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INTEGRATING ASSET PROTECTION AND ESTATE PLANNING

CCH: Mr. Engel, could you briefly explain integrated estate planning and how asset protection planning differs or fits into integrated estate planning?

Asset protection and integrated estate planning trusts have received a lot of attention over the years. These subjects have been written about, talked about, praised, criticized, understood and misunderstood. In the interview below, CCH takes some time to discuss these topics with noted expert Barry S. Engel, Senior Principal of the law firm Engel & Reiman PC in Denver, Colorado. Mr. Engel is the author of CCH's Asset Protection Guide, the second edition of which has recently been published (see Editors' Note at the end of this interview).

to preserve the client's estate given the various threats to wealth that one can encounter. This is the definition I have been using for well over a decade.

Integrated estate planning differs from asset protection planning only in the sense that it is a broader concept. The second of the two components, traditional estate planning, tends to focus more on the death-time side of things, such as estate tax mitigation, probate avoidance, tax mitigation, and the like. Thus, one can say that integrated estate planning integrates the lifetime side of the estate plan with the death-time side of the estate plan.

CCH: In your opinion, what are the main concerns that the legal community faces with regard to asset protection planning? Are they well founded?

Mr. Engel: I would say there are two. First, some would argue that asset protection planning *per se* involves transfers fraudulent as to creditors. This position has been

heard less and less over the course of time, and aside from the legal fallacies of this thinking, I believe there has been such widespread acceptance of the relevant underlying concepts that it is hard to argue that asset protection transfers are *per se* fraudulent transfers.

The second major concern has to do with the contempt issue. That is, can or will a settlor of a trust be found in contempt if assets are ordered turned over by a court and the foreign trustee does not surrender the assets? Is this a real risk? If the planning is not designed and implemented correctly, or not administered correctly, it certainly is a real risk. I have been doing this work since 1987, I have been through many-a-challenge with clients, and no client of mine has been found in contempt.

Some detractors continually point to the same three reported cases involving a settlor being found in contempt of court, but my educated guess is these are three cases out of literally tens of thousands or more. Interestingly enough, there has not been a contempt case of major import for several years. The three cases most often cited by detractors are the *Anderson* case (*Federal Trade Commission v. Affordable Media, LLC*, CA-9, 179 F3d 1228) and the *Lawrence* case (*Bankr. Fla.*, 289 BR 498), both from 1999, as well as the *Eulich* case (*J.F. Eulich, D.C. Tex.*, Civil Action No. 3:99-CV-1842L), which is more recent, but it involved failure to produce documents that, by the way, amazingly appeared once the settlor was faced with contempt. If contempt is such a threat to the proper asset protection plan, where are all

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the cases? Why do detractors of integrated estate planning keep going back to the same few cases from a number of years ago? (The issue of contempt is analyzed in depth at chapter 17 of the newly released second edition of CCH's ASSET PROTECTION PLANNING GUIDE)(The GUIDE.)

CCH: Mr. Engel, you just mentioned widespread acceptance—what signals this for you?

Mr. Engel: There are a number of signals. First, the American Bar Association's Real Property, Probate and Trust Section has its own asset protection sub-section. An organization of this repute would not support such planning if it was unacceptable. Second, about 25 foreign jurisdictions have statutorily embraced asset protection trusts. Third, a number of state legislatures have been statutorily embracing these concepts since 1997 when the Alaska legislature enacted asset protection-style trust provisions. Fourth, estate planners nationwide have looked at this planning and have increasingly recommended this planning to their clients.

CCH: Have there been any recent cases that have clarified the use of asset protection planning?

Mr. Engel: There have been, yes. But first, integrated estate planning and its asset protection component involve many areas of the law, such as domestic trust, foreign trust, income, gift and estate tax, fraudulent transfer, bankruptcy, and so on. It is, therefore, a bit of a challenge to point to a few cases of defining impact, because there many cases in a variety of areas of law that are relevant to integrated estate planning.

