MILLER, MONSON, PESHEL, POLACEK & HOSHAW

A PARTNERSHIP OF PROFESSIONAL LAW CORPORATIONS

JULY 2015 NEWSLETTER

501 WEST BROADWAY, SUITE 700
SAN DIEGO, CALIFORNIA 92101-3563
TELEPHONE: (619) 239-7777
FAX NUMBER: (619) 238-8808

IN THIS ISSUE

College Students Need an Estate Plan Too

By DeEtte L. Loeffler, J.D., L.LM

In June, my son graduated from high school. Like many of his peers, he will be going away in the fall to attend college in another city. For months we have been planning for this transition, making arrangements for his food, housing, transportation, classes, and a campus bank account, and we have bought necessary equipment and supplies, such as a laptop and dorm room essentials. While these are all important things to do, one of the most important things we have done is to have him sign a basic estate plan.

You might ask – why would an 18 year old need an estate plan? He has no real "estate" at this point, but an estate plan consists of much more than just a Will and/or a trust. An estate plan includes certain documents that every parent needs to help a child who is away from home.

1. A Financial Power of Attorney. Students are busy and often need help managing their bank, UTMA, 529 plans, or other financial accounts. They also often need assistance making required payments in a timely manner. However, now that your child is age 18, you, as a parent, no longer have legal authority to manage your child's bank and/or investment accounts unless you are also named on those accounts. In addition, you do not have legal authority to deal with your child's creditors (such as cell phone providers or insurance companies) or to access your child's financial records (such as the student's tuition and housing accounts). Oral approval by the student for access to on-line accounts, or to deal with creditors, is not legally sufficient for dealing with third parties.

A financial power attorney can grant the parent the ability to handle any and all financial issues arising for the child while he or she is at college. Over the last two years (since our oldest child entered college) we have relied on a power of attorney numerous times to obtain cooperation from third parties and to simplify our child's life (and by extension, our own).

2. Advance Health Care Directive. Most parents mistakenly assume they can continue to make medical decisions for their children as long as those children remain "dependent." On the contrary, once a child attains the age of 18

years and graduates from high school, only that child (now a legal adult) has the right to make these decisions. A medical power of attorney is therefore an essential document for any student headed off to college.

An Advance Health Care Directive (AHCD) allows the child (the “Maker”) to express his or her desires regarding medical care and end-of-life medical decisions. It also grants the named agent a right to make medical decisions for the Maker if he or she is unable to do so. Without an AHCD, parents may be unable to obtain information about their adult child’s medical condition in the event of an accident or serious illness. Moreover, treatment for the adult child may be delayed or care provided that is inconsistent with the child’s desires.

When our son, the day after his 18th birthday, shattered his elbow in a fall, his AHCD gave my husband and me the legal power to work with his doctors to determine the best medical treatment options and to make decisions for our son during and immediately after the surgery that followed.

3. Authorization to Release Medical Information. Another critical medical care document to have is an Authorization to Release Medical Information (also called a “HIPAA Waiver”). Under current federal and California law, health care providers are prohibited from discussing an individual’s sensitive medical information without the written consent of the patient. A HIPAA Waiver provides that written consent. Simply put, a HIPAA waiver would allow parents to obtain information about a sick or injured student to help them to make better decisions regarding the adult child’s care.

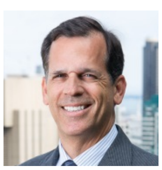
In addition, a HIPPA waiver is essential if the parent is to deal with medical bills incurred by the child. For example, if the adult child was injured and received care at a hospital near the university, the parents could deal with payment of the bills while the adult child recovered. Having used a HIPAA waiver for this myself, I can assure you that having this document significantly reduced the frustration when dealing with billing agencies.

This critical document can be especially important if a child experiences a mental health issue, such as depression. According to the US Department of Health and Human Services, 1 in 10 young adults experiences a period of major depression, and 1 in 5 adults experiences a mental health issue. According to National Alliance on Mental Illness, 1 in 4 adults between the ages of 18 and 24 have a diagnosable mental illness. With an Advance Health Care Directive and HIPAA waiver, the parents would be able to accompany the adult child to the mental health care facility, assist with the admissions process, and deal with the medical and other bills while the adult child receives care.

