

MILLER, GRIFFIN & MARKS, PSC



LEGAL NOTES

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Business, Tax and Estate Planning

Dear Friends:

In reading the informative articles in this newsletter on taxation issues, I am struck by the changed nature of our practice since our firm's founding. When I first was employed, we focused on criminal law and personal injury litigation. One of my early mentors was my uncle, Robin Griffin, a founding partner of our firm. Prior to his retirement, we made a conscious decision to strive to be in a position to provide full services to the individuals and companies who needed assistance with their business formation and operation along with tax concerns. We have now evolved into a full service firm, as is evidenced from the articles. Robin would be very pleased to see how far we have come. Unfortunately, after a long illness, Robin has recently passed away. We will miss Robin and dedicate this newsletter to his memory and foresight.

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HORSE RELATED ACTIVITIES: A HOBBY OR A BUSINESS?

By: Greg A. Hunter
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Many individuals become involved with horse activities because of the love of these great animals. However, the love for horses will only carry the individual so far. As the expenses of breeding or horse racing activities grow, the individual is properly advised to place their horse racing or breeding activities into a business entity, whether it be a corporation or a limited liability company.

There are numerous reasons to place these activities in a business form, including, but not limited to, limited liability and tax aspects. With regard to the tax aspect, as a general rule, individuals are not allowed to deduct any losses that are attributable to an activity not "engaged in for profit" pursuant to Internal Revenue Code Section 183. However, during loss years, a business in the horse industry could deduct losses against income from other sources.

To be able to deduct any horse business losses, the entity must be "engaged in for profit." Section 183 of the Internal Revenue Code provides a presumption as to whether a horse related business is engaged in for profit. Section 183 provides that if an individual, partnership or Subchapter S Corporation shows a profit on its income tax return in two

(2) years within a seven (7) year period beginning with the first year of profit, it is presumed to be "engaged in for profit." If an entity is "engaged in for profit," then losses resulting from the business activities are deductible against other income. However, this presumption is not absolute. Two (2) years of profits occurring during a seven (7) year period does not guarantee that the Internal Revenue Service will not consider the activities a hobby. Also, not showing two (2) years profit within a seven (7) year period of horse related activities will not guarantee that the Internal Revenue Service will consider the activity a hobby. However, if the activity does not show two (2) years profits during the seven (7) year period, the burden of proof is shifted to the entity during audit to demonstrate that the activities of the entity are "engaged in for profit."

The regulations issued by the Internal Revenue Service list nine (9) factors which will be taken into consideration in determining whether an activity is "engaged in for profit" or whether the activity is considered a hobby. Many courts have opined that no single factor is determinative. In addition, many courts have determined that a simple majority of positive factors is also not determinative. The factors are considered cumulative.

These factors include:

1. The manner in which the taxpayer carried on the activity.
2. The expertise of the taxpayer or his advisers.
3. The time and effort expended by the taxpayer in carrying out the activity.
4. The expectation the assets used in the activity may appreciate in value.
5. The success of the taxpayer in carrying out other similar or dissimilar activities.
6. The taxpayer's history of income or loss with respect to the activity.
7. The amount of occasional profit, if any, which is earned.
8. The financial status of the taxpayer.
9. Whether elements or personal pleasure or recreation are involved.

When considering whether an activity is "engaged in for profit" or is a "hobby," the courts look at the facts and circumstances of the case taken as a whole as being determinative guided by these nine (9) factors.

If you have a horse activity business which has not turned a profit at least two (2) of the prior seven (7) years, you may be at risk for an audit by the Internal Revenue Service.

The equine and tax attorneys at Miller, Griffin & Marks, R.S.C.

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have had numerous experiences dealing with the Internal Revenue Service regarding whether a horse related activity is "engaged in for profit" or a hobby. If you believe your equine activity may be subject to an audit, the attorneys at Miller, Griffin & Marks can assist you with such an audit or assist you in the creation of a business plan in preparation of such an audit.

THE JOBS AND GROWTH ACT OF 2003: WHAT DOES IT MEAN FOR YOU?