The first case that comes to mind, though, is *Riechers v. Riechers*, 679 NYS2d 233, in which a surgeon who was concerned with the risks associated with practicing his profession came to us and settled an integrated estate planning trust. A few years later, divorce proceedings were filed. The New York State Supreme Court stated that "assuming this court had jurisdiction over the corpus of the trust, which it does not [because of its foreign nature], a cause of action would not lie to set aside the trust since it was established for the legitimate purpose of protecting family assets for the benefit of...family members."

Another case worthy of mention is an unreported contempt case involving a client of mine. No, the client was not found to be in contempt of court. The court, a federal court, did acknowledge, and in fact stated it would look "silly" if it "entered [repatriation] orders it could not enforce." It also stated that "it is a violation of due process to enter orders...that cannot be complied with."

And of course, there are a handful of reported cases involving a poorer result than the settlor had hoped for, and these are important from the standpoint of one

learning how not to plan. I am happy to say none of these involved a client of mine. (A detailed discussion of these cases can be found in chapter 18 of The GUIDE.)

CCH: Special note is generally made in legal publications of any case that seems to show that asset protection planning does not work. Of course, you rarely hear about the many success stories. What is your response to those who say that asset protection planning does not work or is a waste of client's time and money? And have there been any successful challenges to one of your asset protection trusts in the Cook Islands?

Mr. Engel: On your first question, I would say the many clients of mine who have successfully weathered a challenge or threat would be very surprised to hear their plans did not work.

On your second question about successful challenges, what does it mean when one says a plan "worked" or a plan "failed to work?" There have been cases where the claimant or creditor has received something in a settlement, yes. But the question of whether these trusts "work" must be defined by reference to the results that would have been obtained if no planning was in place. It is my view that a plan can be said to have "worked" when the client ends up at least moderately better than he otherwise would have in the absence of any planning. My own standard of "moderately better" has been surpassed in every case where my firm has been involved in the protective measures process that begins once a threat is detected and in which the client has followed protocol. Of course, each case, whether one of mine or one of another planner's, is case specific and fact sensitive. (A few of these cases involving a challenge are summarized at paragraph 185 of The GUIDE.)

CCH: Based on your experience, what pitfalls, traps and planning pointers should practitioners be careful

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to address when drafting an asset protection trust or crafting an integrated estate plan?

Mr. Engel: Practitioners obviously need to take care so as to avoid messing up. I have seen plans prepared by attorneys who only dabble in this area, and I would say this area of planning is not for the dabbler.

By the way, not only would a planner expose himself to liability for messing up, as I put it, but there is also liability to third parties for plans that are too aggressive or involve fraudulent transfers. That said, many of us recognize that one does not have to be wrong or commit a wrong to be sued or to then be found liable. I hear concern voiced that you can be sued as a co-conspirator or an aider and abettor of a fraudulent transfer doing this work, and this is a genuine concern, yes. After about 20 years and 1,000 plans, I have not had that sort of allegation tossed at me. That probably has something to do with always exercising caution in what we do and for whom we do the planning.

Aside from civil liability, there can be criminal exposure and exposure to one's local board of ethics. No client's problem is worth losing your freedom or losing your right to practice your profession. Again, exercising caution and knowing what you are doing are the watchwords. As a planning pointer, one should always explore not only assets as part of the integrated estate plan, but also liabilities of the client, whether certain or uncertain, fixed or contingent.

Based on this, a practitioner certainly needs to address client solvency and, of course, should be in tune to the possibility that a client is not making full disclosure during the fact finding and intake meeting.

Last but not least, two very important items to address are what jurisdiction to use, and what trustee company to use. Either one of these can be the weak link in the chain known as the client plan.

CCH: Are there specific issues that practitioners must address when creating plans for clients with a business interest or professional practice?

Mr. Engel: It is very important to distinguish between planning for the protection of wealth in the hands of the client, and planning for the protection of an operating business or professional practice. For example, transferring shares in a closely held family business to a family trust may protect the shares if the shareholder is later sued. But if the company itself is a defendant in an action based on some wrong alleged of it, then the company's assets are exposed to the claimant should the claimant graduate to becoming a judgment

creditor. Once the first level of planning is in place, we encourage that a client then look at planning for the protection of the active business or professional practice. (Chapter 19 of *The GUIDE* addresses this second level of planning, which we creatively refer to as "Level 2 Planning.")

