 737.

Problems 1 and 2 :Determining the amount of pre-contribution gain recognized:

Step 1: Section 704(c)(1)(B) Gain: This Section determines what the distributee partner's share of the gain would be if the partnership sold the distributed asset for fair market value.

Step 2: Section 731 (c)(3)(b) Gain:

If the property distributed is marketable securities, determine the amount of gain recognized on the distribution - the amount that the value of the securities distributed exceeds the distributee's basis.

Step 3: Section 737 Gain:

Compute the gain under 737(a)(1) and (a)(2) and then use lesser number.

737(a)(1) - "Excess Distribution":

FMV of distributed property less the partner's outside basis in the partnership (taking into account the gain computed under 704(c)(1)(B) less cash received in same or related distribution).

737(a)(2) - "Net Pre-Contribution Gain":

Amount of gain the distributee partner would recognize (under 704(c)(1)(B)) if all property which had been contributed by the distributee partner within 7 years of the distribution had been distributed to another partner.

Final Step: Add up gain under steps 1-3 above and the end result is the total gain that must be recognized.

The distributee's basis in the distributed property is determined by 732(b):

Outside basis in the distributee's partnership interest plus gain recognized under Sections 704(c)(1)(B), 731(c)(3)(b), and 737 minus cash received

Problem 2:

The second problem focused on the fact that if the partnership is an "investment partnership" (90% or more of the assets of the partnership at all times are portfolio assets and the partnership is not conducting an active business), the distribution of marketable securities to an "eligible partner" does not give rise to gain recognition under 731(c)(3)(b).

An "eligible partner" is any partner other than those who contributed non- portfolio assets.

Problem 3: Income Tax Issues At Formation

This problem focused on which assets owned by an individual would be suited for contributing to an FLP. Mr. Donaldson pointed out that if investment assets are contributed, consideration must be given as to whether the partnership will be an Investment Company (80% of more of assets are portfolio assets) or and Investment Partnership (90% of assets are

"investment assets" and there is no trade or business - investment assets can include investment real estate as well as marketable securities). There was also discussion regarding making sure the person forming the partnership retains enough assets outside of the partnership to avoid the argument by the IRS that he/she is using partnership assets for personal expenses.

Problem 4: Special Allocations

This problem focused on the pro-rata allocation requirements under IRC Section 704(e)(2) for FLPs and also the fact that special allocations can give rise to the application of IRC Section 2701 which provides that certain preferred rights are ignored for valuation purposes.

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Our on-site local reporters who are present in Miami this year are Gene Zuspann Esq. of Zuspann & Zuspann in Denver, Colorado, Shelly Merritt Esq., a solo practitioner in Boulder, Colorado, Connie T. Eyster Esq. of Hutchinson, Black & Cook LLC in Boulder, Colorado, Jason Havens Esq. of Havens & Miller PLLC in Dustin, Florida, Bruce Stone of Goldman, Felcoski & Stone, PA of Coral Gables, Florida, Herbert L. Braverman Esq. of Walter & Haverfield LLP in Cleveland, Ohio, and Jeffry L. Weiler of Benesch, Friedlander, Coplan & Aronoff LLP of Cleveland, Ohio. The editor again this year will be Joseph G. Hodges Jr. Esq, a solo practitioner in Denver, Colorado who is the Chief Moderator of the ABA-PTL List.

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