

The Estate Analyst®

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Mid-Year Roundup, 2005

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Midway through this year, there is already a surplus of legislation, regulation, prognostication, consternation, and edification on a range of subjects including bankruptcy reform, the housing bubble, the estate tax repeal, living wills, and a \$52-million tax deficiency in an FLP case! Let's get right to work.

Bongard, En Garde!

"Beware the ides of March," was a famous warning that went unheeded.¹ If you appreciate irony, as the

Tax Court undoubtedly does, then note with great caution the arrival of, *Bongard v. Commissioner*, on March 15, 2005.²

Although no one is anticipating a murder of anyone by Pompey's statue in the temple of Venus, the warning about family limited partnerships (FLPs) is clear: Beware! The IRS never gives up; it is like the kid who loses the game, takes the ball home with him, and won't let anyone else play unless the rules are changed.

Presented With Our Compliments

In the case of Mr. Bongard's estate, the point of contention comes down to the inclusion of certain interests in the gross estate under sections 2035(a) and 2036(a).

If you printed out this 54-page decision and find yourself no closer to resolving this issue (and lamenting the waste of paper and ink), you are not alone. Suffice it to say, the IRS wants various interests included, and determined a \$52,878,785 estate tax deficiency as a result. The Tax Court is in partial agreement with the IRS over what constitutes a bona fide sale and this case is headed for the Appeals Court.

But didn't *Strangi* and related cases clear the way for confident use of FLPs? And isn't this entire discussion in the context of a tax which Congress is eliminating? Yes, but that's not the point. Until the fat lady sings, the IRS will attack arrangements that are too successful until it intimidates planners from utilizing them.

And the IRS strategy is working. For example, *The Wall Street Journal's* coverage of *Bongard* prompted a website for accountants (*Accountingweb.com*) to warn readers, "Tread carefully if you are thinking of moving family estate assets into a partnership to reduce your tax burden. A U.S. Tax Court decision is making it more difficult to shield assets."

Similarly, the website of an insurance professional warned colleagues, "In the ever-changing world of estate planning, the recent rulings in the *Strangi*, *Bongard*, and *Bigelow* cases will of course impact your individual clients' decisions relative to life insurance in connection to a FLP."

Stay tuned, gentle reader, this story is going to get interesting by Act III.

Bankruptcy Reforms Enacted

Economic pressures and the prospect of impending reforms caused U.S. businesses and consumers to file a record 400,394 bankruptcies in the second quarter of 2004, a 24.5% increase from the previous year.

The American Bankruptcy Institute reported that filings of 767,235 over six months put the nation on track to break the record of 1,442,549 cases set in 1999. A study by Global Insights projected that annual bankruptcy filings in the U.S. would reach 1.74 million in 2007 and pointed out Maryland, Nevada, New Jersey, Utah, and Virginia as states that would experience the most significant increases.

With consumer debt approaching \$2 trillion, credit card companies and commercial creditors have been pressuring Congress to follow up on the Bankruptcy Reform Act of 1994. This year, Congress took action. President Bush signed the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 on April 20, 2005, and the new provisions take effect 180 days later on October 17, 2005.

The new law will make it harder for people to wipe away all debts with a Chapter 7 filing and instead will require the use of Chapter 13 filings that involve scheduled repayment plans. Along with rules, other rules, and more rules, there are a few areas estate planners will need to keep an eye on.

The new law has altered the timing of a bankruptcy in several major ways. Bankruptcy trustees will utilize a two-year look back rule to be able to void transfers made within two years of filing for bankruptcy in general (doubling the previous one-year rule).

What is the domicile of the bankruptcy? The six-month look-back period is being extended to a two-year look-back. A related provision prevents newly acquired homes from gaining homestead exemption status; homestead protection is limited to \$125,000 for debtors who have lived in a house and previous homesteads less than 40 months.

In addition, a 10-year look-back provision precludes a debtor from converting non-exempt property to a homestead with the intent of defrauding a creditor.

Note that another 10-year look-back will apply to certain self-settled trusts. The latter area will have to be revisited in that the new law refers to self-settled trusts in three different ways.³

Florida's Homestead

As though to underscore the motivation for the new bankruptcy reforms, a Florida appellate court upheld the state's generous homestead laws even when they were clearly being exploited by the conversion of non-exempt funds to exempt assets.

