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BEAN KINNEY & KORMAN PC
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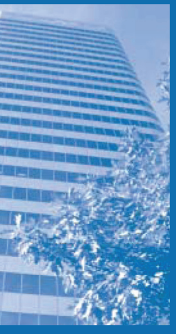
Trusts and Estates Newsletter



Inside This Issue:

Tax Court Finds Gift of Limited Partnership Interests Don't Qualify for Annual Gift Tax Exclusion................................Page 1

Death, Taxes and Chocolate................................Page 2

Estate Tax Pre-Payment Option As Trade Off for Lower Rates....Page 3

Tax Court Finds Gifts of Limited Partnership Interests Don't Qualify for Annual Gift Tax Exclusion

By: Jonathan C. Kinney, Esquire

In a Tax Court memo issued at the beginning of this year (2010-2), the Tax Court followed an earlier ruling in Hackl (2002) 118 TC 279 that in order for a gift to qualify for the annual exclusion under Code Section 2503(b), the party receiving the gift must have the unrestricted and uncontingent right to the immediate use, possession and enjoyment of the property and/or the income from the property. This is known as the present interest rule.

Over a period of five years, Mr. and Mrs. Price gave their three adult children interests in a partnership (Price Investment Limited Partnership) which owned stock in a diesel power equipment company and commercial real estate. Subsequently, the partnership sold the diesel power equipment company stock and invested the proceeds in securities.

The IRS contended that the partnership interests transferred to the children represented future interests because under the terms of the partnership agreement, transfers to third parties were effectively barred and the partnership did not require annual distributions to the limited partners. The partnership agreement generally prevented any partner from withdrawing its capital contributions and restricted the transfer and assignment of partnership interests. The taxpayer argued that the partnership interests were gifts of present interest because the children could freely transfer their interest to one another and to the general partner.

The Tax Court concurred with the IRS, claiming the taxpayers failed to show that the transferred partnership interests gave the beneficiaries the immediate use, possession or enjoyment of the transferred property or the income from the partnership.

The Court focused on the fact that the partnership agreement restricted withdrawals from the partnership and return of a partner's capital account and expressly prohibited limited partners from selling, assigning or transferring their partnership interests to third parties or otherwise disposing of their partnership interests without the written consent of all the partners (limited and general).

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Tax Court Finds Gifts of Limited Partnership Interests Don't Qualify for Annual Gift Tax Exclusion
Continued from Page 1

Following the Tax Court ruling in Hackl the court believed that the taxpayer had to show that the partnership would generate income in the period immediately after the gift, that there would be a steady flow of income to the donees and that the income flowing to the donees could be ascertained with reasonable certainty.

On the surface it appeared that the partnership passed some of these tests since it did own real property under long term leases which produced rental payments. The court felt that while the partnership could be expected to generate income in the immediate timeframe following when the gifts were made, it was not ascertainable whether or not the income would flow on a steady basis to the donee at the time of the gift, thus failing to meet the present interest test since the gift did not confer on the donees the right to immediate use, possession or enjoyment of either the transferred property or the income therefrom.

Our advice: there are probably two ways to respond to this Tax Court memorandum. One is to re-write limited partnership agreements and/or operating agreements for limited liability companies to allow for the unrestricted transfer of ownership interests to third parties. The other method is to consider giving the donee a "crummy" power to effectively demand income or principal for a short, limited period of time after the gift. This power is commonly used in connection with annual gifts in life insurance trusts and has been deemed to meet the present interest requirements.

While we understand a client's reluctance to allow free transferability or less restricted transferability of limited partner and limited liability company interests, our experience has been that this is more of a fear than an actual reality. It is very unusual and highly unlikely for a third party to be interested in purchasing minority interests in family limited partnerships or limited liability companies. If you are unwilling to consider totally free transferability of membership interests, then free transferability subject to a right of first refusal to the partnership or limited liability company should be considered. Even if a transfer is subject to a right of first refusal, it would at least allow for the immediate use, possession and enjoyment of the transferred property.

Bottom line, if you are contemplating giving gifts of limited partnership or limited liability interests using the annual exclusion (currently $13,000 for an individual and $26,000 for a couple), you should have the limited partnership and/or limited liability company agreement reviewed (and revised) prior to making any further gifts. Alternatively, consider giving the beneficiary a "crummy" power to demand income or principal in lieu of the gift of partnership or membership interests.

