



Quarterly Tax Report

Volume I, Issue I

April I, 2006

DID YOU KNOW?

- Schantz & Gray, LLC represents buyers and sellers in all aspects of residential and commercial real estate transactions.
- We can assist you in the sale or purchase of real estate from preparing and/or reviewing sales documents through closing.
- As Approved Attorneys for Penn Title, Inc. we are able to offer discounted title insurance to our clients.

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Lookback Period for Medicaid Qualification is Increased

Although not a tax issue, Congress has significantly changed the rules regarding the lookback period for Medical Assistance applicants. Under prior law, the government looked back 36 months for outright transfer and 60 months for transfers in trust. If an applicant made an outright gift 37 months before he or she needed Medical Assistance benefits, there would be no period of ineligibility because the transfer occurred outside the lookback period.

Pursuant of Public Law 109-171 known as the Deficit Reduction Act of 2005, Congress increased the lookback period for outright transfers to 60 months, so that all trans-

fers that occur within 60 months of the application for benefits will cause a period of ineligibility.

Some applicants, in an effort to preserve assets, would transfer assets as gifts to his or her heirs and hope that he or she would not need nursing home care for at least 36 months. In other words, they would attempt to wait out the lookback period. If they were successful, at the end of 36 months, the applicant would be able to apply for Medical Assistance for nursing home care and would suffer no period of ineligibility because no transfers were made during the 36 month period.

Under the new law, such an applicant will need to

wait 60 months instead of 36 months which creates a greater risk of a nursing home need. If an applicant makes transfers and attempts to wait out the period and fails, he or she will be required to pay for nursing home care from his or her individual assets. If those assets are insufficient, the applicant will be required to rely on the gift recipients to pay for his or her care.

Let's hope the recipients didn't spend all the money on a vacation home.

IRS Issues Guidance for Election to Treat Family as One S Corp Shareholder

The IRS recently released Notice 2005-91 that provides guidance for electing to treat all members of a family as a single S Corp shareholder.

Members of a family include a common ancestor,

lineal descendants of the common ancestor, and spouses or former spouses of common ancestor or lineal descendant.

To make a valid election, a taxpayer must provide the following:

- The name of the electing family member;
- Name of the Common Ancestor;
- The first S Corp year to which election applies.

Tax Court Approves Discounts for LP funded with Cash and CDs

In *Estate of Kelley v. Commissioner*, TC Memo 2005-234, the Tax Court denied the estate's 53.5 percent discount claimed on limited partnership interests owned by the Decedent but applied a 12 percent minority interest and a 23 percent lack of marketability discount.

The Decedent funded a newly created limited partnership in 1999 by transferring cash and certificates of deposit. In addition, Decedent created a limited liability company ("LLC") which owned the 1% general partnership interest.

At the time of his death, decedent owned 33% of the LLC and 94.83%

of the limited partnership interests. On its Form 706, the estate claimed combined valuation discounts of 53.5 percent.

In reaching its decision, the Court began by valuing the underlying assets owned by the partnership. Because the partnership owned only cash and certificates of deposit, the Court classified it as an investment company and gave the greatest weight to the Net Asset Value method.

Each expert and the Court purported to apply the closed-end fund approach to determine minority discounts. The Court disregarded

the estate's expert because it used only funds with the highest discounts. Instead, the Court agreed with the Service's expert who used the average of the entire set of closed-end funds.

In reaching a marketability discount, the Court applied the private-placement approach which is a subset of the restricted stock study and is appropriate for valuing an interest in an investment company.

It is significant that the Court and apparently the IRS did not raise business purpose or other typical anti-FLP arguments.

Congress Passes Katrina and Rita Relief

On September 23, 2005, President Bush signed the first of several Hurricane relief bills into law.

The bill provides the following incentives and relief:

- Relief from filing deadlines if the taxpayer or the taxpayer's professional advisor is located in Hurricane affected areas
- Employers that hire qualified employees before December 31, 2005 qualify for a special tax credit.
- Taxpayers who provide rent-free shelter to hurricane victims can deduct up to \$500 per victim up to a maximum of \$2,000 for 2005 and 2006. Taxpayers need not itemize to benefit from this deduction.
- The 50% AGI limit for charitable deductions is waived for contributions to charities involved in hurricane relief.
- Hurricane victims can take penalty-free distributions from IRAs and the IRS has increased the borrowing limit from qualified plans.

If It Seems Too Good to be True . . . It Probably Is

The headline is essentially what the Tax Court told the taxpayers. In *Rogers*, TC Memo, 2005-248, the Taxpayers signed on with a promoter who guaranteed a reduction in income taxes. Pursuant to the plan, the Taxpayers transferred all their assets to a trust and reported one tenth of the income they reported the previous year. In addition, the trusts reported no in-

come and paid no income tax.

Based on the promoter's recommendation, the Taxpayers hired a CPA to prepare their individual and Trust returns.

The issue before the Tax Court was whether the accuracy penalty of IRC 6662 applied because the Taxpayers claimed they relied on the

advice of a CPA which gave them reasonable cause.

The Tax Court held that the Taxpayers should have known better because there is no way to eliminate income tax by simply transferring assets to a trust. In addition, the taxpayers had a duty to inquire into the relationship of the CPA and the promoter.

