MacElree Harvey

Dealing with the IRS and Other Important Tax Issues

June 8, 2005

Louis N. Teti, Esq.
Duke Schneider, Esq.
James B. Urie, Esq.
Presenters

Lou Teti: We find that these seminars have been very helpful. Not only for you, our friends and clients, but also for us because we learn from your experiences. The interchange we have and the questions that you have as a result of what we present, is very helpful to us, because you present your real life situations to us and it helps us to expand our basis for advising you.

Today, we decided to do something slightly different than what we've done before. We wanted to draw upon the resources of members of our firm. One is a recent addition and one has been with us for several years. I know that they won't be strangers to either of you. Jim Urie is to my immediate right, and you'll be hearing from Jim first, and to my further right is Duke Schneider. Duke and I, along with Joe Bellinghieri and Jim, work in the estate planning area of the practice and handle the estate planning and the estate administration functions at the firm.

Today's issue is one that our clients requested that we talk about. You're not going to be hearing much from me today, because I'd like to sit back and learn more about the expertise that Duke and Jim have to bring to the table in these areas. We are going to have a question and answer session as we move through it. I would encourage you as we speak, if you have questions - if someone says something that raises a question in your mind, please raise your hand and let us know. This helps bring us into an area we may be missing.

I will give an overview and then pass it over to Jim and Duke to speak.

I should mention that Jim comes to us from the Internal Revenue Service, so he has a special area of knowledge in that area. I can tell you as a practical matter, in the day-to-day practice, when you are advising clients, it really does help to have the insight of someone who has been on the "other side" in terms of what issues to look out for, what issues to be careful about and to give you a really good idea of how the IRS will view your client's situation. It strengthens our ability to advise in that area.

Duke, as I said before, has vast experience with estate planning matters. If you've ever met or worked with Duke, you know that when you engage Duke in a conversation or if you get involved with him in a one-on-one, he's extremely helpful in estate planning areas because he has such a depth of knowledge and a very solid and practical outlook and advises clients accordingly. He relates to clients very well, and clients feel good about working with Duke and Jim.

So, with that, we're going to start with "How Do We Handle an IRS Audit?" If you get that letter from the IRS, what happens? Jim is going to take us there. He is also going to talk about the collection alternatives. In other words, if it is determined that there is an IRS problem or a debt due to the IRS, how do we handle collection alternatives?

Private Letter Rulings - you've probably heard about those; why they are so important and valuable, and how you can go about getting one.

Circular 230 is something which you probably haven't heard about, but Jim will fill you in.

Then, we are going to move into something slightly off that track, namely the choices of entity that people have when they are going about starting a business. Should they start with a sole proprietorship or corporation, LLC, LLP? We will talk about succession planning as our time permits. If you've got a family business or a business that you own with other people, and you want to pass it down through generations or to the next in line, what's the best way of approaching that? Also, we will talk a little bit about tax-exempt organizations and how these entities might play a role in your estate plan and your business succession plan.

So with that as an overview, I'm going to sit down and pass the ball over to Jim, who will start us out with that awful letter that you sometimes or hopefully never see from the IRS. Jim.

Jim Urie: Thanks Lou. Like Lou said, prior to joining MacElree Harvey, I worked at the IRS for three years. In that capacity I worked in their General Counsel's Office in Philadelphia and I handled everything from pre-filing of return issues to bankruptcy collections. I saw the entire process from beginning to end, so if you have any questions on any of those, just feel free to ask throughout my presentation. Also, as part of my experience at the IRS, I did a lot of seminars at the Philadelphia IRS Service Center. The seminars covered how they, the IRS, should view returns and how they should

deal with the taxpayer, because I was the one who would have to ultimately litigate the case in tax court, so I wanted to make sure that they did their jobs.

Let's just start with the return. I'm going to give a basic overview of what happens when you file the return regardless of individual, LLC or Fortune 500 Company. You file the return. What happens? An individual actually goes through each return, believe this or not, and flips through and makes sure you have W-2s attached; makes sure, if you're claiming Schedule A expenses, you have Schedule A attached; Schedule D is attached. If you have any rental properties, Schedule E is attached. And they make sure that your return is complete and signed, and then it goes on to the next level. Now, this is a first level where I've personally gotten calls and letters from the IRS because I said I had a Schedule D, but I didn't attach it, so they gave me a call and I immediately faxed it. Because until you provide them with a complete return, including all schedules, it is not complete, in which case, if it is not complete and say it is now April 16th, it is late. That's why you respond immediately whenever you get a notice of any kind from the IRS.

