

WEDNESDAY THURSDAY FRIDAY MONDAY **TODAY**

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Estate tax March Madness: taxpayers 3, IRS 0

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Very few taxpayers prevail in the U.S. Tax Court. Why? First, because the Internal Revenue Service usually settles with taxpayers who have attractive facts. Second, because perhaps as many as 90 percent of all taxpayers represent themselves.

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So it is refreshing to report on three taxpayer victories in the estate and gift tax area that occurred in the space of just over a month. These taxpayer victories are helpful because, until the end of 2012, each taxpayer has a \$5,120,000 gift tax exclusion. On Jan. 1, 2013, it will decrease to \$1,000,000. The Obama Administration has proposed a \$3,500,000

exclusion. Some Republican Senators introduced a bill to repeal the estate tax. The uncertainty has motivated many taxpayers to engage in gift tax planning now. These favorable cases will make the use of some important tax planning structures much more comfortable.

One such structure is the family limited partnership, or FLP. The IRS has been consistently able, in the published cases, to convince courts that the FLPs' assets should be included in the parents' estates. However, each IRS victory has involved bad facts, e.g., an FLP established by a nonagenarian or terminally ill octogenarian. In contrast, practitioners know that the IRS does not challenge FLPs established by healthy taxpayers who live to a normal life expectancy.

Now, we have important reminders that, when properly established and operated, an FLP will prevail in spite of IRS opposition in the cases of *Estate of Joanne Harrison Stone*, T.C. Memo 2012-48 (February 22, 2012), and *Estate of Beatrice Kelly*, T.C. Memo 2012-73 (March 19, 2012).

Mr. and Mrs. Stone had a great deal of real estate. They intended to keep one property as a "family asset." On advice of counsel they formed a limited partnership to simplify the gift-giving process and guard against partition suits. After three years of gifts, Mr. and Mrs. Stone only owned a 2 percent interest as general partners; the adult children owned the 98 percent limited partnership interests. Health was not a factor: Mrs. Stone taught Sunday School for 60 years, including the last Sunday before she passed away at age 81, and Mr. Stone was 91 at the time of the trial. The issue before the court was whether the decedent had a legitimate and significant non-tax reason for creating the FLP.

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The IRS argued, and Judge Goeke agreed, that gift giving alone is not an acceptable non-tax motive for forming the FLP. However, creating a "family asset" to be managed by the family is itself a sufficient non-tax motive to avoid estate tax inclusion. Also, even though the Stones had a testamentary purpose, legitimate non-tax purposes are often interwoven with testamentary objectives.

Questions and Comments

NEWS RULINGS VERDICTS

Tuesday, August 28, 2012

Bar Associations**Supreme Court returns 18 more discipline cases to State Bar -- but not 24**

The Supreme Court sent 18 more discipline plea bargains back to the State Bar but rejected the bar's motion to remand 24.

Government**Judicial Council committee urges slower approach to AOC reforms**

Recommendations to the state Judicial Council on how to adopt proposed reforms of the Administrative Office of the Courts were made public Monday.

U.S. Court of Appeals for the 9th Circuit Appeals court allows state, utilities to seek refunds from power providers

A federal appellate court on Monday opened the door for the state of California, Pacific Gas & Electric Co. and others to get refunds for money they spent buying power during the energy crisis a decade ago.

California Supreme Court**Santa Clara judge withheld evidence as a prosecutor**

A Santa Clara County deputy district attorney who is now a judge had a key role in willful prosecutorial misconduct, the state Supreme Court held Monday in granting a San Quentin death row inmate a new shot at life.

Law Practice**Sidley taps new tech transactions leader**

Sidley Austin LLP has hired Glenn G. Nash, a former Latham & Watkins LLP partner, to serve as the new global co-leader of the firm's technology transactions practice.

Judges and Judiciary**9th Circuit reverses Wright for the third time this year**

U.S. District Judge Otis D. Wright II of Los Angeles was wrong to admit evidence at a chief executive's securities fraud trial that the SEC filed a prior civil complaint against him, a 9th U.S. Circuit Court of Appeals panel held Monday.

Personal Injury & Torts**Grave matters: morgue discovery leads to legal battle**

A plaintiffs' claim of medical negligence in a case of a woman who may have been sent to the morgue alive cannot proceed after a Los Angeles Superior Court judge ruled earlier this month attorneys did not meet the statute of limitations.

Bar Associations**Pasternak named to State Bar Board of Trustees**

The California Supreme Court named David J. Pasternak, a former Judicial Council member from Los Angeles, to the State Bar Board of Trustees, the first appointment by the court under the bar's new governance rules.

