



BUSINESS COUNSELING UPDATE

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IRS SUFFERS “STINGING” DEFEAT ON FAMILY LIMITED PARTNERSHIPS

In May of this year, the IRS suffered what some commentators have called a “stinging” defeat in its battle against estate and gift tax planning utilizing family limited partnerships and limited liability companies (FLPs). FLPs continue to offer significant estate and gift tax planning opportunities. In recent years, the IRS has challenged FLPs on a number of fronts. [See, Business Counseling Update, Winter 2003 issue.] Initially, the Service argued against substantial valuation discounts. More recently the IRS has been asserting that FLP assets should be brought back into a decedent’s taxable estate under Section 2036(a) which requires that transferred assets be included when the taxpayer has retained the ability, either directly or indirectly, to control possession and enjoyment of the property or the income generated by the property. Section 2036(a) does not apply, however, in the case of transfers that qualify as a “bona fide sale for an adequate and full consideration in money or money’s worth”.

In *Kimball v. U.S.*, the Fifth Circuit Court of Appeals held that a decedent’s transfer of property to a FLP in exchange for a limited partnership interest was a bona fide sale for full and adequate consideration. Consequently, the provisions of Section 2036 (a) would not operate to bring the underlying FLP assets back into the decedent’s taxable estate. Rather, only the decedent’s limited partnership interest would be valued for estate tax purposes. In *Kimball*, the estate had reported the decedent’s limited partnership interest on the estate tax return at a 49% discount to the value of the underlying assets of the FLP.

In addition to its value as a legal victory for taxpayers in the FLP battles, the *Kimball* case is significant in that it provides estate planners with guidance on the important elements which need to be addressed in connection with the structuring of FLPs in order to withstand a challenge by the IRS. Strict adherence to the formalities involved in the formation, funding and capitalization of FLPs is essential. Additionally, careful consideration should be given to the non-tax business and investment objectives which must underlie the establishment of an FLP, and those business purposes should be well-documented. FLPs continue to remain an important estate and gift tax planning tool that can be successfully implemented and defended with careful structuring.

Donald L. Erftmier, Jr.

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EMPLOYEES MAY NOW ELECT PRE- OR AFTER-TAX LTD

Many employers pay long term disability (“LTD”) premiums for their employees. On June 9, 2004, the Internal Revenue Service addressed the taxation of LTD benefits when employees are given the opportunity to make an irrevocable election, prior to the beginning of each plan year, to have the employer pay the premiums for the coverage on a pre-tax or after-tax basis. Pre-tax means that the premiums paid by the employer are not included in the employees’ taxable W-2 income. After-tax means that the premiums paid by the employer are included in the employees’ taxable W-2 income.

If you decide to pursue the tax advantages of LTD premiums, you will need to draft and adopt a short form LTD plan document that refers to the group insurance policy and sets forth the employee election rules.

Revenue Ruling 2004-55 states that the LTD benefits received will be fully excludable from income (i.e., not taxed) or fully includable, depending on the employee’s election for the year in which the employee becomes disabled. If the election for that year was to have the employer pay the premiums on an after-tax basis, then benefits are treated as attributable solely to

after-tax contributions and are excludable from the employee’s gross income. If the election was to have the employer pay the premiums on a pre-tax basis, then benefits are treated as attributable solely to pre-tax contributions and are includable in the employee’s gross income.

The LTD “plan document” for most employers consists of the group insurance policy issued by the insurance company. If you decide to pursue the tax advantages of LTD premiums, you will need to draft and adopt a short form LTD plan document that refers to the group insurance policy and sets forth the employee election rules. The IRS ruling requires that the plan contain specific provisions related to irrevocability of the election for each plan year. If a summary plan description (SPD) also serves as the plan document, these changes should be made to that document. If the SPD is separate from the plan document, revisions to the SPD will be required. In addition, an election form is required.

You may want to consider providing this alternative to your employees. It is a good way of providing additional benefits with only minimal additional administrative costs to the company.

Brian J. McGrath



THEFT OF CORPORATE OPPORTUNITY RESULTS IN NONDISCHARGE IN BANKRUPTCY OF OFFICER’S DEBT

Many people are aware, at least generally, that one of the principal goals of a Chapter 7 bankruptcy case is a “fresh start” for the debtor, which is accomplished in large part by the debtor obtaining a “discharge” of his debts at the conclusion of the case. Section 523 of the Bankruptcy Code establishes a laundry list of exceptions to discharge, which includes debts to governmental authorities for certain taxes, certain alimony and child support obligations to a spouse or former spouse, government guaranteed educational loans, and others.

Section 523(a)(2) creates an exception for money, property, services, or credit obtained by false pretenses, a false representation, or actual fraud; section 523(a)(4) excepts debts for “fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny;” and section 523(a)(6) excepts from discharge debts for “willful and malicious injury by the debtor to another entity or to the property of another entity.”