Then, after it goes through this review, a person will actually input all the information into the computer. They'll put in name, social security number. They put in whatever you put on the income line; your expenses, so on and so forth because then what they do is match that information. They match that information with the information that your employer reported to the IRS. That is the easiest way to catch people and it is surprising that people still do that. Your W-2 income has to match because that is what the IRS is going to be using because that was what was reported to them.

After this, assuming that nothing is out of the ordinary, it then goes into another level where they have a checklist. They have certain guidelines for use in examining returns. So when you file your return, they'll be able to check that against the list. If you have $50,000 in income and you had $40,000 worth of mortgage interest, that's a red flag. Then they just add up these flags. Then, assuming enough flags have been added, it goes to a next level of review to an examiner who is actually going to look through the return and maybe this time start communicating with the taxpayer. This may be the first letter that you receive and it may just be Dear So and So, we are reviewing your return for this, this and this.

After this process, if it is not resolved, then it goes to the next level where an agent actually gets involved and maybe now it's, alright, you haven't responded or you haven't responded to our satisfaction, here is what we actually think that you owe and then they send out a letter you owe this. If you don't think you owe this, go to tax court. If you do think you owe it or don't want to go to tax court, pay us.

Question: Does any of that change at all if you e-file?

Jim Urie: No.

Question: When do you need a representative to get involved?

Jim Urie: It absolutely depends on the type of records that you have, the amount of time you have and what the issue is. I can't say it enough - just try to keep all your records for the same year in one place. Whether or not it is alphabetized or just grouped together, it just makes it so much easier.

The IRS is changing their examination methods. The IRS now has cycle times. Each step of the process is limited to a particular amount of time. So, for instance, the initial person may only have 30 days to look at the issue, contact you, receive your information, make a decision and then pass it on. But, that's not happening because what's going on is they write a letter - we think you owe or you forgot your W-2 or something, so you get it, you might be on vacation. Who knows? You get it, you look for the requested information, a week and a half later you mail it. By the time it actually catches up to the person who wrote the letter, they've already shipped it off, so it's now to the next person. And now here's your W-2 and here's your file. It's always one step behind and that's often the case because if people delay, even just a little bit, and they're not as persistent because, especially with business owners, you don't have time to be on the phone trying to badger the IRS. So that's why it depends upon the issue as to when you get a representative involved. Sometimes you can deal with the IRS via fax. If you can just fax something, great. Then you can handle it. But regardless, you might want to immediately advise your tax advisor/counsel because they may have a lot of the informa-

tion that you need. That may be another reason why you get a representative involved. But, at a certain level, at the preliminary level when you are just getting these preliminary notices, a lot of times individuals can handle it themselves, but then when you get into the repeated, hey, we're not getting anywhere, then I think it is time to get somebody else involved.

Lou Teti: One question on that, that Bob raised, another question I think some people might have is records. You said keep your records for one year in one place is what you said. You mean for a certain year. You don't mean keep your records only for a year, right?

Jim Urie: Right. No, thanks Lou. I mean if you just have a box of records covering several years, that is no good. You will want to keep records for each separate year in a separate box. Most of you probably do that already and are probably even more organized than that, but you'd be surprised at how many people just commingle years. It gets especially more difficult if your business is on something other than the regular calendar year. Say if you have a January 31st end of year, it gets more difficult because, alright, which year am I in. Technically, I have a 2004 invoice, but it is really part of my 2003 year. But, definitely keep records separated. You want to keep them for, I think the IRS might even say on the website, seven years.

The IRS generally has three years from the due date of the return or the date you actually filed the return, whichever is later, to actually examine your return and then determine that you owe additional tax and send you a statutory notice of the tax. So they have three years. So this April 2005, the IRS just got done doing the 2001 year because the 2001 return was due April 15, 2002. So, three years from the due date of the 2001 return was April 15, 2005. It's often hard to grasp, but they only have three years from the due date of the return to look at it unless it is egregious and you forgot to report 70% of your income, then it goes into six years.

