



The Tax Installment

Presented as a courtesy to the clients and friends of:

Hyden, Miron & Foster, PLLC

200 Louisiana, Little Rock, Arkansas 72201

501-376-8222 800-467-8297

June 2008

Hyden, Miron & Foster, PLLC stands ready to assist you with the new issues that abound in tax, estate, trust, business, and litigation matters. "The Tax Installment" is only part of our commitment to serve our clients and friends. Our goal is to educate you on the options available for your specific circumstances and the reasoning behind those options. You remain our top priority, and we will continue to serve you throughout the years to come.

Entities that Benefit an Estate Plan

Organizing a limited liability company ("LLC"), a family limited partnership ("FLP") or a family limited liability company ("FLLC") for asset protection, estate planning, and business succession purposes allows the taxpayer to maintain the underlying assets of the entity within the family unit, usually of sentimental importance, while hopefully removing those same assets from the taxpayer's taxable estate.

To accomplish this objective, the taxpayer must incorporate the entity. Next, the assets must be transferred and titled to the entity. The taxpayer then gifts ownership interests in the entity to any heirs or beneficiaries they choose. By receiving the gifted membership interests, the donee(s) are essentially receiving an interest in the assets, which, depending on the terms of the entity, can continue to be held and operated by the family unit.

One of the most significant tax advantages associated with gifting membership interests in LLCs, FLPs and FLLCs is the possible valuation discounts for lack of marketability and minority interests. A minority interest may be worth less than a majority interest because people are more apt to buy a majority interest for the voting rights. As a result, the IRS may allow minority discounts to be valued less than a purely pro rata amount. Meaning, a 25% interest in a FLP won't necessarily be valued as 25% of the net worth of the entity. Instead, the value would be reduced below 25% of the entity's net worth because, in the realities of the market place, no one would pay that amount to purchase it from the minority owner. Some studies have found the average discount for lack of marketability (DLOM) to be "in the range of 30-35%, while (others) have reported average DLOMs generally around 45%. Studies also have found a very wide range of discounts, depending upon the

CONTINUED ON PAGE 2

Table of Contents	Page
Entities that Benefit an Estate Plan	1
Special Needs Trusts	3
Accidentally Disinheriting Your Heirs: Seven Mistakes to Avoid	4
Borrowing from your Retirement Plan	5
Protecting Your Will	6
New Faces at the Office	6
Home Sweet Home	7
Arkansas Natural Gas Severance Tax	7

Entities that Benefit an Estate Plan —Continued from Page 1

transaction, from 90% to less than 10%. (However), a valuation professional cannot simply apply the average or median discounts..., but must analyze the characteristics of the subject company to determine a rational and supportable DLOM.”¹

Valuing gifts of LLC interests should be undertaken with great care and substantial documentation because a 20% tax penalty may be imposed if there is a substantial estate or gift tax valuation understatement.² Also, discounts for minority interests and lack of marketability have received unfavorable authority recently when used in estate planning.

For example, in “the *Strangi* case, the IRS successfully claimed that the assets contributed by Mr. Strangi, the decedent, to his FLP (rather than the discountable partnership interests he owned) should be included in his estate on a non-discounted basis.³ The IRS determined, and (the 5th Circuit Court of Appeals agreed despite a contrary preliminary ruling by the Tax Court), that Mr. Strangi had retained not only the right to the income from, but also the possession and enjoyment of, the property he transferred to the FLP. As a result, such property was includible in his estate and subject to estate tax.”⁴ In the case, the “Tax Court properly determined on remand that (the) value of multimillion dollar assets and personal residence which decedent transferred to FLP (a) few months before death were includible in (his) gross estate under Code §2036(a)(1): (the) record clearly reflected (an) implied agreement that (the) decedent would retain (the) assets’ continued possession or enjoyment post-transfer. Notable facts included that numerous FLP distributions were used to pay funeral, estate’s and decedent’s personal expenses; asset transfers consisted of 98% of his wealth and left him without any meaningful liquid assets; and he continued to live in (the) residence until death without paying any rent. Also, (the) facts that rent was charged and later paid post-death

were’n’t dispositive, particularly since (the) rental deferral in itself provided significant economic benefit.”⁵ Note that the Tax Court originally held the FLP assets outside the decedent’s estate and the IRS subsequently appealed to the Federal Court, thus demonstrating (and seemingly commencing) the increased scrutiny that FLPs and their marketability discounts are receiving.