4. Optional documents. Additional documents which the adult child may want include a Nomination of Conservator, a Will, and if appropriate, a trust. The Nomination of Conservator is a short form that allows the adult child to recommend someone to be appointed to care for their person and/or property in the event they become legally incapacitated. This document is less necessary than those listed above because courts generally appoint the parents to serve as Conservators. Individuals from a divided family, or who prefer to name a particular person, should sign a Nomination.

Finally, your adult child may want a Will. Without one, the laws of the state will control who inherits the adult child's assets. Under California law, the assets of a childless person who dies intestate (i.e., without a Will) are distributed first to the parents (equally), then to the brothers and sisters, then to more remote family members. If the adult child wishes to change this distribution plan, a Will is required. So long as the value of the adult child's estate is valued at less than $150,000 and does not include real property, the assets can be transferred to the heirs through the use of a simple probate proceeding. If the child has assets outside of a trust in excess of $150,000, or owns an interest in real property, a trust should be considered.

Being prepared for financial and medical issues can provide both the adult child and the parents with peace of mind. If you have an adult child headed off (or back) to college in the fall, we recommend you and your child consider adding an estate plan to your preparations.



Is Your FLP or LLC Subject To Future Reassessment?

By Timothy C. Polacek, J.D.

Many families own real property inside a family limited partnership ("FLP") or limited liability company ("LLC"). Such entities were commonly used in the 1980s and 1990s for business and estate planning purposes. In creating an FLP or LLC to minimize estate and gift taxes, real property could be contributed to the entity on a proportional ownership basis to maintain the low property tax values.

If properly structured, an exemption was available so that no property tax reassessment occurred on formation of the entity. This was the good news. However, use of the exemption would result in reassessment of the property when a majority of the interests of the original partners/members was transferred. This was the bad news, and many families were unaware (and still are unaware) of this caveat.

In situations where senior generations created an FLP or LLC to reduce estate taxes, there may be a pending property tax reassessment that will occur upon the death of the survivor of "mom and dad." This is because parents often created FLPs and LLCs while retaining a majority interest in the entity (rather than gifting a majority interest of the real property before formation of the entity). Under such arrangements, it is inevitable that a majority of the original FLP or LLC interests will be transferred (and reassessment will occur) no later than the death of the surviving spouse. If the market value of the property is much greater than its assessed value at that time, the pending reassessment can be substantial. In some cases, reassessment can be fully or partially avoided by dissolving the entity before the death of the surviving spouse (see discussion below).

Even worse, for some families it may be the case that property tax reassessment has actually occurred but has gone undetected. In these instances, certain family members, such as trustees of irrevocable trusts, may one day have to decide whether to report the reassessment and pay taxes, or postpone what might become an even larger liability.

<u>The "Original Co-Owners" Rule.</u> It is well established that real property may be transferred to cause a change in the manner of holding title without reassessment. For example, real property may be transferred from co-tenants into an FLP or LLC without causing a "change in ownership" for property tax purposes. This is because Revenue & Taxation Code Section 62(a)(2) allows "proportional" ownership transfers into and out of business entities without reassessment. As long as the share of capital and profits in the real property

before the transfer is the same as the interest in the capital and profits of the entity, reassessment will not occur.

Let's review a common fact pattern we have observed that explains some of the property tax issues that should be reviewed.

Example. Bill and Sara are husband and wife. In 1999, when they each were age 65, they owned a $4,000,000 apartment building that was assessed at $1,200,000. Before forming an FLP, they gifted 2% of the real property to their son John (using parent-child exclusions), and then formed an FLP. They became 98% owners and their son was a 2% owner. They took advantage of the Rev. & Tax. Section 62(a)(2) "co-owners" exemption upon formation and notified the County Assessor that Bill, Sara and John had become original "co-owners" of the apartment building.

The "original co-owners" rule provides that the apartment will be reassessed and a "change in ownership" will occur for property tax purposes at such time that more than 50% of the original FLP interests of Bill, Sara, and John are transferred.[1] For purposes of determining if a transfer has occurred, the rules look solely to changes in "beneficial" ownership of the interests, and therefore include both voluntary (gift or sale) and involuntary (transfer on death) transfers to a person other than the transferor (note: spousal transfers between Bill and Sara are specifically exempt).

Notably, any transfer in the FLP from Bill or Sara to John will not qualify for the "parent-child" exclusion. The parent-child exclusion only applies to interests in real property and does not apply to transfers of an FLP interest, because this is a security and not an interest in real property.