The audit process is complicated. Just to recap, it's file the return, you may get responses about the actual return, then that may progress into more serious notices which then progresses into the IRS actually doing a calculation and saying, we think you owe an additional tax, penalty, interest, so on and so forth. You either pay us or you have to go to tax court.

Now let's assume that has happened. You've gone, you maybe ignored the notices, you did whatever. Maybe you even agreed with them. Maybe you filed the return and you just couldn't pay. The next step is the IRS collection procedure. This is probably the most hated part of the IRS. The difference is that revenue agents are the ones that look for additional tax. Revenue officers are the ones that actually go out and collect the tax. When you get two of those side by side they are just totally different people. It takes an interesting individual to just go knock on doors all day trying to collect tax. Those people are the ones that have been accused of being a little too aggressive in trying to collect tax.

So, assuming that you owe the tax, then the IRS sends an automated letter. It's just a computer-generated letter. It might even be the same day that you agreed that you owe the additional tax or the day that you filed the return and actually put in that you owe additional tax and it's not attached. The letter comes out, dear so and so, you owe us X in tax, Y in interest and Z in penalties. And you'll get that and you'll ask what is this? Where is this from - 2001, 2002? It can catch you off guard. Perhaps you made payments and maybe the IRS didn't credit the payments correctly. So you get this letter and it says you owe tax. What do you do now? This is where you might want to get a representative involved a little more quickly because this process goes much faster and it's more severe. What happens is they start sending you these computer-generated letters. You try to call them and you just get bounced all around a lot of times. But, if you're not responding quickly enough, another computer generated letter goes out that says, alright, you haven't been responding and now we're just warning you that the IRS has sharing arrangements with states so if you have any state refunds, we can automatically just take those. They're already going to take your federal refunds if you had any. They're just going to start grabbing them to pay off this tax. Now they're saying we're going to levy on those state refunds and at the same time we're also looking for additional assets that we can take. And that's the second threatening letter.

The next letter is usually sent certified, and says, alright, you haven't been responding and here's our notice that we just filed a federal tax lien against you. So now they just filed a federal tax lien against you, or the notice might be, hey, we just filed a levy against you and in fact in thirty days we're going to go levy your bank account at so and so bank. Alright, then what?

Well, then you now have some procedures available where you can actually appeal these letters. You can actually say I don't agree with this. This is not my tax. I don't know what's going on here. You can actually appeal and go through an administrative process and have the IRS look at everything to make sure that everything has been done correctly. It might be that you were never credited for a payment. You can also dispute the tax. You can say, I was in a rough time then. I didn't respond to your original audit notices, but now I want to cooperate. A lot of times the IRS will be more flexible. The problem is you've got to respond. You have to go at them and give them options because they may have a lot of leeway here in what they're going to do.

There's also another alternative. You can appeal to the tax court and they can make a decision of whether or not the lien or levy was appropriate, but it's rare that they say it's not appropriate.

Other collection alternatives include the offer in compromise process, which is actually where the IRS will compromise the tax liability. You owe $100,000; they may compromise for $10,000. They may compromise for $70,000, $99,000. There's a formula they run through, but there's a form that you fill out - 656 Offer-in-Compromise Form. You don't have to know the name of these forms. Basically, what you do is put what year or years you owe tax. You put how much you owe. Then on the back they want some financial information. Okay, well how much do you make and what kind of assets do you have? What is your earning potential? How old are the taxes? Then they do a calculation and they say, okay, well you owe $100,000 tax penalty and interest, from what we see, you can't full pay the liability nor can you full pay it even if you made installment payments for the next eight years, however much is left on the statute of limitations, which I'll get into later. So they say, okay, this is what we think that you can afford. We think you can afford to pay $24,000 over the next four years to pay off this $100,000 liability and you can say yes or no. That's your option. But, I've seen that a lot. It's actually a good process.

Question: Does that affect your credit at all?