CCH: What guidance can you provide to practitioners regarding the choice of domestic trust vs. foreign trust?

Mr. Engel: At bottom, there are two main distinctions that resolve in favor of foreign situs asset protection trusts. First, some of the offshore jurisdictions that have asset protection trust provisions provide with specificity that foreign judgments and orders are not to be recognized. This gives a foreign situs trust much more protection when compared to a domestic trust given the full faith and credit clause in the U.S. Constitution.

Second, a fundamental principal of law in the United States is that federal law pre-empts state law. This presents a host of issues when the federal government is the creditor and when the trust is governed by the laws of one of the states. There is no pre-emption principal as between federal law, on the one hand, and, say, the law of the Cook Islands on the other hand.

There is another concern with domestic trusts, which is more general in nature but is certainly a critical concern, and that deals with the wisdom of relying on the domestic system for protection when that is the very system that a client is seeking protection from. This concern is best illustrated by the new 10-year lookback rule that came about under the new U.S. bankruptcy provisions that became effective this past October. (There is an in-depth analysis of this issue in Chapter 11 of *The GUIDE*.)

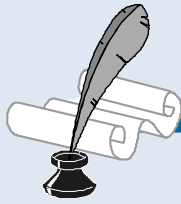
CCH: What advice can you give to other practitioners with clients concerned about losing control of their assets with an asset protection planning trust?

Mr. Engel: First of all, control is not an all or nothing proposition. Degrees or gradations of control can be retained or given away. Second, the proper structure will have checks and balances, safeguards, incorporated into its design. Finally, control or elements of control can easily be allocated among a number of trustees and/or trustees. I guess that is a check and balance right there.

CCH: Do you see any trends in the use of integrated estate planning trusts that you would like to mention?

Mr. Engel: One important trend I see is one I mentioned to you earlier, and that is the increasing acceptance of asset protection and integrated estate planning. Sec-

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LEGISLATIVE UPDATES

Tax Reconciliation and Pension Bills Await Conference

Although both houses of Congress passed bills containing various tax extenders and pension reforms,

Two major pieces of legislation are slowly winding through the conference process. However, numerous differences exist between the House and Senate versions of both of these bills. In the following discussion, we consider a number of the significant components of these bills.

how they accomplished that objective has led to a protracted and sometimes contentious conference process. Major components of the respective bills

differ significantly. The end result is that even at this late date it is not entirely clear what provisions will remain intact in the final conference bills.

Tax Reconciliation

A comparison between the House-passed H.R. 4297 and its Senate counterpart is almost like comparing apples and oranges. For example, the approach to two very significant components—capital gain/dividend rates and alternative minimum tax (AMT) relief—have very little in common. The House bill would extend the lower rates for long-term capital gains and qualified dividends for two years beyond their current expiration date at the end of 2008. The Senate bill contains no capital gains/dividend provision. With respect to the AMT, the Senate bill would extend the allowance of nonrefundable credits against the AMT until December 31, 2007. Instead, the House bill would only allow this to occur until the end of 2006. The two bodies also differ on the amount of AMT exemption that would be allowed for 2006. In fact, H.R. 4297 contains no provision on this point, which was addressed separately by the House in H.R. 4096. The Senate grants a more generous limit of \$62,550 for joint filers, as opposed to only \$58,000 in the House counterpart.

Charitable Provisions. Another major avenue of departure between the two bills concerns the treatment of charitable giving. The Senate concentrated on a variety of provisions to encourage charitable giving and to crackdown on certain perceived

abuses involving charitable entities. The House decided not to provide any proposals whatsoever in this particular area under reconciliation. Perhaps the most discussed provision in the Senate bill would allow an above-the-line deduction for charitable contributions made in 2006 and 2007 that exceed a threshold amount (\$210 for single persons and \$420 for married couples filing jointly). The Senate would also allow tax-free distributions to charity from an IRA if the account owner was over age 70 ½.