“The IRS has won most subsequent FLP cases, including the *Estate of Edna Korby* and the *Estate of Austin Korby*. The original decisions favoring the IRS in *Korby* were recently affirmed by the 8th Circuit Court of Appeals, which covers Minnesota, North Dakota, South Dakota, Iowa, Arkansas, Missouri, and Nebraska. Not surprisingly, a significant number of so-called “bad facts,” (i.e. transfer of substantially all of a grantor’s assets or too many personal assets, retention of income rights, reversionary interests, etc.) were present in most of these cases (including *Korby*), making it very easy for the courts to side with the IRS. In reality, the Service was only litigating the cases it knew it could win.”⁶ Presumably, if a family limited partnership is more like an actual business and looks less like a protective cocoon of family money, the IRS and Courts would be less inclined to disallow the discounts. Additionally, the Courts have traditionally scrutinized family limited partnerships and not LLCs, yet there is no policy reason to treat FLPs, FLLCs, and regular LLCs used for estate planning purposes any differently.

Thus, the IRS does not appear to be expanding the restrictions on gifting minority interests, rather it is increasing enforcement of rules and regulations. If all the required formalities are not followed, the Service is now more likely than before to challenge the transfer and include all FLP assets in the grantor’s estate. Some taxpayers have tried to isolate FLPs from

CONTINUED ON PAGE 3

Entities that Benefit an Estate Plan —Continued from Page 2

their business purposes and use them only as estate planning vehicles. To curtail this perceived abuse, the IRS has increased litigation. Therefore, the gifting of FLP interests, FLLC interests, and interests in regular LLCs, organized for asset protection and estate planning, should employ critical diligence towards satisfying business formalities and valuation of those interests.

¹ Understanding the Valuation Discount for Lack of Marketability; Online CPA Journal, Glazer, Russell T., (August 2005); <http://www.nysscapa.org/cpajournal/2005/805/essentials/p60.htm>.

² Code § 6662(g)(1).

³ Estate of Strangi v. Commissioner, 96 AFTR 2d 2005-6895 (429 F.3d 1154).

⁴ An Update of Family Limited Partnerships: Forming, Operating and Fixing FLPs Following Recent Successful IRS Challenges; Fredrikson & Byron, P.A., by Gollin, David B. (2007); http://www.fredlaw.com/articles/estate/esta_0705_dbg.html.

⁵ Estate of Strangi v. Commissioner, 96 AFTR 2d 2005-6895 (429 F.3d 1154).

⁶ An Update of Family Limited Partnerships: Forming, Operating and Fixing FLPs Following Recent Successful IRS Challenges; Fredrikson & Byron, P.A., by Gollin, David B. (2007); http://www.fredlaw.com/articles/estate/esta_0705_dbg.html.

Special Needs Trusts

Parents of adult children with mental or physical disabilities are faced with unique estate planning challenges. In most cases, an outright gift cannot be made because the child may not be able to manage the gift or it may adversely impact the child's government benefits. Special or supplemental needs trusts (SNT) may be a way to provide for your child without worries about mismanagement or losing government benefits.

There are a number of types of SNT available and you will need to consult your estate planning attorney to determine which best meets your needs. The most common is a third party grantor trust. This trust is usually created by a parent, grandparent, or any other individual who is not legally responsible for the beneficiary. The trust will provide that at the death of the grantor the special needs trust will be funded, usually with the share the child would have otherwise received. The SNT should provide that the funds are not intended to replace any government benefits that the child currently receives or may receive in the future. Further, the Trustee should have complete discretion on when and how trust funds are used. While each state may interpret the law differently, there is currently no federal requirement to provide for repayment to the state for monies expended for the care of the child in this type of trust. Thus, there should be direction for the disposition of funds at the death of the child.

