



Trusts & Estates Client Alert

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Please read the important information relating to U.S. tax advice at the end of this Client Alert.

New Bill Makes \$3,500,000 Estate Tax Exemption and Maximum 45% Gift and Estate Tax Rate Permanent and Has Onerous New Gift and Estate Tax Valuation Rules For Entities

Representative Earl Pomeroy (D. North Dakota) recently introduced a bill, H.R. 436, that contains proposed changes to the gift and estate tax provisions.

Bill Extends \$3.5 Million Estate Exemption and Maximum 45% Gift and Estate Tax Rate

H.R. 436 would extend the current \$3.5 million estate tax exemption indefinitely. The bad news for some taxpayers is that there would be an estate tax in 2010 – under current law there is no estate tax for that year. The good news is that the \$3.5 million exemption would stay in effect even after 2010, when the exemption was scheduled to be pared back to \$1 million. The Bill also would keep the current maximum 45% gift and estate tax rate in effect (it was scheduled to rise to 55% after 2010), but it would impose a limited surcharge for a taxable estate exceeding \$10 million.

Bill Would Adopt New Valuation Principles For Certain Assets Held In Entities

The Bill also would have significant impact on the method by which a taxpayer values property for estate and gift tax purposes. Valuation is a critical factor in estate and gift taxation. The more property is worth, the higher the gift or estate tax when the property is gratuitously transferred to another, as a general rule. Other than for cash, publicly traded

Please feel free to discuss any aspect of this Client Alert with your regular Milbank contacts or with any of the members of our Trusts & Estates Group.

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stocks and bonds, the estate and gift tax value of property usually is determined by deciding at what price the property would trade hands between a “willing buyer” and a “willing seller”— essentially, what the price would be if it were bought and sold between two unrelated parties. That is the case, for example, for privately held business interests, real estate and works of art. The law also currently provides that other characteristics of the property must be considered in determining its value. For example, an interest in an entity that does not represent control, so the owner cannot force its liquidation to obtain ownership of the underlying assets or to direct the entity’s affairs, is worth less, and often far less, than an interest that does represent control of the entity.

Under H.R. 436, for gift and estate tax purposes, upon the transfer of an interest in the entity, any passive asset (i.e., any asset not employed in an active trade or business) held by the entity is valued as if a proportionate interest in the passive asset were transferred directly by gift or at death, ignoring the fact that the passive asset is held by the entity. For example, real estate owned by an entity will be treated as a passive asset unless the taxpayer “materially participates” in the operation of the real estate. In addition, although not expressly stated, the Bill would appear to treat publicly traded stock, bonds, cash and similar portfolio type investments as passive assets. It also appears that the Bill would apply to any assets owned by an active business to the extent those assets are not used in the active conduct of the business. The Bill would, in the case of any interest in an entity, require the taxpayer to determine the passive assets of the entity and then value the transfer of the entity interest as the sum of a proportionate share of the net asset value of the passive assets plus the actual interest in the entity (with applicable discounts except a minority discount if the entity is family owned) ignoring the passive assets. In effect, the Bill would disregard the existence of an entity such as a family partnership, limited liability company (LLC), corporation or other entity and treat any gift or bequest as being made of the assets owned by the entity except for those assets actually used by the entity in the operation of a business. This eliminates the ability of the taxpayer to value such assets at a discount because of the restrictions in the governing documents of the entity (i.e., lack of control, restrictions on withdrawals, etc.) which reduces the value of such interest to a third party transferee.

Bill Would Disallow Minority Discounts If the Family Holds Control

The Bill also would eliminate any minority or similar lack of control discount in valuing interests in an entity (whether that entity holds passive assets or is an active business) where the family controls the entity. For example, if two siblings, or an aunt and nephew, or an individual and her step-granddaughter’s husband own a controlling interest (generally, more than 50%) of the stock in an active company (such as a car dealership, restaurant or farm) but neither individually owns more than 50% of the stock, the stock owned by either at death would be valued for estate tax purposes without regard to the fact that such a minority interest, in fact, is worth less than a proportionate part of the business valued as a whole. That rule applies even if, on account of animosity or for other reasons, the related owners would not dispose of their interests together. However, a discount for lack of marketability for such a business interest apparently would continue to be permitted.