Jim Urie: Depends if there's a federal tax lien. The IRS reports taxes owed based upon the federal tax lien, so that's going to just affect everything. A lot of times banks, if you have a federal tax lien, won't even touch you as far as mortgages and so on and so forth.

Lou Teti: And we aren't at the point yet where they've gotten a federal tax lien in your process.

Jim Urie: You may be or you may not be, but normally when you are at this process you're not. You're still negotiating. You've kind of said, you know what, I do owe it, but what can I do about it? How can I compromise? How can I pay a little bit less?

Also intermingled in here will be perhaps additional penalties on there that you disagree with. You may be able to negotiate with the IRS on penalties. There was just a notice issued by the current Chief Counsel a couple weeks ago - Chief Counsel is the head of the legal division of the IRS - that too often the IRS was bargaining away penalties, so it may be a little more difficult now. I don't think so. So you have another option to try to get rid of some of the penalties.

That's basically the offer in compromise phase. Maybe it was accepted, maybe it wasn't. However, one problem with the offer in compromise, not problem but one issue about the offer in compromise phase is that you're making an agreement with the IRS. The agreement says IRS, I agree to pay you $24,000 over the next however many years or maybe in one lump sum, you agree to eliminate the rest of the tax. I further agree that I'm going to file returns for the next five years, going to be absolutely compliant, I'm going to make all estimated payments, I'm going to do everything I have to do to stay in compliance. IRS then says, and you then agree that if you don't remain in compliance, then all that tax we said you didn't owe comes right back. And that's a big hang-up for a lot of people, especially as business goes up and down. Sometimes you may not be able

to make an estimated payment so it is difficult to remain compliant. But you can communicate with the IRS, and they'll normally at least give you an extension to get those payments in and will try to work with you.

Question: What's the normal amount of time for that phase, the offer in compromise?

Jim Urie: The official IRS timing is six months. The actual timing on average is 18 months to three years.

Lou Teti: Jim, can I ask you a question? A lot of these people are business owners and sometimes they don't get their withholding taxes in. Are withholding taxes treated any differently than income taxes in terms of how the IRS looks at whether they've been paid or not?

Jim Urie: No. As far as the quarterly, they want to make sure you make those quarterly payments on time. If not, the IRS charges an estimated tax penalty.

A lot of times people go into the offer in compromise process because when you file an offer in compromise, it basically stops the IRS collection efforts in its tracks. If they are threatening - we're going to start levying and we're going to file a lien on your house - normally it stops them from taking that action. When you go in this phase, they want everybody to be working together. They can file a lien to "protect" their interest, but I never saw that when I was there. That's also the reason why some people go into it, is to stop the process, to get on their feet, because in essence it takes 18 months, which means you have 18 months to get on your feet. So sometimes you can use the offer in compromise process to your benefit if you are really dealing with the IRS and you just want to stop the collection efforts. Since it takes them so long to process everything, by the time they get back to you, you might be back on your feet and decide to pursue another collection alternative, which I'll segway into now - the installment agreement.

It's just like a loan. You owe $100,000. I can't pay it now. How about I pay you over the life of the collection statute of the tax. Then they come out with a payment formula, like pay us $500 a month and you keep paying that until the tax is paid in full. Again, that stops the IRS in its tracks with respect to collection because they're not going to come after you if you're making installment payments because they're getting paid and that's part of the agreement of going into the installment agreement. I guess one thing I should mention as I've been touching on it, is this collection statute. It seems like the IRS can come at you forever and that's not true. The IRS can come after you in general, for ten years from the date that the tax is assessed. An assessment is a term where the IRS puts the tax on the books. You file your return, you owe an extra $2,000, the day that it is actually assessed and put in the books, that is the date of assessment. The IRS has ten years from that date to collect that $2,000 and then any penalties and interest that are associated with that. Now, it seems sometimes that the IRS can come after you forever because certain things you do extend that period. People think they can go into bankruptcy and stop the IRS. Well, you go into bankruptcy, unless your tax is completely discharged in the bankruptcy, all that does is just stop the IRS. Basically, they just stop the clock and so they tack on any period they could not collect against you. So if you are in bankruptcy three months, they just add three months to your ten-year statute. So they are always going to have ten years no matter what. You go into the offer and compromise, the day that it's filed and they look at it, the date that is done stops the clock. Congress said, since the IRS cannot collect against you, they shouldn't be hurt by it, so the statute was extended. Same thing with installment agreements. While you're making those installment payments, the IRS isn't coming after you; therefore, the statute gets extended. So that's another consideration you want to keep in mind when thinking about offers in compromise and whether or not you want to go into any. That's basically the collection process. I could get in more detail in one aspect or another. Does anybody have any questions?