A trust may also be created using the child's assets. A self-settled trust may be created by the child's spouse, parents, or a court acting on behalf of the child. Often these trusts are created to hold the proceeds of litigation related to the individual's disability. The idea is the same as a grantor trust – to provide for any needs that are not provided for by government benefits. However, at the beneficiary's death, the state is entitled to repayment from any remaining funds for the amount it has expended in caring for the individual. If there are any funds left, they would pass as directed in the trust.

These are just a few types of SNT available. Because this area is constantly changing, it is important to discuss any needs you may have for this type of planning with your estate planning professional.

Accidentally Disinheriting Your Heirs: Seven Mistakes to Avoid

There are several mistakes that lead to disinheriting heirs. The most common are:

1) Failure to Update a Will or Trust

An estate plan is not something that you should do once and forget about. It should grow and change with your family and life. It is a good idea to reevaluate your estate plan every five years or at a major life event – birth, marriage, divorce, or substantial change in assets.

2) The Faulty Will

These are instances where, for whatever reason, your will was not executed properly. This most often occurs when individuals prepare their own wills. Common problems include: too few witnesses, the testator fails to sign or has someone else sign incorrectly, or failure to properly revoke previous wills. Drafting and executing a will on your own may create unforeseen problems and expense in the future.

3) Disinheritance by Stepparent Succession

In this situation, an individual remarries and simply retypes their old will with the new spouse's name. The result is the "new will" leaves everything to the stepparent who passes it all to their own children. There are a number of ways to avoid this situation, including having the "new will" reviewed by an attorney, using a trust to limit the stepparent's ability to disinherit the stepchildren, or entering into a mutual will to distribute assets to both families.

4) Disinheritance by Ademption

Ademption occurs when a gift of specific property is made in an individual's estate plan but at the time of the individual's death the property is no longer in the estate. The beneficiary of this specific property receives nothing.

Ademption may be prevented by updating your estate plan when specifically devised items are removed from your estate or by placing the proceeds from the specifically devised property in trust for the

benefit of the beneficiaries in the will.

5) Disinheritance by Misunderstanding Survivorship

This occurs when pay-on-death or transfer-upon-death designations are not updated. These designations should be consistent with one's current estate plan. Failure to change the designations could affect a new plan. Prevention involves reviewing the designations every time the estate plan is changed, which may be cumbersome if you change your estate plan often. Consult an estate planning attorney about the best way to designate these accounts.

6) Disinheritance by Mirror-Image Wills

Mirror-image wills are very common for married couples who want the same thing to happen at their death. These wills contain the exact same distribution provisions which create problems when the surviving spouse does not change their will. The result is often unintended double inheritances when the goal was to evenly distribute the estate. An easy way to prevent this is to update your estate plan after major life events.

7) Disinheritance by Failure to Prepare an Estate Plan

Without an estate plan, property is distributed according to the state's intestacy statutes which may not be how you wanted your property distributed. A more significant implication of not having an estate plan is that it can leave your children without a guardian. If you are a parent, preparing an estate plan affords you the opportunity to appoint a guardian for your children.

While no one likes to think about estate planning, it is something you must do if you want to ensure that your wishes are carried out.

Would you like to begin receiving our quarterly newsletter by e-mail? If so, visit www.hmflaw.net/Newsletters.htm and follow the links to register.

Borrowing from your Retirement Plan

Ideally, participants will not access their retirement funds until they retire, allowing them to grow continuously. However, this is not an ideal world! In an emergency, the funds in a 401(k) plan may be available in the form of a participant loan, if the document provisions are drafted to allow the option of participant loans.

Retirement plan loans are generally easy to obtain and are not associated with a lot of expenses. Participants repay the interest to themselves on the loan, which is typically preferred to paying interest to a lender. Additionally, if a participant's credit score is low, it may be easier and cheaper to borrow from their retirement plan than from a commercial lender.

Giving employees the option to borrow from their 401(k) accounts can sometimes increase participant contribution rates because the participants have the security of knowing that their money is available "just in case". This allows the participant to comfortably make a sizable commitment to retirement savings in the plan. On average, a participant in a plan which offers loans appears to contribute 0.6 percentage point more of his or her salary to the plan than a participant in a plan with no loan provision. Also, about 20% of employees eligible for a plan loan have one, and the average outstanding loan balance is approximately \$6,300.