Additional charitable provisions would expand the ability of businesses to make donations of food and books. Artists would also benefit in that they would be allowed to make charitable donations of their own works based on the fair market value of the work rather than its cost. Charitable volunteers would be able to exclude mileage reimbursements from income for 2006 and 2007.

Reports in the general press and hearings held during 2005 by the Senate Finance Committee revealed a number of potential abuses of the current rules involving charitable donations. As a result, the Senate bill also includes a number of provisions aimed at limiting these abuses. For example, donations of taxidermy property and of historic building facade easements would be limited by the bill. Charitable arrangements involving life insurance policies and tax shelters would also be the target of increased punitive measures. Under new rules, donees receiving a fractional interest in tangible property would be required to take actual possession of the item for that portion of the year corresponding to the organization's percentage interest in the item. Even donors of clothing and household goods would be subject to increased record keeping requirements.

Revenue Raisers. Yet another point of controversy between the House and Senate's approaches to tax legislation is exhibited by the inclusion of revenue raisers or "offsets" in the Senate bill. Because of the Senate's rules with respect to the budget impact of tax legislation, these items are often passed as part

of a Senate proposal only to be stripped out later in conference. As a result, many of the Senate's revenue raisers have appeared in previous proposed legislation. How many of these particular items will survive the current conference process remains to be seen, but there are a number of controversial items found among these provisions as well.

At the top of the list of controversial items is yet another attempt to put some legislative flesh on the bones of the economic substance doctrine. This quest has been championed by, among others, Senate Finance Committee Chairman Charles Grassley (R. Iowa) and has been attempted in various forms over the course of the last several years, but has never made the cut into a final bill. This time, the proposed language would impose a 40-percent penalty for an understatement of tax resulting from a transaction that lacks economic substance and would also deny a deduction for interest paid on a tax deficiency resulting from such a transaction. Another controversial item, which has gone so far as to draw the rare threat of a presidential veto, is a proposal to disallow 75 percent of the benefits of last-in, first-out accounting for inventories by certain oil companies. Other offsets would increase penalties on tax underpayments stemming from the concealment of taxable income in an offshore account and would generally deny a deduction for fines and penalties paid to a governmental agency for violations of any law.

Another controversial provision involves a change in the nonconventional fuel production credit (Code Sec. 45K) that would slow down the phaseout of the credit that would otherwise have occurred as a result of the recent run up in oil prices. Although referred to by *TIME MAGAZINE* (March 6) as a stealth provision that would cost taxpayers money, it is scored by the Joint Committee on Taxation as a revenue raiser.

Some Similarities

Despite the vast differences in the House and Senate bills, there are a number of provisions that are identical as well as some that differ only with respect to their effective dates. For example, the Code Sec. 179 expensing limit of \$100,000 would be extended under both bills until the end of 2009. The allowance of a deduction for state and local sales taxes in lieu of income taxes would be extended through 2007 by the Senate, but only through 2006 by the House. Similarly, the research and development credit would be extended for two years by the

Senate and only one year by the House. In terms of the applicable time limits, more generous treatment is also afforded under the Senate bill to the deduction for qualified higher education tuition and related expenses (through 2009 versus 2006), the deduction for a teacher's classroom expenses (through 2007 versus 2006), and for the saver's tax credit (through 2009 versus 2008).

Pension Legislation

No less contentious is the wrangling that has occurred over pension reform legislation. In this case, negotiations are centered on provisions of the Pension Protection Act of 2005 (H.R. 2830), as passed by the House, and the corresponding Pension Security and Transparency Act of 2005 that emerged from the Senate. Although the main impetus for both bills relates to the funding rules for single employer and multiemployer defined benefit plans, this topic is by no means a true indicator of the scope of the bills. Other issues covered in one or both bills include interest rate assumptions for lump-sum distributions, amendments to provisions dealing with the Pension Benefit Guaranty Corporation (PBGC), investment advice provided to plan participants, portability of retirement plan benefits, as well as provisions dealing with diversification and spousal rights.