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Death, Taxes and Chocolate

By: Jonathan C. Kinney, Esquire

Congress failed to act on estate tax legislation this year. Despite expectations throughout the 2009 calendar year by most estate planning commentators that Congress would act in some form or fashion, this did not happen. Congressional leaders indicate that they intend to retroactively reinstate estate taxes with an effective date of January 1, 2010. However, given the divisions that we saw in the Senate in December, we have become particularly concerned that it may not be possible to obtain a 60 vote majority on any plan involving estate taxes.

We urge you, just out of caution, to review your estate plans immediately. The repeal of the estate tax may cause results that are totally unintended when you drafted your will and/or trust. By necessity, many wills and trusts have used formulas to determine how distributions are to pass to a

Death, Taxes and Chocolate
Continued from Page 2

spouse, children and grandchildren. Sometimes, for example, the will or trust has language that provides something to the effect "the largest amount that can pass free of federal estate taxes." With estate tax repeal, language of that nature may contradict the client's intent; with estate tax repeal the parties most likely to be effected by language of this nature are spouses who might see their inheritances either reduced or eliminated. The Virginia Legislation has approved a temporary fix to this issue for 2010.

Most commentators still expect a retroactive "fix" to this matter in 2010, but we are already three months into the year and nothing has been done. Furthermore, it is likely that any retroactive tax legislation will be challenged on constitutional grounds even if legislation can get through the Senate.

Effective January 1, 2010 estate, gift and generation skipping taxes are as follows:

1. Federal estate and generation skipping taxes are repealed;

2. $1 Million lifetime gift tax exemption, 35% rate;

3. Limited stepped up basis of estate assets (prior to January 1 all assets in an estate were stepped up to current market value); and

4. Limitation of $1.3 Million (plus $3 Million for surviving spouse) on the stepped up basis. Otherwise a beneficiary will receive the deceased basis in the property being conveyed.

What happens in 2011? Unless action is taken, estate, gift and generation skipping tax rates are scheduled to increase to 55%. The exemption (which had been at $3.5 Million in 2009) will be reduced to $1 Million.

It is extremely important that you review your estate plan immediately to see if the funding schedule in your estate plan is consistent with your wishes based on the possibility that Congress will be unable to act on estate tax changes during 2010.

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Estate Tax Pre-Payment Option
As Trade Off for Lower Rates

By: Jonathan C. Kinney, Esquire

With the Senate and House still unable to craft a plan on potential revisions to estate tax provisions, a novel approach is being bandied about as a possible compromise plan. The prepayment plan is being reviewed by Senate staffers and is being pushed by Senator Maria Cantwell (D-WA).

The plan, which is still being fleshed out, would effectively allow the wealthy to "pre-pay" estate taxes. Assets placed in a "prepayment trust" would only be subject to a 35% tax, while assets of a decedent would otherwise be taxed at a 45% rate. The tax on assets placed in the "prepayment trust" would have to be paid over five years. For both the very wealthy and very old, this reduction in taxes would seem to create interest in the plan.

There is technically no federal estate tax in 2010 although one could be enacted retroactively (subject to potential constitutional challenges). If no action is taken, the estate tax is designed to return in 2011 at a 55% rate with a $1 Million exemption.

The Obama administration has proposed a 45% tax rate on all assets over $3.5 Million for an individual ($7 Million for married couples). A group of moderate Republican and Democratic Senators are proposing a 35% rate with an exemption amount

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Estate Tax Pre-Payment Option As Trade Off for Lower Rates
Continued from Page 3

of $5 Million ($10 Million for married couples). Proposals such as this have secured a majority vote in the Senate in the past but have never been able to secure the 60 votes needed to make the proposal permanent.

It is expected that the Joint Congressional Committee on Taxation will review the impact of the prepayment of estate inheritance taxes and determine its effect on the budget numbers. Since the government is running a large deficit and has to pay interest on funds borrowed, the prepayment of taxes, even at a lower rate, has the potential effect of lowering the increase in the budget deficit in the immediate future although it is likely to have a negative effect in the long term. As envisioned, owners who prepay would lose the $3.5 million or $5 million unified credit exemption thus making it primarily a tool for the very wealthy. However, it is the very wealthy who pay the overwhelming majority of the estate tax.

There is no political sign off on this proposal, but proposals such as this one that have the effect of lowering the increase in the deficit in the immediate future (i.e. over the next few years) always seem to merit politcal consideration.

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This newsletter was prepared by Bean, Kinney & Korman, P.C. as a service to clients and friends of the firm. The purpose of this newsletter is to provide a general review of current issues. It is not intended as a source of specific legal advice. © Bean, Kinney & Korman, P.C. 2009.

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