President's Tax Panel Presents Two Proposals

The President's Advisory Panel on Federal Tax Reform presented two reform proposals in its report dated November 1, 2005. After considering value added taxes, national sales taxes, consumption taxes, and flat taxes, the panel finally proposed two simplified income tax scenarios that eliminate many of the preferences contained in the present tax code. Both proposals eliminate the alternative minimum tax and marriage penalty for all individual taxpayers.

The first proposal which the Panel called the "Simplified Income Tax Plan", calls for four individual tax brackets (15%, 25%, 30%, 33%). The standard deduction, personal

exemption and child tax credit are replaced with a Family Credit of \$3,300 for married filing jointly and \$1,500 for each child.

Among the most controversial features of both proposals is the replacement of the mortgage interest deduction with a Home Credit equal to 15% of the annual interest paid on mortgages that do not exceed the average regional price of housing (estimated to range from \$227,000 to \$412,000).

Another significant feature of both proposals is a charitable deduction for all taxpayers who give more than 1% of income to charity. This eliminates the need to itemize deductions to claim charitable contri-

butions and meet certain minimum AGI limits.

Similar to charitable deductions, both proposals permit full deduction of health insurance premiums without regard to AGI floors or the need to itemize. Deduction of health care premiums would be limited to the average cost of health care estimated to be \$11,500 for a family.

Each proposal has its own feature and rates regarding dividends received and capital gains.

The second proposal provides only three tax brackets at 15%, 25% and 30%. The proposals also contain business tax reform which will be discussed in the next installment.

Buy-Sell not Respected to Determine Estate Value

Under certain circumstances, a value established in a buy-sell agreement will determine the value for estate tax purposes. However, in *Estate of Blount v. Commr*, 2005-2 USTC P60,509 (11Cir, 2005), the circuit court disregarded a redemption agreement..

The Court looked at the three elements necessary to bind the IRS: (1) agreement has a bona fide business purpose; (2) the agreement does not

permit a wealth transfer to natural objects of decedent's bounty; and (3) agreement must be comparable to arms length agreements. In deciding that the agreement did not bind the Service, the Court was influenced by the fact that the agreement could be unilaterally modified by the decedent. Although the agreement provided that it could only be modified with the unanimous consent of all the parties, the only parties to the agreement at the

time of Decedent's death were the corporation which decedent controlled and decedent.

The Court also ruled the IRS erred by including insurance proceeds in the value of the corporation. The court applied the rule that insurance proceeds are not included in the value of a company where the company has a corresponding obligation to purchase stock from the estate of a shareholder.

Settlement with IRS Does Not Protect Corporate Officers from Trust Fund Recovery Penalties

In *CTI v. US*, 2005-2 USTC 50,626 (N.Dist III, 2005), the District Court denied CTI's request to prevent the application of Trust Fund Recovery Penalties ("TFRP") against corporate officers, even though the IRS had accepted a settlement with the corporation. The Court denied the relief

requested because the complaint was filed by CTI and not the corporate officers. The Court held that the liability of CTI, the employer, is separate and distinct from the TFRP and that the corporation does not have standing.

The Court also held that the Anti-

Injunction Act prevents CTI from maintaining the action because it seeks to enjoin the IRS from collecting taxes.

To prevent a whipsaw position by the IRS, practitioners should ensure that settlement agreements address the TFRP exposure of corporate officers.

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Schantz & Gray, LLC was formed in 2006 by Andrew V. Schantz, William E. Schantz and Christopher R. Gray. Schantz & Gray is built upon a tradition of quality legal representation to the Lehigh Valley. With more than 70 years of experience, our three native Lehigh Valley attorneys provide the personal attention and care of a "family" firm with the full spectrum of legal services, professionalism, and expertise of a "large" firm.

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Tax Court Denies Discount for IRA

In a case that for all intents and purposes eliminates the notion of discounting the value of IRA accounts by the expected income tax liability, the Tax Court ruled that an estate was required to include the entire date of death value of decedent's IRA accounts.

In *Estate of Kahn v. Comm.*, the decedent's representatives included on the Form 706, the value of two IRA accounts owned by Decedent reduced by the expected income tax due when the account assets are subsequently distributed. The accounts were discounted by 21% and 22.5% to account for the income tax liability of the designated beneficiary. On review, the IRS denied the discount and issued a notice of deficiency for \$843,892.

Some practitioners analyzed the tax liability of an IRA as similar to a line of cases where an asset with

built-in-gain was owned by a corporation. In those cases, various courts held that a willing buyer would factor in the tax liability that would be incurred to liquidate the underlying assets.

In rejecting the Taxpayer's argument, the Tax Court stated that reliance upon this line of cases is misplaced because unlike corporate stock, an IRA by law cannot be transferred. Consequently, there will be no willing buyer and willing seller for the IRA account.

The next line of cases cited by the Taxpayer held that tax benefits were to be taken into account when applying the willing buyer/willing seller test. However, the Court distinguished the IRA discount by observing that in the cited line of cases the tax benefit was at least partially offset by a tax liability.

Similarly, the Taxpayer attempted to apply a lack of marketability argument that would apply to closely-held stock. However, the Court noted that the securities inside the IRA are freely transferable and by law the IRA itself is not able to be transferred. Therefore, the Court held that the lack of marketability does not apply to IRAs.

The Taxpayer asserted several other discount situations to no avail. The Court refused to consider marketability and transfer arguments because the Court said that IRAs are trusts not assets that can be transferred.

With a Tax Court decision that so completely rejects the notion of discounting an IRA, Taxpayers should exercise extreme caution when taking such a position.