The Estate Planner

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Watch your step!

Step transaction doctrine can increase tax on FLP and LLC gifts

Family limited partnerships (FLPs) and limited liability companies (LLCs) can allow you to transfer substantial amounts of wealth to your loved ones at discounted values for gift tax purposes. But watch out for the step transaction doctrine. The IRS sometimes invokes the doctrine to collapse a series of transactions into a single transaction for gift tax purposes, dramatically altering the tax outcome.

FLPs and LLCs in action

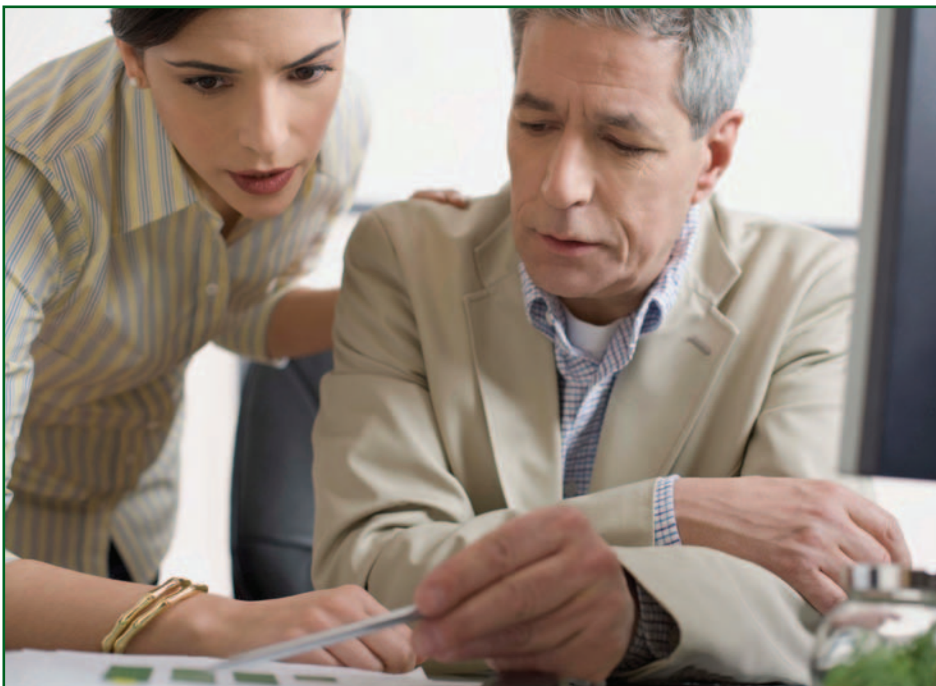
If you follow a typical arrangement, you 1) establish an FLP or LLC, retaining all of the partnership or membership units, 2) contribute assets to the entity, such as cash, real estate, marketable securities or business interests, and 3) give (or sell) minority interests in the entity to family members or to trusts for their benefit.

This technique allows you to retain control over assets while shifting most of the ownership interests to your family at a minimal tax cost. That's because, for gift tax purposes, minority FLP and LLC interests generally are entitled to substantial valuation discounts (often in the neighborhood of 40% to 50%) for lack of marketability and control.

To ensure the desired tax treatment, the FLP or LLC should have a legitimate nontax business purpose.

Pitfalls to avoid

To ensure the desired tax treatment, the FLP or LLC should have a legitimate nontax business purpose, such as maintaining control over a family business, consolidating management of an investment portfolio or protecting family assets from creditors. Also, you must treat the entity as a legitimate, independent business, observing all business formalities and documentation requirements.



Even with legitimate nontax reasons for forming an FLP or LLC, families frequently get themselves into trouble because they're lax about business formalities or they commingle personal and business assets. Failing to adhere to these formalities may cause the IRS to conclude that the entity is a sham, disregard it for

Dotting the i's and crossing the t's

To preserve the gift tax benefits of a family limited partnership (FLP) or limited liability company (LLC), proper documentation is a must. Consider the case of *Linton v. U.S.* The Lintons, a married couple, signed paperwork transferring securities, real estate and cash to an LLC and transferring minority LLC interests to trusts for the benefit of their children, all in the same meeting, on Jan. 22, 2003. The latter documents were undated, but several months later an attorney filled in the missing dates as Jan. 22.