Intervivos FLP Transfers. Let's now assume that in the year 2000, Bill and Sara gifted a 47% limited partner interest to John. Because this transfer was less than a majority of the original co-owners' interests and John's 49% ownership did not give him a controlling interest, no property tax reassessment occurred.

Let's further assume there were no other FLP interest transfers and that Bill passed away in the year 2012. Under their estate plan, all of Bill's remaining interest in the FLP was transferred to a bypass trust (solely for Sara) upon his death so that ownership of the FLP then became Sara - 25.5%, Bypass Trust 25.5% and John 49%. Because Sara is the sole beneficiary of the Bypass trust, the transfer by Bill qualifies for the interspousal exemption and is not counted as a transfer by an original co-owner.

However, under the facts in this example, the transfer by Sara of more than 3% of the FLP will cause a reassessment and this should be understood by her estate planning advisors. As a practical matter, this means that upon Sara's death (she would be age 85 in 2015), there will be a reassessment of the apartment building because there will be a change in the beneficial ownership of both the interest held by Sara and the Bypass trust - thereby causing a transfer of more than 50% of the original co-owners' interests.

To Dissolve or Not to Dissolve the FLP. It may be possible to avoid property tax reassessment by dissolving the FLP during Sara's lifetime and having ownership of the apartment return to a co-tenancy arrangement. Because Rev. & Tax. Section 62(a)(2) allows

[1] It should be stated that reassessment will also occur at such time someone other than Bill or Sara acquires a majority of the FLP interests (Rev. & Tax. 64(c)).

proportional ownership interest transfers from an entity to its owners to avoid reassessment, a dissolution of the FLP would enable Sara to use her $1,000,000 parent-child exclusion to transfer her 25.5% interest in the apartment to John, either during her lifetime or at death. Additionally, it may be the case that additional planning can be implemented to avoid future reassessment of the 25.5% interest that then would be held by the Bypass trust (but such analysis is beyond the scope of this article).

Of course, there may be practical reasons why it is necessary and appropriate to continue ownership of the apartment in the FLP. In many instances, the FLP or LLC provides creditor protection and family succession planning. In other instances, the ownership of the entity may be held by two or more generations of family members such that co-tenancy ownership would be more difficult. Additionally, the property may be subject to a loan in which consent of the lender will be necessary to dissolve the FLP.

<u>Death of Surviving Spouse: Notice of Change of Ownership of Legal Entity.</u> Continuing our example, let's assume that Sara did not take any action to dissolve the FLP. Sara passes away in 2015, leaving all of her interest to John, with John's children receiving all of the interest held by the Bypass trust. Because there was a change in the beneficial ownership of these interests at Sara's death and because Bill and Sara no longer own any of the 98% FLP interest they held as original co-owners, there has been a change of ownership for property tax purposes that must be reported to the State Board of Equalization.

Under Rev. & Tax. Section 64(d), a change in ownership occurs when cumulatively more than 50% of the original co-owners' interests in the legal entity is transferred and property was proportionally transferred into the entity without reassessment. In such case, only the interest in real property that was previously excluded from reassessment under Rev. & Tax. Section 62(a)(2) is subject to reassessment as of the date of the change in ownership. This means the apartment is subject to property tax reassessment because of the transfer of a majority interest of the co-owners.

However, in our sample case, it should also be noted that on Sara's death, John has become the beneficial owner of 74.5% of the FLP interests, meaning he has acquired a controlling interest in the FLP that causes property tax reassessment under a second statute. Namely, Rev. & Tax. Section 64(c) provides that a "change in control" occurs when any person or legal entity obtains more than 50% of the ownership interest in a legal entity. The significance of this statute to our example lies in the fact that John's acquiring control of the FLP will result in the property tax reassessment of all of the property of the FLP, not just the apartment. Thus, if the FLP had acquired additional real property after its formation, Sara's death would also result in property tax reassessment of that property, too.

Regardless of which basis for reassessment applies, California law requires Form BOE-100-B to be filed for the FLP within 90 days of Sara's death to give notice of the change in ownership or control as of Sara's death. This form is filed with the Board of Equalization (BOE) at its office in Sacramento. If not timely filed, a 10% penalty is applied to the amount of reassessment and interest can begin to run at the rate of 7%. But even worse is the fact that a failure to notify the BOE of the change of ownership or control means the statute of limitations on reassessment does not begin to run so that a reassessment may be made at any time in the future.