Funding. With respect to the issue of funding for single employer plans, the bills are somewhat similar. Although current law generally allows employers to fund 90 percent of pension liabilities (only 80 percent in some cases), the House bill would require employers to fund up to 100 percent of their pension liabilities, with shortfalls to be amortized over seven years. The Senate bill would set an increasing target percentage, depending on the year, for determining a plan's funding shortfall. The bills also differ in exactly what interest rate is used and how it is applied to determine the present value of a plan's liabilities. The House bill uses three segment rates based on duration (up to five years, more than five years and up to 20 years, and over 20 years) and a three-year weighted average of rates on investment-grade corporate bonds, while the Senate bill uses a 12-month average. In the case of multiemployer plans, the Senate included controversial relief provisions aimed at the airline industry.

The ultimate approach remains unclear. In a December statement, following passage of the Senate bill, President Bush expressed his intent to veto

any pension legislation that “weakens pension funding for American workers.” Similarly, the American Benefits Council issued a press release concerning the Senate’s interest rate methodology for calculating pension obligations and referred to it as inappropriate for a long-term obligation such as a pension plan and stating that it would introduce too much unpredictability and cost volatility to the process.

PBGC Provisions. The recently enacted Deficit Reduction Act of 2005 (P.L. 109-171) increased the flat-rate premium for single employer plans from \$19 to \$30 per participant for plans years beginning after 2005. The House bill would increase the premium in increments over five years and allow for future adjustments based on increases in average wages. The Senate bill includes an increase to \$30 in 2006 with cost-of-living adjustments after that also based on increases in average wages. The interest rate used to determine the amount of unfunded vested benefits for purposes of imposing variable rate premiums (\$9 per \$1,000 of unfunded vested benefits) would remain at 85 percent of the long-term corporate bond rate for 2006. However, beginning in 2007, the House bill would change the determination of unfunded vested benefits to reflect the changes made to the funding rules elsewhere in the bill. The Senate bill would apply the variable-rate premium to all unfunded benefits, not just unfunded vested benefits.

Disclosure. The funding notice currently required to be distributed to participants in multimember defined benefit plans would be required to be provided to participants in single-employer plans under both the House and Senate bills. However, the Senate bill would require slightly different information in the notice for each type of plan and would provide a later due date (versus 90 days after the end of the plan year) for plans that cover 100 or fewer participants. Both bills would also require additional information in the annual report that defined benefit plans must file. The Senate bill also contains provisions on notification of distress terminations that are not included in the House bill.

EGTRRA Provisions. The Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16) (EGTRRA) included a number of provisions increasing the allowable limitations on contributions to retirement plans and IRAs. EGTRRA also added the concept of “catch-up” contributions for taxpayers who are age 50 or older. The House bill (but not the Senate) would make these provisions permanent.

Similarly, the House bill would make the Code Sec. 25B Saver’s Credit permanent.

Other Proposals. The Senate would allow distributions from qualified plans, tax-sheltered annuities, and Code Sec. 457 plans to be rolled over to a Roth IRA and treated as a Roth IRA conversion. The Senate proposals would also allow state and local governments to establish 401(k) plans for their employees. Both the House and Senate bills would clarify the legal status of cash-balance plans, but these amendments would be prospective in nature. Both bills would also give employers the option of providing employees with access to professional investment advice. However, the House bill includes a provision granting an exemption from the prohibited transaction rules if the investment advisor meets certain fiduciary and disclosure standards.

Additional provisions would:

- encourage employers to offer automatic enrollment in 401(k) plans to their employees (House and Senate);
- allow rollovers from qualified plans by nonspouse beneficiaries (House and Senate);
- modify the interest rate assumptions used for determining lump-sum distributions (House and Senate);
- allow “working retirement” distributions to employees age 62 and older (House);
- allow direct payments of tax refunds to IRAs (House);
- codify the carryforward of up to \$500 of unused benefits in a health care FSA (House); and
- direct the Secretary of Labor to issue regulations clarifying the requirements for qualified domestic relations orders (Senate).