On their gift tax returns, the Lintons applied 47% valuation discounts to the LLC interests. The IRS rejected the discounts, arguing, among other things, that the transfers were indirect gifts of the underlying assets under the step transaction doctrine.

The Lintons claimed that the Jan. 22 date was erroneous — that in fact they transferred the LLC interests on Jan. 31. A federal district court agreed with the IRS, however, and granted summary judgment in favor of the government.

The U.S. Court of Appeals for the Ninth Circuit reversed the lower court's decision, finding sufficient evidence to justify a trial. Even though the Lintons signed the transfer documents on Jan. 22, there was evidence to support the inference that the gifts didn't become effective until some later date — such as the date the documents were delivered to the trustee.

In addition, several documents — including the LLC's federal income tax returns, the Lintons' gift tax returns and a valuation report — indicated that the LLC interests were transferred on Jan. 31, which, the appellate court said, could be sufficient to overcome the step transaction argument.

Ultimately, the Ninth Circuit gave the Lintons another opportunity to prevail in court. But the family could have avoided many headaches and litigation expenses by executing the transactions over a longer time period and dating their documents properly.

gift and estate tax purposes, and assess tax on the full value of the assets, rather than the discounted amount.

Another common mistake is to complete all of the transfers at around the same time. People often set up an FLP or LLC, transfer assets to the entity and transfer FLP or LLC interests to family members all in the same meeting. If the IRS determines that the transactions were simultaneous — or, worse, that FLP or LLC interests were transferred *before* the entity was funded — it will likely apply the step transaction doctrine and treat the arrangement as an indirect gift of the underlying assets, taxable at full value. Even if the transactions are completed in the right sequence, the IRS may challenge the arrangement as an indirect gift under the step transaction doctrine.

Step transaction doctrine explained

Under this doctrine, separate steps may be collapsed into a single transaction if:

- The parties, at the time of the first step, had a *binding commitment* to undertake the later steps,
- The steps were prearranged parts of a single transaction designed to produce a particular *end result*, or
- The steps are *mutually interdependent* — that is, so closely intertwined that they're meaningless on their own.

Binding commitments are uncommon, but it's not unusual for the IRS or a court to invoke "end

result" or "mutual interdependence" tests. Under these tests, a key to avoiding step transaction treatment is to establish that the intermediate steps have tax-independent significance. Among other things, this means that enough time should pass between funding an FLP or LLC and transferring minority interests so the assets are subject to "real economic risk" during the interim.

Unfortunately, there's no magic number for determining how long you should wait; it depends on the nature of the assets, economic factors and other circumstances. Generally, funding an FLP or LLC and transferring interests later the same day won't be enough.

But the U.S. Tax Court has held that a six-day delay was sufficient. In that case, parents funded an FLP with heavily traded, highly volatile stock and assumed the risk during the six-day period that the stock's value would fluctuate before they transferred limited partnership interests to their children.

More stable assets, such as lightly traded securities or real estate, may require a longer waiting period to establish economic risk.

Time it right

If you plan to use an FLP or LLC as an estate planning vehicle, work with your advisor to determine an appropriate waiting period between funding the entity and transferring interests to family members. And to avoid an IRS challenge, be sure to document these transactions properly. (See "Dotting the i's and crossing the t's" on page 3.) ✤

HSAs

Dual benefits in one saving strategy

As health care costs continue to increase, many people are looking into the benefits of Health Savings Accounts (HSAs). What they're finding is that, in addition to being a viable option to reduce health care costs, HSAs can positively affect their estate plans. Why? Because HSAs grow on a tax-deferred basis.

HSAs, defined

An HSA is a tax-exempt account funded with pretax dollars. Like an IRA or 401(k) plan, contributions may be made by employers, employees or both.