Loan Basics (if allowed by Plan)

Participants can borrow up to 50 percent of their vested account balance, not to exceed \$50,000.

- The loan must be repaid over a five-year repayment period (or less). The one exception is for a loan that is a mortgage for a primary residence. The repayment period may be longer for this type of loan.
- The interest rate will be determined on the

day the loan is taken. While interest rates vary, the most common is the "prime rate" plus one percent. The current "prime rate" can be found in the business section of the newspaper.

- Loan payments are processed through payroll deduction.
- There is no penalty for paying the loan off early.
- Plan loans usually have a minimum amount requirement, typically \$1,000.
- Loans are typically secured by the participant's vested account balance so there is usually no additional collateral required.
- The purpose for the loan can be limited or unlimited, depending on the plan language selected.

Generally, borrowing from a 401(k) isn't the best idea. Nevertheless, it does provide participants access to their retirement money (within limits) without incurring the 10% early withdrawal penalty required for distributions prior to age 59 ½.

If you would like to consider adding a loan provision to your plan document, please contact your third party administrator or plan ERISA attorney.

Do You Need a Speaker?

The attorneys at Hyden, Miron & Foster, PLLC have experience speaking to groups of all sizes. Please contact us if you would like an attorney to speak to your employees, civic group, or organization regarding estate planning, business planning, asset protection, employee benefits, or taxation.

Protecting Your Will

The best place to keep your will is in a safe deposit box at the bank. It is generally not a good idea to keep your will at your home because it may be stolen or destroyed by a fire or natural disaster. It is usually a good idea to keep a copy of your will with your important documents at home so you may refer to it if needed. However, it is often a bad idea to give your family a copy of your will. If you ever make changes, you would need to get that copy back which is sometimes difficult. Finally, if your attorney has kept your original will, make sure to provide them with your current contact information so they can contact you if they move or retire.

Although it may seem like a bad idea to have an old will lying around after you have executed a new one, that is not always the case. For example, if your new will is invalidated for some reason, a court may be willing to reinstate your old will. Given the choice between using your old will and allowing your estate to pass via intestate succession, you would probably choose the old will.

It is a common tendency for people who are planning to change their will to make the changes on the document itself. This, however, is not a good idea because the updates are not valid and may be viewed by a court as a revocation. The best thing to do if you want to make changes to your will is to contact your attorney. Depending on the extent of the changes, a codicil to your existing will may be all that you need.

New Faces at the Office

James C. McNiece, Jr., concentrates his practice in the areas of taxation, federal tax controversy, estate planning, business law, entity formation, administration, and termination. He also emphasizes on probate and trust administration, business planning, retirement plans, and charitable organizations. Prior to joining the firm in 2007, Mr. McNiece was a legal research assistant to Professor Ed Hood at the University of Missouri at Kansas City School of Law. He was also a student representative of qualifying taxpayers at the University of Missouri at Kansas City Tax Clinic. Mr. McNiece is a member of the Arkansas Bar Association. He received a B.S. degree from Hendrix College, his J.D. from the University of Arkansas at Fayetteville School of Law, and his LL.M. in Taxation from the University of Missouri at Kansas City School of Law.

Brenda S. Wagner concentrates her practice in the areas of estate planning, business law, corporate law, probate administration, and business/real estate transactions. Prior to joining the firm in 2007, Ms. Wagner was a paralegal concentrating on estate planning and probate administration at Lewis, Anderson, Phillips and Hinkle, PLLC in Chapel Hill, North Carolina. She was also a legal intern at the Allegheny County District Attorney's office in Pittsburgh, Pennsylvania. Ms. Wagner is a member of the Arkansas Bar Association, Arkansas Association of Women Lawyers, and the Pulaski County Bar Association. She received a B.S.B.A. in Business Management from West Virginia University and her J.D. from Duquesne University School of Law.

This newsletter presents general informational material only and is not intended to offer legal advice. You should not rely on or use information presented here without consulting an attorney regarding your specific circumstances, changes to applicable laws, rules and regulations, and other legal issues.

Receipt of this newsletter does not establish an attorney-client relationship. If you desire representation, please contact our office.