By: Greg A. Hunter
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On May 28th, 2003, President George W. Bush signed into law a \$350 Billion tax cut bill on the premise that the tax cut would strengthen the U.S. economy and promote job growth. This is the 3rd largest tax cut in United States history.

The following is a summary of how your taxes could be affected by this new tax law.

Tax Rate Reductions. The new tax law calls for an acceleration in the reduction of the higher tax rates. In 2003, single individuals with income in excess of \$28,400, married filing jointly couples with income in excess of \$56,800, head of household individuals with income in excess of \$38,050 and married filing separately individuals with income in excess of \$28,400 will benefit from this accelerated rate reduction. The tax rate reductions range from 27% reduced to 25% and 38.6% reduced to 35%.

Expansion of the 10% Tax Bracket. The new tax law expands the lowest tax bracket which is currently 10%, for single, married filing separately and married filing jointly returns. Because of the expansion of the 10% income tax bracket, single, married filing separately, and married filing jointly couples will benefit from this expansion. However, the maximum benefit under this provision is \$50.00 for single and married filing separately filers and \$100.00 for married filing jointly filers.

Increase in the Child Credit. One of the most substantial changes to the new tax law is the increase in the child credit from \$600.00 to \$1,000 per child for the tax years 2003 and 2004. The 2003 increase will be paid in advance. This means many individuals with children will begin receiving checks in July, 2003. However, the eligibility for this child credit increase does have a phase out provision which begins at \$55,000 for married filing separately, \$75,000 for single, head of household and qualifying widowers and \$110,000 for joint filers. For the typical couple, the maximum benefit received because of this change in the tax law is approximately \$800.00.

Marriage Penalty Relief. The tax law also provides marriage penalty relief for 2003 and 2004. This relief is provided by an expansion of the 15% tax bracket for married filing jointly filers. Under the new law the 15% tax bracket for married filing jointly filers ends at \$56,800 rather than \$47,450. Another change with regard to marriage penalty relief is an increase in the married filing jointly standard deduction. The standard deduction increases to \$9,500 as opposed to \$7,950.

Reduction in Capital Gains Rates. Probably the most significant

change implemented by the new tax law is the reduction in capital gains tax rates. The new law reduces capital gains tax rates from 10% and 20% to 5% and 15% respectively for capital gain assets sold after May 5, 2003. This change is effective for the tax years 2003 - 2008. In 2008, the 5% tax rate drops to 0% tax while the 15% rate remains unchanged in 2008. After 2008, pursuant to the Sunset Provision, the 10% and 20% rates return.

Reduction in the Tax on Dividends. One of the most publicized provisions of the new tax law is the reduction on the tax of dividends. The law before the Jobs and Growth Act of 2003 taxed dividends as ordinary income. The maximum tax rate for ordinary income was 38.6%. The new tax law provides that dividends from domestic corporations are taxed at long term capital gains rates as provided above. However, there are restrictions on this reduced tax rate on dividends. To qualify for the reduced tax rates, the shareholder must hold the stock for more than 60 days during the 120 day period beginning 60 days before the next dividend date. However, most experts believe that the actual benefit of this reduced tax on dividends is relatively small for most taxpayers.

Bonus Depreciation for Business Owners. Business owners are allowed additional bonus depreciation in 2003 and 2004. The provision allows up to 50% of qualified property to be deducted in the year the asset is placed into service if the asset is placed into service after May 5, 2003 and before January 1, 2005. This is a substantial increase in the first year depreciation of most assets placed into service by business owners.

Additional Expense under Section 179. In addition to the first year depreciation, the new law allows up to \$100,000 in 2003 to be expensed pursuant to Section 179. However, this amount is phased out if more than \$400,000 of qualified property is placed in service in one year. An election must be made to receive this increased expense. The increased expense under Section 179 will help larger businesses deduct assets faster while many smaller businesses will not receive such a benefit because their annual asset acquisitions to be placed in their businesses generally are not large enough.

As you can see, many of the provisions either are applicable for a few years or have Sunset Provisions that limit their applicability. However, there is no reason taxpayers should not take advantage of the benefits offered by the Jobs and Growth Act of 2003.