In a very recent decision out of the United States Bankruptcy Court for the Western District of Michigan, *In re Sullivan*, 305 B.R. 809 (Bankr. W.D. Mich. March 11, 2004) the court took the exceptions created by subsections (2), (4), and (6) in what appears to be a new and interesting direction. The court found that the debtor, the former president of Digital Commerce, Ltd. (“Digital”), had taken actions during the time



when he was planning to resign from his position with the corporation which amounted to a usurpation of Digital's corporate business opportunity, and resulted in the debtor's debt to the corporation in connection with such usurpation being nondischargeable.

When the employee is an officer or director of a corporation, the fiduciary duties imposed under state law are even more stringent.

Digital was a Michigan corporation that specialized in providing business internet solutions for clients, designing software (or altering existing software) that enabled its clients to sell their products or services to businesses and consumers over the internet. The crux of Digital's claim against the debtor was that the debtor committed numerous breaches of his state law duty of loyalty to the corporation during his tenure as president. Of these, the most serious charge was that the debtor usurped the corporation's opportunity to work with a client, ASR, for his own benefit. Specifically, the debtor had affirmatively advised ASR not to work with Digital, but rather with a new firm that he and another employee had formed. These discussions occurred while the debtor was still employed as president of Digital.

The court found that Michigan common law (similar to that of Iowa

and Nebraska) imposes a fiduciary duty of loyalty on all employees of a corporation that forbids them from taking action contrary to the interest of their employers. The court further held that when the employee is an officer or director of a corporation, the fiduciary duties imposed under state law are even more stringent. The court concluded that the debtor had diverted the opportunity from Digital to prepare a needs analysis for ASR, kept the opportunity for himself and then transferred it to his new company, and that Digital had a valid claim against the debtor for usurping a corporate opportunity in violation of his fiduciary duty of good faith.

The court held that the debtor's wrongful stealing of a corporate opportunity resulted in a debt in the amount of \$15,930, and that such debt was nondischargeable under section 523 on each of three grounds: First, the court held the debt nondischargeable under section 523(a)(6) as a debt "for willful and malicious injury by the debtor to another entity or to the property of another entity," concluding that the debtor's usurpation of the ASR opportunity was undertaken with blatant disregard for the duty of loyalty the debtor owed to Digital as its president. Second, the court found that the debtor's conduct with respect to the corporate opportunity was "sufficiently egregious to fall within the reasoning of the actual fraud decisions," holding that his theft of a corporate opportunity by nondisclosure, and a subsequent attempt to cover up the evidence thereof, constituted actual fraud.

Finally, and most interestingly, the court said the debt should be excepted from discharge under

section 523(a)(4) as a debt arising from embezzlement or larceny. Finding that the "property" at issue in the case was Digital's corporate opportunity to prepare the needs analysis for ASR, the court said that the threshold question was "can intangible property, such as a business opportunity, be embezzled for purposes of section 523(a)(4)?" It concluded it could: *In this modern society, with its great reliance upon intellectual property and commercial ideas, theft of intangible property is always possible. Although the undersigned judge believes that any expansion of the meaning of "property" to include intangibles in the embezzlement context may be subject to some criticism, the facts in this case warrant a conclusion that the debtor appropriated to his own use property (a concrete corporate opportunity) that was entrusted to him (in his capacity as president) in a fraudulent (secretive and unwarranted) manner.*

In this modern society, with its great reliance upon intellectual property and commercial ideas, theft of intangible property is always possible.

CONCLUSION

This decision is likely to be much discussed, and will certainly be cited in cases where creditors, whether former corporate employers or otherwise, seek to block the discharge of a specific debt which has arisen as a result of the "embezzlement" of intangible property.

Frank M. Schepers



HEALTH SAVINGS ACCOUNTS

Health Savings Accounts were authorized in the 2003 Medicare reform legislation and became effective January 1, 2004. Health Savings Accounts allow savings for health care expenses in a tax-favored vehicle. Health Savings Accounts consist of two parts. The first part is a health insurance policy that covers large hospital bills, referred to as a High Deductible Health Plan. The second part of the Health Savings Accounts is an investment account from which you can withdraw money tax-free for medical care.

Health Savings Accounts may be set up by an employer, a self-employed individual or independently by a person who is under age 65. Subject to limits, an "eligible individual" may make deductible contributions to Health Savings Accounts. An "eligible individual" is any person

who is covered by a High Deductible Health Plan and is not at the same time covered under any health plan that is not a High Deductible Health Plan and provides coverage for any benefit which is covered under the High Deductible Health Plan. An eligible individual must also not be claimed as a dependent on another's tax return and can not be entitled to Medicare benefits.

Distributions for "qualified medical expenses" incurred after the Health Savings Account is created are tax-free.

Earnings from invested contributions accrue tax free and the account balance rolls over annually. Distributions for "qualified medical expenses" incurred after the Health Savings Account is created are tax-free.



In the event distributions are made for non-qualified expenses, the distributions are included in income and subject to a 10% penalty.

Health Savings Accounts were established in an effort to provide consumers a way to potentially reduce their health care costs. Another advantage of a Health Savings Account is the ability to spend tax-free money out of a Health Savings Accounts for long term care insurance.

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