Home Sweet Home

The pride that comes with owning a home is great but a home is more than that. It is an asset - usually the biggest asset one will ever own. A home's biggest benefit is equity - whether created by paying down the principal on your mortgage or through appreciation. You usually benefit from equity when your home is sold. However, you may benefit from equity even if you are not selling through a home equity loan. This loan uses your equity in the home as collateral. Typically these loans are used for home improvement but may also be used for other expenses like a child's education or an emergency. Interest on home equity loans is often less than other types of loans and is deductible.

Home ownership comes with many tax benefits. Homeowners may take a mortgage interest deduction. As long as your mortgage balance is smaller than the price of your home, you can fully deduct the amount of mortgage interest you paid during the year. Further, you may fully deduct real property taxes paid on your first home and a vacation home. There is also a capital gains exclusion on the proceeds from the sale of your primary residence. If the home was used as your primary residence for two of the last five years, you are allowed to exclude the first \$250,000 for a single person and \$500,000 for a married couple of the profit from capital gains treatment. A recent law extends this exclusion for two years after the death of a spouse. Previously, a surviving spouse would have to sell the home during the year in which the spouse died to receive the \$500,000 exclusion. Now, they will receive the exclusion if the house is sold within two years from the date of the spouse's death, assuming all other requirements are met.

The Mortgage Forgiveness Debt Relief Act of 2007 allows "taxpayers [to] exclude debt forgiven on their principal residence if the balance of their loan was less than \$2 million" (or \$1 million individually).¹ "The new law applies to debt forgiven in 2007, 2008, or 2009. Debt reduced through mortgage restructuring, as well as mortgage debt forgiven in connection with a foreclosure, may qualify for this relief."² Eligible homeowners may claim this relief by using Form 982.

¹Mortgage Workouts, Now Tax-Free for Many Homeowners; Claim Relief on Newly-Revised IRS Form, www.irs.gov, February 12, 2008.

²*Id.*

Arkansas Natural Gas Severance Tax

In April 2008, Governor Mike Beebe signed a bill into law that will increase the state's severance tax to 5% of gas sale proceeds, less some actual costs, received by the producer. The increase takes effect in January 2009 and is estimated to generate \$57 million in revenue in the first year. Ninety-five percent of the revenue from this tax will be used for highways. The remaining portion will go into general revenue.

The new law affords natural gas companies an opportunity to recover some expenses before having to pay the full tax. Specifically, a natural gas company will pay a reduced rate of 1.5% for the first 3 years of production on new high cost wells and for 2 years on other new wells. A reduced rate of 1.25% will be charged for new or old marginal gas wells which produce below minimum requirements.

With the development of the rich natural gas resources in the Fayetteville Shale, it is unclear how this increase in the severance tax will affect the state's natural gas industry or landowners.

The Tax Installment

Hyden, Miron & Foster, PLLC
200 Louisiana
Little Rock, Arkansas 72201

The Tax Installment

Visit Our Website

The next time you are surfing the internet, stop in and visit our website: www.hmflaw.net. The site explains the services we provide to our clients and allows you to e-mail the firm with suggestions or questions you may have.

E-mail Us Directly

James W. Hyden

jim.hyden@hmflaw.net

Mary Stobaugh

mary.stobaugh@hmflaw.net

Danny W. Broaddrick

danny.broaddrick@hmflaw.net

Pam Chambers

pam.chambers@hmflaw.net

Lori L. Holzwarth

lori.holzwarth@hmflaw.net

James C. McNiece, Jr.

jj.mcniece@hmflaw.net

Jean Theus

jean.theus@hmflaw.net

Philip Miron

philip.miron@hmflaw.net

Tina Medlock

tina.medlock@hmflaw.net

Guy W. Murphy, Jr.

guy.murphy@hmflaw.net

Jennie Bickham

jennifer.bickham@hmflaw.net

Christopher D. Brockett

chris.brockett@hmflaw.net

Administrative Staff**Angela Bortowski**

angela.bortowski@hmflaw.net

Lyle D. Foster

lyle.foster@hmflaw.net

Joni Mercer

joni.mercer@hmflaw.net

Shaneen Kelleybrew Sloan

shaneen.sloan@hmflaw.net

Brenda S. Wagner

brenda.wagner@hmflaw.net

Ashley Blancett

receptionist@hmflaw.net