Are Courts Trying to End the Use of FLPs and FLLCs?

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Family Limited Partnerships ("FLPs") and Family Limited Liabilities Companies ("FLLCs") have long been useful estate planning tools for owners of realty and family owned businesses. FLPs and FLLCs provide significant non-tax and tax benefits to their owners. Some of the non-tax benefits include asset consolidation and diversification, family management, liability protection, centralized control, and dispute resolutions. In addition to these non-tax benefits, FLPs and

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FLLCs also provide numerous tax benefits to the owners. These entities provide an owner the means to transfer ownership of the entity to younger generations. When transferring these ownership interests, owners of FLPs and FLLCs often take advantage of "minority discounts" when valuing these transfers. Numerous discounts can be utilized when transferring ownership of FLPs and FLLCs, including but not limited to, lack of control, lack of marketability, and illiquidity. These discounts range from 20% to 40%. Closely held family businesses and real estate FLLC's generate the highest discounts while marketable securities FLLC's generate the lowest discounts.

The following recent cases are very significant to individuals utilizing FLPs and FLLCs as estate planning tools. Based upon these decisions, owners of FLPs and FLLCs should have their entity documents reviewed before making any gratuitous transfers of interest to ensure that the transferor does not continue to enjoy benefit from or use the assets transferred to the entity and that the transferors do not exercise control over the entity assets or retain the power to distribute the assets themselves.

Hackl v. Commissioner

Insuring that gifted interest in FLPs and FLLCs qualify for the annual exclusion are of the utmost importance to owners of family owned businesses. Recently, the United States Tax Court ("Tax Court") adjudicated a case regarding this issue. In the case of, the Tax Court ruled that gifted LLC interests made by Mr. and Mrs. Hackl in 1996 were gifts of future interest as opposed to present interest and therefore did not qualify for the annual exclusion. In this case, Mr. and Mrs. Hackl formed a LLC, Treeco LLC, and contributed two (2) tree farms and approximately \$7.9 million dollars in cash and marketable securities in 1995. In 1995 and 1996, Mr. and Mrs. Hackl made gifts of LLC interest to their children, their children's spouses, as well as in trust for their grandchildren.

When forming the LLC, Mr. and Mrs. Hackl executed an Operating Agreement which designated Mr. Hackl as the manager of the entity. The Operating Agreement provided numerous restrictions over the entity, such as: (1) Mr. Hackl was the sole manager for life; (2) Mr. Hackl reserved the power to name the next manager of the LLC; (3) a transfer of any member's interest required the manager's consent; (4) a transfer in violation of this consent would result in the transferee taking the interest as an assignee; and (5) no distributions were to be made to the members without the manager's consent. The Tax Court analyzed the gifts made by the Hackls and concluded that the gifts did not confer upon the donees the "unrestricted right to the immediate use, possession or enjoyment of property or the income from property." In making this conclusion, the Tax Court examined the Operating Agreement and relied upon the restrictions contained therein regarding cash flow distributions, return of capital and the transfer of membership interest. Also, the Tax Court considered the underlying property and assets of the LLC. Because the LLC contained tree farms in their infancy stage, the Tax Court found that the property of the LLC was unable to produce income to be distributed to the LLC's members. In addition, the Tax Court determined that, even if the property did produce income, income was not required to be distributed to the members but was subject to the approval of the manager.

Therefore, the Tax Court ruled in favor of the Internal Revenue

Service that the gifts were not a gift of a "present interest" and required the taxpayer to pay gift tax on the gifted interest to his children, children's spouses and grandchildren in trust.

The decision of the Tax Court was affirmed by the 7th Circuit Court of Appeals on July 11, 2003.

Harper v. Commissioner

Harper created a limited partnership in which his living trust was the only limited partner and his two children held general partnership interests. Upon Harper's death, the Internal Revenue Service asserted that the value of assets contributed by Mr. Harper to his limited partnership should be included in his gross estate death pursuant to Internal Revenue Code Section 2036 because Mr. Harper retained the enjoyment and use of the assets during his lifetime.