Although California income tax returns (Forms 565 and 568) ask whether there has been a transfer to cause property tax reassessment, it is our experience that after a client has passed away, many preparers wait until the FLP or LLC actually recognizes the beneficiary as a successor owner before answering this question in the affirmative. However, because the property tax rules look to the beneficial ownership of the interest, a transfer of the interest occurs for property tax purposes on death.

In summary, the ownership of real property in an FLP or LLC entails an understanding of the property tax rules and a duty to periodically review whether a change in ownership has occurred. For many persons, a failure to understand the applicable law can lead to adverse tax consequences that might have been prevented if properly planned for.

If you hold real property in an FLP or LLC and have made transfers or received interests, you might benefit from a legal review of this property tax issue.

FEDERAL TAX NEWS

By DeEtte L. Loeffler, J.D., LL.M. Taxation

TSP Changes for Some Workers. The House and Senate passed legislation amending the federal tax code to eliminate the 10% penalty for certain early withdrawals from a federal Thrift Saving Plan (TSP). The TSP is similar to 401k plans offered by private employers, but is available only to federal employees, including military service members. The legislation will benefit only federal law enforcement officers, firefighters and certain border protection and customs officers who withdraw funds from their TSP after the age of 50 and before the current permitted withdrawal age. Under current law, withdrawals cannot be taken from a TSP (or 401k plan) before the age of 59.5 years without incurring the 10% penalty. Withdrawals will still be subject to federal income taxes.

Cheaper Beer? Craft beer may become less expensive under the Beverage Modernization and Tax Reform Act (S. 1562). This bill would reduce taxes from $18 to $3.50 per barrel on the first 60,000 barrels produced, provided the brewer produces less than 2 million barrels. San Diego has a large number of small breweries who could benefit from this tax reduction.

Civilian BRAC Act Proposed - Again. A bipartisan bill would reduce government spending and increase revenues by disposing of “underutilized” federal properties (both owned and leased). The Civilian Property Realignment Act would establish an independent Commission to review the current uses of federal property to recommend consolidation and disposal. The bill would require the Commission to identify $9 billion in savings over a 10 year period. To accomplish this goal, the Commission would be granted tremendous power. The bill provides for the Commission to submit a report to the President. Once approved by him, the recommendations in the report would become law within 45 days unless Congress passed a resolution to disprove the proposal. Similar legislation proposed in November of 2013 did not even get to a vote.

STATE TAX NEWS

By DeEtte L. Loeffler, J.D., LL.M. Taxation

SB 8, which would impose a tax on services and reduce state income taxes, has not been advancing. This bill does not appear likely to be adopted this year. If adopted, this tax change is expected to increase, rather than reduce, overall state revenues.

One bill before the legislature would substantially increase the cost of recording real property deeds. The current cost to record a deed in San Diego County is generally less than $25. AB 1335 would impose an additional recording "fee" of $75-225 per transaction. This fee would not apply to transfers where a documentary transfer tax is imposed (such as on the sale of real property between unrelated parties). This fee would hit especially hard on trusts, inter-family transfers, and inter-business transfers, where no money generally changes hands. The goal is to raise $300-500 million annually to provide Affordable Housing. In 2012 the legislature dissolved the existing redevelopment agencies for mismanaging funds.

Another new fee being proposed would be imposed on all residential and commercial property fire and multipurpose insurance policies. AB 1203 would impose a "special purpose surcharge" of 5.0% of the "total policy premium" on all policies. The purpose of this new fee would be to replace the extremely unpopular Fire Prevention Fee imposed by the legislature in 2011 to replenish the state's firefighting fund. The current fee is $153 per dwelling in rural areas of the state. This new fee is estimated to bring in $500 million in new taxes (and to exceed the revenue under the existing fee). If adopted, this new fee will likely also be challenged as an illegal tax.

MILLER, MONSON, PESHEL, POLACEK & HOSHAW
A Partnership of Professional Law Corporations
Providing quality legal services since 1959

RALPH GANO MILLER, RETIRED
THOMAS M. MONSON
MARY J. PESHEL
TIMOTHY C. POLACEK
WILLIAM D. HOSHAW†
SUSAN L. HORNER
BRADFORD N. DEWAN
PHILIP R. FREDRICKSEN†
DeETTE L. LOEFFLER
JUDY S. BAE
†OF COUNSEL

http://www.mmpph.com