Criminal

The Stones made mistakes, e.g., they used a "bill of sale" to make the gifts. However, there were strong favorable facts, e.g., Mr. and Mrs. Stone did not depend on distributions from the FLP; there was no commingling of partners' personal and partnership funds; and there was no discounting of limited partnership interests.

Mrs. Kelly, the focus of the second case, was incompetent, which is a bad way to begin a Tax Court case involving an FLP. However, there was a powerful non-tax motive: the children wanted to avoid litigation among themselves after their mother's death. Therefore, they established, with probate court approval, one limited partnership per child to facilitate an equal post-mortem division. The probate court order confirming the multiple FLP approach mentioned that it would "avoid undesirable tax consequences." However, the Tax Court did not believe that tax savings motivated the structure. Importantly, Mrs. Kelly retained sufficient non-partnership assets for her personal needs and the family observed partnership formalities. This one partnership per child approach had been the key to a taxpayer victory in *Estate of Eugene Stone v. Commissioner*, T.C. Memo 2003-309 (2003).

The third taxpayer victory involved the use of a formula clause to define the amount of the gift. Example: mom and dad give the number of limited partnership units equal in value to \$10,240,000 (their combined 2012 lifetime gift exclusion). At the time of the gift they believe that each unit is worth \$10,240, so the gift is of 1,000 units. The gift document provides that if the IRS later increases the unit value, any excess units will be transferred to charity. On audit the IRS decides that each unit is worth \$11,377.78. Therefore, the number of units needed for the gift to the children is only 900 (900 times \$11,377.78 equals \$10,240,000). As a result, the other 100 units is transferred to charity, giving mom and dad a (100 times \$11,377.78) \$1,137,778 income tax charitable deduction.

The IRS has traditionally fought this approach as being against public policy. One part of the IRS's rationale has been that by having the excess transfer to charity, the defined value gift takes away the IRS's incentive to conduct an income tax audit. In three recent (2006, 2009, and 2011) cases, taxpayers have prevailed. The question left open for practitioners was: will taxpayers prevail if the excess does not go to charity?

Wandry v. Commissioner, T.C. Memo 2012-88 (March 26, 2012) is the first case which approves a formula clause without a gift over to charity. The Tax Court indicated that the policy of encouraging charitable gifts, which was a factor in the earlier decisions, was not determinative to the result of the three earlier cases. In *Wandry* the excess units were simply returned to the parents. As a result, many more taxpayers will be using this structure.

Stone and Kelly confirm that FLPs are important tools to transfer valuable assets at significantly reduced gift (and estate) tax values. *Wandry* confirms the use of an important device to avoid creating a taxable gift. The three are a powerful incentive for taxpayers to use their \$5,120,000 gift exclusion before the end of 2012.

OC lawyer gets 6-month sentence for tax offenses

An Orange County attorney who failed to file multiple income tax returns and helped create an offshore corporation later investigated by federal authorities now owes the government more than \$225,000 - plus prison time.

Judges and Judiciary

Two judges vie to be second-in-command of San Francisco County Superior Court

Two judges are about to face off in a race for San Francisco County Superior Court's assistant presiding judge seat.

Litigation

Saudi prince wins round in mansion battle against LA

State court judge rules in favor of Prince Abdul-Aziz ibn Abdul-Aziz al Saud, the third son of Saudi King Abdullah and Saudi Arabia's deputy foreign minister, in real estate spat.

Mergers & Acquisitions

Dealmakers

A roundup of recent mergers and acquisitions and financing transactions and the lawyers involved.

Criminal

In the spotlight: what is the legal definition of rape?

Examining the legal definition of rape - and how it differs from the public's concept of rape. By

Wendy Patrick

Law Practice

Listening practice

Better listening is the key to being heard. By

Timothy Tosta of McKenna Long Aldridge LLP

Public Interest

Lawyers' critical role in the war on poverty

Access to the judicial branch ensures that the government, in the person of a judge, will hear grievances and respond. By **David A. Lash** of O'Melveny & Myers LLP

Law Practice

Who can enforce mortgages sold in the secondary market?

Courts and litigants are often confused about just who can enforce a mortgage that has been transferred in the secondary market. Here's the law. By **Mark Didak**

Judicial Profile

Tim P. Kam

Superior Court Judge Solano County (Vallejo)

Intellectual Property

Apple's patent win puts company on the offensive

Apple Inc.'s \$1 billion verdict from a San Jose federal jury for patent and trade dress infringement Friday is only likely to whet the company's appetite for more aggressive action in the worldwide smartphone wars, legal observers say.