In, *Conseco Services v. Cuneo, 3rd Dist. (2005)*, a married couple sold \$8 million of securities and mortgaged a Connecticut home for \$2.5 million so as to purchase a Florida home for \$10 million during litigation.

An Indiana Court refused to enjoin the couple from using this maneuver and declined to take jurisdiction

over Florida realty. Florida courts then dissolved a notice of *lis pendens* and concluded there was no nexus between the Florida home and the subject of litigation.

A Repeal Set in Stone

In February, representatives Kenneth Hulshof of Missouri and Bud Cramer of Alabama introduced H.R. 8, the Death Tax Repeal Permanency Act of 2005. In April, the House approved the immediate and complete repeal of the estate tax by a vote of 272 to 172 that was largely along partisan lines.

An alternative involving an exemption of \$3.5 million (essentially an acceleration of the exemption scheduled to arrive in 2009) was defeated by a vote of 238 to 194.

Reports in mid-June indicate that a vote could come up in the Senate by late July. The expectation is that the Senate will fall just short of the 60 votes needed to make the estate tax repeal permanent.

However, stranger things than the conversion of a couple of votes have happened in our nation's Capital before this. A case in point is the 2001 repeal of the estate tax, which, albeit delayed and incomplete, was a repeal a lot of professionals never expected.

Everyone is taking sides on this issue, pushing estate tax repeal (and therefore estate planning in general) to its highest profile ever.

Opposing the repeal are groups such as United For a Fair Economy (UFE) and Americans for a Fair Estate Tax (AFE). The AFE claims that Americans favor reform of the estate tax over repeal by a margin of 58 % to 37 %. AFE also claims that as people learn more about the issues, the margin opposing repeal jumps to 67 % versus 27 % to keep the tax.

Such umbrella groups are supported by many diverse interests such as the Association of Art Museum Directors, Children's Defense Fund, Communications Workers of America, Evangelical Lutheran Church, Friends of the Earth, Independent Sector, League of Women Voters, National Council of Nonprofit Associations, Responsible Wealth (a high-profile group that includes William Gates, Sr.), etc.

Arguments such as social equity and impact on philanthropy are buttressed by revenue analysis. According to the Center on Budget and Policy Priorities, the cost of repealing the estate tax for a decade (2012 through 2021) would be nearly \$1 trillion. This includes revenue losses of \$745 billion and higher interest payments on debt of \$225 billion. The Joint Committee on Taxation has estimated that

extending the repeal through 2015 alone would cost \$290 billion.

On the other side of the ledger, estate tax doesn't exactly enjoy a lot of popular support. And there are numerous business groups that are actively lobbying for permanent repeal, including the Family Business Estate Tax Coalition, the United States Telecom Association, etc.

Even the National Beer Wholesalers Association weighed in:

“Permanent repeal of the death tax is critically important to beer wholesalers and small businesses across the nation. There are nearly 2,000 beer wholesalers throughout the U.S. servicing every state and congressional district. Beer distributors are family-owned and -operated businesses that have been passed down through the generations since the repeal of Prohibition. Because of this, they are severely affected by the negative impact of the death tax.”

If the Senate lacks the votes to make the repeal permanent (or if it doesn't like the political consequences of acting on the repeal right now), it DOES have sufficient votes to set other significant estate tax reforms in place, such as lowering the top estate tax rate to 15%.

But the path of least resistance may be to accept the compromise deal of a \$3.5 million exemption right now. Such a move would have bipartisan support and a potentially longer lasting effect than a repeal that could be undone. It would also have a major impact on estate planning.

The Tax Policy Center estimates that with an exemption of \$3.5 million and a top rate at 45%, taxable estates in 2011 would face an average effective rate of 17.4%. This is not vastly different from the data for 2003 that shows that taxable estates had an average effective tax rate of 18.8%. However, estates between \$5 million and \$10 million had the highest effective tax rate, which averaged 29%. Much larger estates had lower effective estate tax rates due to charitable giving.