The Tax Court held the assets contributed to the limited partnership should be included in Harper's estate because: (1) the commingling of funds; (2) the delay in transferring assets to the limited partnership; (3) the disproportionate partnership distributions; and (4) the "testamentary" character of the arrangement.

Unfortunately, because Internal Revenue Code Section 2036 applied, the fair market value of the assets contributed had to be determined without considering discounts and that amount was included in Harper's gross estate and thus subject to federal estate tax.

Kimbell v. United States

Kimbell owned a 99% interest in the limited partnership as a limited partner. The general partner of the limited partnership had the "sole discretion" to determine the distribution of profits to the partners. The general partner could be removed by a vote of 70% in interest of the limited partners, and a majority in interest of the limited partners could elect a replacement. In addition, the partnership agreement waived any fiduciary duty of the general partner to the partnership or to any partner.

The District Court for the Northern District of Texas held that the value of assets contributed by Kimbell to his limited partnership was includible in his gross estate at his death pursuant to Internal Revenue Code Section 2036. The Court opined that because Kimbell retained the power to remove the general partner, Kimbell benefited personally from partnership income, or choose the people who would benefit and thus this transaction ran afoul of Internal Revenue Code Section 2036.

With the application of Internal Revenue Code Section 2036 to this transaction, the fair market value of the assets contributed had to be determined without regarding to discounts and that amount was included in Kimbell's gross estate and thus subject to federal estate tax.

Estate of Thompson v. Commissioner

In this case, an elderly widower contributed virtually all of his assets to FLPs for each of his children. Thompson retained a majority of the limited partnership interest and a child obtained a substantial minority interest. A corporate general partner controlled by the children managed the assets. The children also contributed some assets to the FLPs, but the amounts were insubstantial compared to Thompson's contributions.

Because Thompson contributed the majority of his assets to the limited partnership and had no other assets to support himself, the Internal Revenue Service argued successfully to the Tax Court that at his death, Thompson retained a 100% interest in each FLP. The Tax

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Court opined that Thompson retained the enjoyment and use of the assets during his lifetime. A factor that persuaded the Tax Court was that some of the assets contributed by the children were sold, with the proceeds of the sale going to the children, contrary to the terms of the FLP documents.

With the application of Internal Revenue Code Section 2036 to this transaction, the fair market value of the assets contributed had to be determined without regarding to discounts and that amount was included in Thompson's gross estate and thus subject to federal estate tax.

Conclusion

These cases are very significant to individuals utilizing FLPs and FLLCs as estate planning tools. Based upon these decisions, one can be assured that the Internal Revenue Service will vigilantly audit and litigate the use of FLPs and FLLCs as estate planning vehicles.

Notwithstanding the foregoing, we believe a properly managed FLP or FLLC remains an invaluable component of estate planning.

DOES YOUR BUSINESS HAVE TO PROVIDE FINANCIAL PRIVACY NOTICES?

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The Gramm-Leach-Bliley Act (15 U.S.C. §§6801-09), the "Act" signed in law in 1999, requires every "financial institution" that

provides certain financial services to clients to send those clients a notice explaining its privacy policies. These notices were to be sent to clients before July 1, 2003. You have probably seen these notices arriving in your mail in the last several months along with your credit card statements, insurance bills and similar financial documents. The confusion many are experiencing is from the attempt to determine whether one's particular business must make the required disclosures. It appears from the interpretations by the Federal Trade Commission related to the applicability of the Act that those who provide income, estate or gift tax advice or counseling, employee benefits advice, real estate settlement activities or other services related to financial activities may obtain certain "nonpublic personal financial information" from a client, and are required to disclose its policies regarding disclosure of non-public personal information.

As you may have expected, litigation has already commenced to address some of these concerns. One case in particular has been filed by the New York State Bar Association regarding whether the Act should apply to attorneys or law firms. As you know, attorneys are bound by professional standards of confidentiality that are generally more stringent than those required under this new Act. Regardless, at this point the only clear answer is that many businesses must comply with this new law and affirmatively provide the disclosure notices to their clients. Is your business one of them?