As we go to press the conference on the pension reform package is ongoing. However, other than a preliminary meeting, the tax reconciliation conference has been stalled due to procedural hurdles. Senate Finance Committee Chairman Grassley has indicated the necessity to have pension legislation passed before April 15 because that is the due date for quarterly pension payments. On the other hand, he has noted that the same time restraints do not apply to the tax reconciliation package.

Integrating Asset Protection

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ond, to me, it is very interesting to witness the trend of all being generally quiet on the western front. Following a rash of litigation involving foreign trusts in the late 1990s and in the early part of the new millennium, things have been relatively quiet for several years now. Some detractors predicted the number of challenges and reported cases would mushroom. In fact, things appear to have very much gone the other way.

Another trend is the use of the foreign situs asset protection trust for other purposes or to protect against threats other than the litigation threat. Some clients have turned to asset protection as a means to hold funds outside of the U.S. in case a terrorist attack or some other calamity temporarily suspends operations of the government or of private financial institutions, as was close to the case on 9-11.

Another new use that is rather different was very recently described in an article in *THE WALL STREET JOURNAL*, and that involves a person settling a perpetual trust domestically or in a foreign jurisdiction, which names the settlor as the ultimate remainder beneficiary, in a sense, if and when the settlor is “reanimated” through cryogenics. In the meantime, using this process, upon legal death the person is infused, cooled and maintained until medical technology allows the person, or our settlor in this instance, to be rejuvenated and revived. We, in fact, have had one such plan in place for a client for many years now. Wow, just think of the trustee fees that will accumulate! Also, will the person have to refund life insurance proceeds received by his estate? Will the person receive a refund of estate taxes paid? It boggles the mind. One of my partners refers to this as the ultimate estate freeze!

[Editors’ Note: The second edition of the *Asset Protection Planning Guide* not only contains updated information on topics included in the first edition, but a number of new chapters have been added. One is on trust litigation issues. Another covers planning for the protection of a business interest or a professional practice. There is also now a separate chapter on contempt of court issues, and a separate chapter that compares domestic trusts to foreign trusts for asset protection purposes. Areas of update include recently enacted domestic asset protection trust statutes, the Patriot Act, the new bankruptcy reform provisions, and limited liability trusts—to name a few. The Second Edition is extremely comprehensive and an excellent tool for the practitioner. Because it was written for the non-lawyer as well as for the lawyer, many purchasers of the book have been trust settlors or potential trust settlors.

Readers interested in finding more information regarding asset protection and integrated estate planning may visit Mr. Engel’s website, www.engelreiman.com or contact Mr. Engel directly at b.engel@engelreiman.com.] ♦

RETIREMENT PLANNING

IRS to Use Focused Audits on Small Plans

Trouble may be just around the corner for the owners of many small to medium size businesses. This trouble comes in the form of the IRS’s intention to conduct what it refers to as “focused audits” of these companies’ pension plans. According to attorney Seymour Goldberg, senior partner of Goldberg & Goldberg PC, Melville, New York,

Owners of small and medium sized businesses should be aware of the IRS’s plans to closely examine their pension plans. At least one tax practitioner tells CCH that many of these plans may contain some ticking time bombs.

the IRS is planning to conduct audits of several thousand of such plans in the coming year. Mr. Goldberg, who is a member of the IRS’s Northeast Pension Liaison Group and

the author of *Practical Application of the Retirement Distribution Rules* (see www.goldbergreports.com), suggests that many of these plans may be vulnerable to IRS scrutiny. “From what I have seen in my own practice, many smaller firms have relied on prototype documents from brokerage firms or banks and there just has not been the kind of due diligence required to make sure these plans are in compliance with the law,” says Mr. Goldberg. He notes that “often these businesses do not have the technical expertise in house to deal with such issues and even if they did, or could hire someone who does, they may simply be unaware that there is a problem.”