The Tax Policy Center also estimated that with an exemption of \$3.5 million in 2011, only .3% of estates would be taxable. That means 997 out of 1,000 estates would not face estate tax. An increase in the exemption to \$3.5 million right now would have the effect of exempting 88% of all estates that are currently subject to estate tax.

Bubble? What Bubble?

Which heirs will get the house or real estate assets and which will get the other assets? How will taxes be apportioned on these respective assets? How quickly should real estate assets be sold?

Will alternate valuation date strategies come into play? Are there enough capital gains to warrant holding real estate to obtain a stepped up basis or should assets be sold while the market has peaked?

While there are market fluctuations that ebb and flow just beyond the purview of estate planning, which contemplates a range of possibilities, the potential for an unprecedented real estate bubble can't be ignored.

The good news is that property values are at all-time highs. Average U.S. home prices increased by 11% in 2004 after increases of 7% in 2003 and 2002.

Boom markets, in which prices have increased by more than 30% over a three-year period, have been identified in 55 metropolitan areas, including 21 cities in California, 18 in the Northeast and New England, and 11 in Florida.

The bad news is that the bottom could fall out. Although there has never been a nationwide real estate collapse, there could be many regions with problems such as took place between 1990 and 1993.

The Federal Deposit Insurance Corporation (FDIC) is downplaying this with a report, "U.S. Home Prices: Does Bust Always Follow Boom?" The report points out that of 21 housing busts (defined as a decline in home prices by 15% over a five-year period), only nine occurred after a housing market boom.

Local economic pressures are a key component of any bust. The more common aftermath of a boom is not a bubble bursting but rather a period of price stagnation that allows time for the local economy to catch up with inflated home prices.

Buying property on speculation may be contributing to the potential problem. The National Association of Realtors estimates that 23% of homes were purchased as investments (as opposed to residential use) last year.

For the first quarter of 2005, indications are that housing continues to be very strong, with prices on average increasing by 12.5% from the same period last year. In fact, home prices appreciated by more than 20% in 43 markets and did not decline in any of the 265 metropolitan markets

A Developing Story

On December 20, 2004, the Treasury released Circular 230 that became effective June 20, 2005. The Treasury made additional revisions in May.

Circular 230 imposes new practice requirements, including potential liability, censure, disbarment, and fines, for professionals offering tax advice. There are new rules for providing written tax advice and rules for Federal tax practice.

However, Circular 230 raises many unanswered questions such as how tax practitioners may distinguish when a client's has tax avoidance as a "principal purpose" as opposed to a "significant purpose." And estate and gift tax questions have been swept into the same catchall language as the rest of the tax code. This is an area that bears watching.

Living Wills, Postscript

The tragedy of Terri Schiavo continues to play out in the news with the release of autopsy results and the call by Florida Governor Jeb Bush for an investigation of the cause of Ms. Schiavo's condition.

The more enduring legacy, however, is the common ground Americans have in sharing Ms. Schiavo's story. When the headlines, accusations, and contention fade, the need to plan for one's medical treatment during incapacitation will remain with people. Making one's preferences known, regardless of what they are, and naming persons who can act as a proxy or an agent on behalf of them is becoming a prime motivation to have estate planning documents drawn up.

Technical References

1. The quote is from Act I, Scene 2 of *Julius Caesar* by William Shakespeare in which a soothsayer warns Caesar. According to Plutarch's account, written long after the fact in 75 A.D., an astrologer named Spurrina warned Caesar to stay home. But on March 15, 44 B.C.E., Caesar was assassinated on his way to the Senate. Historians now speculate that Caesar had his dates mixed up, thinking that the ides fell on the 13th due to the idiosyncrasies of the Roman calendar.
2. *Estate of Bongard v. Commr.*, 124 T.C. No. 8 (March 15, 2005).
3. "The provision was clearly not drafted by a trusts and estates lawyer," observed attorneys Jonathan Gopman, Robert Lancaster, and Pierre Vogelbacher, discussing revised section 548(e)(2) of the Bankruptcy Code in "New Bankruptcy Act—What Planners Really Need to Know," Steve Leimberg's Asset Protection Planning Email Newsletter #64 April 21, 2005.