These changes in valuation would be in effect for transfers after the date the Bill is enacted, which may be just a few weeks away. The Bill would be applied on a prospective basis only to transfers after the date of enactment.

What Taxpayers Should Do

The Bill, if enacted, would not necessarily mandate that taxpayers modify their basic estate planning documents, such as Wills and Revocable Trusts. However, property owners who own interests in private entities, whether they are active businesses or management vehicles, should consider consulting with their estate planning advisors to determine if action should be taken before the Bill becomes law or to determine if overall estate planning (such as acquiring additional life insurance) should be changed.

New York State Tax Developments

New York State Department of Taxation and Finance Changes Definition of Permanent Place of Abode For Non-New York Domiciled Individuals Who Are Temporary Residents For a Particular Purpose

The New York Department of Taxation and Finance (the “Department”) recently amended NYCRR Section 105.20(e)(1) to remove the “temporary stay” exception from the definition of a permanent place of abode for purposes of determining residency for personal income tax reasons. The amendment is effective for tax years ending on or after December 31, 2008.

Under Section 105.20(e)(1), a New York statutory “resident individual” for personal income tax purposes is any individual domiciled in New York and any individual not domiciled in New York, but who maintains a permanent place of abode for substantially all of the taxable year and spends an aggregate of more than 183 days in New York. A permanent place of abode is defined as a dwelling maintained by the individual (ownership does not matter for purposes of this definition). The amendment eliminates the exception in the definition of a permanent place of abode for individuals who are in New York temporarily for a particular purpose. Prior to the amendment, a place of abode maintained only during a temporary stay to accomplish a particular purpose (such as an individual’s employment) was not deemed to be permanent and excluded as a “permanent place of abode” for purposes of determining statutory residency for tax reasons. The removal of this exception for temporary stays subjects any individual who maintains a dwelling in New York (regardless of ownership) and who remains in New York for more than 183 days to New York personal income tax as if such individual was resident in New York.

Advisory Opinion Provides that Nonresident Decedent Is Subject to New York Estate Tax on New York Property Held in Disregarded Single Member Limited Liability Company

The Department has issued an advisory opinion, dated October 24, 2008, confirming that, if a nonresident creates a single member limited liability company (the “SMLLC”) which is disregarded (because no election is made to treat the SMLLC as a corporation), the SMLLC is disregarded for New York State estate tax purposes. (In the same advisory opinion, the Department ruled that real estate owned by an S corporation would not be subject to New York State estate tax, at least if there was a business purpose for the corporation.) Accordingly, even though the nonresident’s interest in the SMLLC is treated as intangible property for state law purposes, the nonresident is treated as owning the underlying property in the SMLLC for tax purposes, so it would be subject to New York State estate tax to the extent that it consists of real or tangible personal property situated in New York.

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We would be pleased to discuss the potential consequences of these changes in law with you.

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Statement About Circular 230

Recent amendments to a Treasury Department regulation, known as Circular 230, require lawyers and accountants to follow strict rules in issuing a written statement about a Federal tax issue. The most onerous rules of compliance under §10.35 of the Circular involve written advice about so-called Listed Transactions, arrangements that have tax avoidance as their principal purpose and what are called Marketed Opinions. We do not believe any issue discussed in this Client Alert relates to a Listed Transaction. We believe the tax benefit sought is consistent with the Internal Revenue Code of 1986 as amended (Code) and Congressional purpose. That means the principal purpose is not tax avoidance. We also believe no issue discussed herein is a significant Federal tax issue – meaning that we believe the IRS does not have a reasonable basis for a successful challenge on the overall Federal tax treatment of the issues discussed in this Client Alert. That means we do not think this Client Alert must comply with §10.35 of the Circular. Nevertheless, we add the following statements to ensure compliance with said §10.35. Notwithstanding these statements, we believe the conclusions reached herein are correct.

1. The written advice contained in this Client Alert is not intended or written by us to be used, and it cannot be used, by any taxpayer for the purpose of avoiding penalties.
2. No one may use any part of this Client Alert in promoting, marketing or recommending an arrangement relating to any Federal tax issue to any taxpayer.
3. Nothing herein shall be construed to impose a limitation on disclosure by any person of the tax treatment or tax structure of any transaction that is addressed herein.

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