An HSA must be coupled with a high-deductible health plan (HDHP), however. For 2012, to qualify as an HDHP, a plan must have a minimum deductible of $1,200 ($2,400 for family coverage) and a $6,050 cap on out-of-pocket expenses ($12,100 for family coverage).

Even if you have HDHP coverage, you generally won't be eligible to contribute to an HSA if you're also covered by any non-HDHP health insurance (such as a spouse's plan) or if you're enrolled in Medicare.

For 2012, the maximum HSA contribution is $3,100 ($6,250 for family coverage). If you're age 55 or older, you can make additional "catch-up" contributions of up to $1,000.

HSA benefits

HSAs provide several important benefits. First, they reduce unreimbursed health care costs by allowing you to withdraw funds tax free to pay for qualified medical expenses. Withdrawals for other purposes are subject to income tax and, if made before age 65, a 20% penalty.

Second, unused funds may be carried over from year to year, continuing to grow tax deferred. Essentially, to the extent you don't need the funds for medical expenses or for other expenses before age 65, an HSA serves as a supplemental IRA.

HSAs and estate plans

Like an IRA or a 401(k) account, unused HSA balances can supplement your retirement income or continue growing on a tax-deferred basis for your family. Unlike most other retirement savings vehicles, however, there are no required minimum distributions for HSAs.

It's important to carefully consider an HSA's beneficiary designation. When you die, any remaining HSA balance becomes the beneficiary's property. If the beneficiary is your spouse, your HSA becomes his or her HSA and is taxable only to the extent he or she makes nonqualified withdrawals.

If the beneficiary is someone other than your spouse, however, the account no longer will qualify as an HSA, and the beneficiary must include the account's fair market value in his or her gross income. (The beneficiary can, however, deduct any of your qualified medical expenses paid with the funds from your HSA within one year after your death.)

Unlike most other retirement savings vehicles, there are no required minimum distributions for HSAs.

This differs from an IRA, where a nonspouse beneficiary can spread RMDs over his or her lifetime. So, if you're age 65 or older and need to take distributions to pay *non*medical expenses (or for other purposes), you may want to consider whether it makes more sense to withdraw from:

- Your IRA — preserving your HSA so tax-free funds will be available for your own (or your spouse's or dependents') future medical expenses, or
- Your HSA — preserving your IRA's ability to generate tax-deferred growth for your heirs.

The answer will depend on a variety of factors, such as your age and health, the size of each account, and the beneficiary's age, health and relationship to you.

Bang for your buck

In today's uncertain economy, everyone, regardless of wealth, enjoys getting a bang for their buck. Opening and contributing to an HSA account offers just that: a tax-advantaged option that can help reduce health care costs and provide estate planning benefits. ✤

Protecting trust assets when a beneficiary is also a trustee

Trusts are an integral part of many estate plans. From an asset protection standpoint, generally it's best to appoint an independent, professional trustee. But in some cases it's desirable to name the trust's primary beneficiary as trustee. Fortunately, even then there are ways to help protect the trust assets.

Why name the beneficiary?

A properly designed trust helps safeguard assets against claims by a beneficiary's creditors as well as the beneficiary's own mismanagement. Generally, the less control a beneficiary has over the trust assets, the more protection the trust offers against creditors.

Given that, under what circumstances would a person still want to appoint the trust's beneficiary as trustee? A parent might want to give a financially savvy adult child control over the trust's investments while still providing some creditor protection. Or the creator of a credit shelter (or "bypass") trust may want to give his or her spouse control over how the assets are distributed to their children.

In some states, appointing a beneficiary as a trustee exposes the trust assets to creditor claims regardless of whether the trust contains a spendthrift clause.

Maximize creditor protection

Let's review a few tips for maximizing creditor protection when you name a beneficiary as trustee:

Include a spendthrift clause. A spendthrift clause, which is standard in most trusts, prohibits beneficiaries from selling or assigning their interests, either voluntarily or involuntarily. Thus, it

prevents a creditor from reaching a beneficiary's trust interest before the beneficiary receives it. (In most states, there are exceptions for certain creditors, including a child, spouse or former spouse with a claim for support or maintenance and certain government creditors.)