One of the most serious potential problems cited by Mr. Goldberg is the failure to keep up with legislative changes made over time to the Internal Revenue Code or the Employee Retirement Income Security Act, as well as any changes made to the applicable regulations. The IRS will be looking at whether any necessary amendments to the plans have been adopted and, if so, whether they were adopted in a timely manner, indicates Mr. Goldberg. Employee versus independent contractor status is another potential pitfall. “Just calling someone an independent contractor does not necessarily make it so and the failure to offer pension benefits to someone who should have been classified as an employee could be a serious violation of the rules.” A particular problem for small business entities involves improper borrowing from the plan. If such borrowing is deemed to be a prohibited transaction it could result in potentially onerous penalties. Many problems surface when a small business owner dies. Mr. Goldberg points out that in

such a case one cannot simply do a rollover because, if the plan is no longer valid the rollover will be ineffective.

In this and other cases, what should small business owners be doing? Mr. Goldberg suggests a proactive approach, including use of the IRS's voluntary correction program as part of the Employee Plans Compliance Resolution System (EPCRS) outlined in Rev. Proc. 2003-44, 2003-1 CB 1051. For example, in the

case of a deceased business owner whose plan has not been kept up to date, the proper approach would be to first go through the IRS voluntary program and then perform the rollover. According to Mr. Goldberg, the simplest answer is to get expert advice when dealing with complicated pension issues. Possible avenues for seeking such advice include state and local bar associations, C.P.A. societies, and the American Society of Pension Actuaries. ♦



BRIEF IDEAS

Conveyance of Water Rights and Easement Did Not Cause Cessation of Qualified Use

The IRS has privately ruled that the proposed conveyance of water rights and the granting of an easement on property that had been specially valued under Code Sec. 2032A would not constitute a disposition or cessation of the property's qualified use for purposes of imposing the recapture tax, except with respect to that portion of the property specifically used for removing groundwater (IRS Letter Ruling 200608012). The rationale of Rev. Rul. 88-78, 1988-2 CB 330, involving subsurface oil and gas interests, was followed. Accordingly, the property that was specially valued on the decedent's estate tax return and the subterranean water rights were deemed to be separate assets.

The property, which had generally been used as pastureland for grazing, with a small portion dedicated to farming, had never been irrigated. However, a replenishing source of ground water existed under the property. In conjunction with adjacent property owners, the trusts that now own the property wished to lease rights to the groundwater to a local water authority. In addition, the lease required an easement for the development and removal of the groundwater. The trusts also had the right under the lease to use the groundwater to the extent necessary to preserve the qualified use of the property.

Domestic Partner Not Allowed to Report Only Half of Income

In a new ruling, the IRS Chief Counsel has taken a position on the impact of the California Domestic Partner Rights and Responsibilities Act of 2003 (California Act) on the reporting of earned income by each part-

ner (CCA Letter Ruling 200608038). For 2005 tax year returns now being filed, a California individual who is a registered domestic partner under the California Act must include all earned income for 2005 in gross income on a separate federal tax return. He or she cannot report one-half of the combined income earned by the individual and his or her domestic partner (as a married couple filing separately in a community property state normally would).

The California Act provides that "Registered domestic partners shall have the same rights, protections, and benefits ... as are granted to and imposed upon spouses." For state income tax purposes the California Act requires partners to file separate returns and that "earned income may not be treated as community property for state income tax purposes." The California Act is silent on the federal tax treatment.

In *Poe v. Seaborn*, 2 USTC ¶611, 282 U.S. 101 (1930), the Supreme Court held that state community property laws entitled a husband and wife to file separate returns, with each reporting one-half of the community income. Federal tax law could not override that right. According to the Chief Counsel's Office, the issue of income-splitting in community property jurisdictions "has always arisen solely in the context of spouses." Therefore, the IRS will not interpret *Poe* to apply to a state's community property law "outside the context of a husband and wife." The ruling goes on to say that, "the relationship between registered domestic partners under the California Act is not marriage under California law. Therefore, the Supreme Court's decision in *Poe v. Seaborn* does not extend to registered domestic partners."