From: Dennis L. Hayden [dhayden@Haydenci.biz]
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To: 'dhayden@Haydenci.biz'
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Hayden Consulting, Inc.

Dennis L. Hayden, Editor

Offices:
11805 N Pennsylvania St
Carmel, IN 46032-4555

301 East Clinton St
Frankfort, IN 46041-1908

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Contact Us:

http://www.Haydenci.biz

J. Michael Hayden, CFP® CPA
mhayden@Haydenci.biz

Dennis L. Hayden, CPA CVA MST
dhayden@Haydenci.biz

Hayden Consulting, Inc.

Last Week:

- Single Member LLCs
- The Limited Liability Company
- The Limited Partnership

Important Links:

Internal Revenue Service
Indiana Department of Revenue

Know someone who would benefit from this Newsletter? Send us an e-mail address.

TAX CHANGES IN 2011

Unless Congress acts to change the law, on January 1, 2011, a number of taxes will revert to pre-2001 tax cut levels.

- The top income tax rate increases to 39.6 %, and eliminated is the 10 % bracket.
- Eliminated is the $1,000,000 exemption for federal estates, and a 50% maximum tax rate returns.
- Long-term capital gains rate increase to 20% from the current 15%, and a lower 10% rate used by individuals who are in the 15% tax bracket.
- Dividend income, other than capital gain distributions from mutual funds, will be taxed as ordinary income at the highest marginal tax rate.
- The child tax credit, currently at $1,000, will revert to $500 and refundable only to taxpayers with earned income greater than $12,550.
- The partial reduction for self-employment tax paid will expire.
- The direct write-off of equipment placed in service by businesses decreases to $25,000 from the current $135,000 level.
- College savings plans (529 Plans) can no longer pay for a computer or internet access tax-free.
- The Hope college tuition credit is limited to the first 2 years and capped at $1,800. None of the credit is refundable if it exceeds regular income tax liability.
- Repealed is the Earned Income Tax Credit increases for filers with 3 or more children, and income eligibility reduced.
- Mortgage insurance premiums (MIP) for mortgages after 2006 expires and no longer deductible.

FAMILY LIMITED PARTNERSHIPS

The general purpose of a Family Limited Partnership is to transfer property to a younger generation within the same family. These are usually set up with the parents as general partners and children as limited partners, but an LLC may be used instead of a limited partnership and works in similar fashion. Therefore, for this discussion, an FLP is a Limited Partnership or LLC controlled and operated for the benefit of family members.

The planning strategy consists of the transfer of ownership from one generation to another, over time, through the use of gifts when the entity is established or the annual gift exclusion. Discounts are often used to determine the amount of the transfer of value, thereby making these entities a target for IRS scrutiny.

The IRS believes these entities are an abuse of the Internal Revenue Code under various theories, from that of calculation of value upon transfer of an interest, or the lack of economic substance, to parents maintaining control of assets within the entity. An impressive list of court cases have

FOR SALE

BUSINESSES AVAILABLE

1. BRAND NAME garage door installation and repair company - Marion County and surrounding counties.
2. "C" store
3. Office Industrial complex- occupied with long-term tenants, 3 acres of land.
4. Operating Day Care Franchise
5. Beauty shop – Fishers

mounted where the government has battled with taxpayers over the use of the FLP. Some of these cases have been won by the IRS, but most are decided in favor of the taxpayer.

Other than the drawbacks of a possible IRS inquisition, the advantages for the use of an FLP in tax planning are quite valuable. A creditor's sole remedy when attempting to collect a judgment from a partner in an FLP is a charging order. This only allows a debtor to receive the debtor partner's share in partnership distributions. When correctly established, a creditor cannot be admitted as a partner, therefore, would have no say in management or compel the distribution or sale of partnership assets. As a result, a creditor may receive phantom income on which to pay tax with no corresponding cash distribution, and create a better negotiating environment for the partner.

Using an FLP can lower the estate or gift tax. Gift tax is imposed on the fair market value of property transferred by gift to a donee. Estate tax is imposed on the FMV of assets held by a decedent at the moment of death or the alternate valuation date.

For both estate and gift tax, FMV is defined as the price at which property would change hands between a willing buyer and a willing seller, neither being under a compulsion to buy or sell, and both having a reasonable knowledge of relevant facts. Therefore, a limited ownership interest in an FLP may be worth substantially less than the pro-rata Fair Market Value of assets owned by an entity. The reason is that an FLP owner of a limited interest cannot cause a distribution, compel liquidation, or exercise control over management. When an interest is not readily marketable, and with an owner having no control on an entity, discounting an interest 35% or more is not unusual depending on the illiquidity of the assets.

If a family limited partnership is under consideration be aware that failing to respect the formation and structure of the entity is one of the biggest stumbling blocks to prevail against the IRS in court. Make certain the FLP is funded (assets transferred to the FLP) prior to any interest made to family members. The general owner should retain sufficient assets to support his lifestyle outside the FLP. Make certain the FLP's books and records are current and the company maintains its own bank account.

The FLP is doomed to failure when a general owner has a dependency on contributed company assets for support or when the gifts made cannot possibly generate immediate benefit to the donee. There also must exist a bona fide business purpose for an FLP, and disregard emphasizing the tax advantages or discounts in formation of the company. Delay for a period making gifts so the original owners own 100% of the FLP. The operating agreement for the entity must be carefully adhered to and reviewed or amended to reflect the current situation of the company. A proper accounting of the entity must occur, and annual income tax returns filed to reflect its operations.

THESE ARTICLES MAY NOT BE USED FOR PENALTY PROTECTION