A spendthrift clause may help protect trust assets even when a beneficiary is also the trustee. In some states, however, appointing a beneficiary as a trustee exposes the trust assets to creditor claims regardless of whether the trust contains such a clause.

Use ascertainable standards. Discretionary trusts — as opposed to trusts that call for mandatory distributions at specified times or for a beneficiary's support — generally offer the strongest creditor protection. If distributions are within the trustee's sole discretion, the beneficiary can't compel a distribution and, therefore, neither can a creditor.

In some states, naming a beneficiary as trustee of a discretionary trust erases this creditor protection. These states allow a creditor to reach the "maximum amount the trustee-beneficiary can properly take," subject to a court's discretion to reserve a portion of that amount for the beneficiary's support.

In states that have adopted the Uniform Trust Code, however, a trust is protected from creditor

claims to the extent discretionary distributions to a beneficiary-trustee are limited to an "ascertainable standard," such as amounts necessary for health, education, support or maintenance.

Appoint a co-trustee and name at least one other beneficiary. If you're in a state that permits creditors to reach assets available to a beneficiary-trustee — or if the law is unsettled — consider naming a co-trustee and at least one other beneficiary. Many states offer creditor protection if a trust includes a spendthrift clause and the beneficiary-trustee holds discretionary distribution power jointly with a co-trustee who owes a fiduciary duty to other trust beneficiaries.

Adding a co-trustee or beneficiary also helps avoid the "merger doctrine," which provides that, if an individual becomes the sole beneficiary and sole trustee, the trust terminates, exposing the assets to creditor claims.

Don't try this at home

The laws regarding creditor protection are complex and vary significantly from state to state. We've discussed only general guidelines here, so it's critical to consult your legal advisors to ensure your trust is structured and drafted to maximize creditor protection. ✤

Estate Planning Red Flag

You haven't chosen the right executor or trustee

No matter how much effort you put into planning your estate, your plan won't work smoothly if you choose the wrong executor — or, if you have a living trust, the wrong trustee.

Your executor (referred to as a "personal representative" in some states) may have a wide range of responsibilities, such as arranging probate, identifying and taking custody of assets, making investment decisions, filing tax returns, handling creditors' claims, paying the estate's expenses, and distributing assets according to your will. The trustee of a living trust (also called a "revocable trust") will have similar responsibilities.

Here are some common mistakes people make when choosing an executor or trustee:

Automatically choosing a family member. You want to select someone you trust, and a family member may be appropriate. Too often, though, family members lack the requisite skills and experience with financial matters — though they can retain professional advisors. Also, choosing a family member can create tension if other relatives believe your choice is biased.

Choosing someone far away. Selecting a person who lives and works at a distance from the location of your assets and beneficiaries can make the process more difficult, time consuming and expensive.

Not making sure the person is willing to serve. He or she isn't obligated to take the job, so be sure to discuss your plans first.

Failing to designate a backup. Name one or two alternates in case your first choice declines to serve — or resigns, becomes incapacitated or dies before your estate is settled.

If you're having trouble finding someone who meets all of your requirements, consider appointing co-executors or co-trustees. For example, you might choose a family member to work with a financial or legal professional. Co-executors or co-trustees can create other challenges, though. For instance, you won't want to name two people who're unlikely to have a productive working relationship.

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- A high level of quality, sophistication, and experience.
- A creative and imaginative approach that focuses on finding solutions, not problems.
- Accessible attorneys who give clients priority treatment and extraordinary service.
- Effectiveness at a fair price.

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Estate planning is a complex task that often involves related areas of law, as well as various types of financial services. Our clients frequently face complicated real estate, tax, corporate and pension planning issues that significantly impact their estate plans. So our attorneys work with accountants, financial planners and other advisors to develop and implement strategies that help achieve our clients' diverse goals.

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We welcome the opportunity to discuss your situation and provide the services required to help you achieve your estate planning goals. Please call us today and let us know how we can be of assistance.

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