Question: Backup withholding. Do they normally just do that when you haven't filed? Backup withholding. When do they start that and why?

Jim Urie: It's usually because you haven't filed. A lot of times they'll do it based on past history.

Also, the IRS has made certain business decisions concerning at which level they will consider

examining. If you earned less than $40,000 or your clients earn less than $40,000 with W-2 income and you didn't file a return, the IRS has an inside policy where they don't care. Because most likely you have enough withholdings and you have enough itemized deductions that you're either going to be entitled to a refund or you're going to owe maybe $100. But, the process is expensive to the IRS because there are just so many man-hours involved. Time that they could use to go after somebody else.

They just recently switched. When I left, the IRS said they were going to go after people who make over a quarter million dollars and don't file returns. Why they don't do that all the time, I don't know. But, that's the new program.

Now, I don't know how many are practitioners or deal with the IRS or anything, it's probably just me, but let's touch on Circular 230. Circular 230 are the regulations that the Treasury Department, with the IRS, have promulgated to explain how they want tax practitioners, people dealing with the IRS, to act and practice. It defines the type of people that can practice before the IRS and people that can't. Lawyers can. CPAs can. Then there are other people, called enrolled agents, who is basically any individual who passed a test administered by the IRS. It tests your knowledge of the tax procedure process. If you pass it, you're an enrolled agent. You get a number and you can start representing clients in dealing with the IRS on behalf of your client. One important thing about Circular 230 is that it has been recently altered and amended a little and this may affect some people here. A few years ago, and actually I was working on it before I left, there were huge tax shelters that were resulting from the heyday of the stock market in '99 and early 2000. This particular tax shelter was being sold by accounting firms and law firms. What these law firms and accounting firms were doing was they were taking advantage of a specific provision in the IRS Regulations which says, in essence, with respect to a certain penalty, you owe a penalty unless you can show us you had reasonable cause. That's basically what the statute says. Well the thing is, I don't know how it got in; the regulations say that you can show reasonable cause if you had a legal opinion that said that this was more likely than not to result in favorable tax treatment. So, this tax shelter is just littered with these more likely than not opinions, because everybody just said, oh, more likely than not. The IRS was sick of those. I was sick of them. Because they all said the same thing. Some firms sold 3,000 of these. The only thing different was the name of the taxpayer and the amounts they were trying to shelter. So, the IRS just got fed up because the taxpayer was relying on these forms more likely than not opinions. We looked at it and we're like this isn't a legal opinion. This is just a marketing material. Well, what the IRS and Treasury have done as a backlash, is amend Circular 230 and say to practitioners, you're more likely than not opinions, they don't apply anymore. If you're going to offer a more likely than not opinion, then your client won't get the benefit of this favorable provision in the regulations that says if you have a legal opinion, you're not subject to the penalties. So they changed it. They said we don't like these more likely than not opinions and if you have one, it's not worth anything. In fact, they're going back through the process now and they're going to amend that regulation.

Let's go into other ways to use the IRS to your advantage and this is with private letter rulings. There are tax help lines. There are a whole bunch of different administrative procedures now. Even the IRS website is tremendous now. They've gotten into the information age and, in fact, I went last night and Googled Circular 230 to see when the final regulations are going to come into effect. In Google, you put Circular 230, the IRS is the first thing that comes up, so they are actually spending some money to go up the ladder on some of the search engines. The website has a wealth of information where a lot of times when you originally get contacted by the IRS, you can go there and find specific information. You can find past forms. You can find contact information. If you need to fax something somewhere and you don't remember what the number was, they have fax numbers all over the place. With the availability of the information there, it's tremendous. They also have on there all public information that was released by the IRS. When I worked at the IRS and somebody asked me a question in the field, an agent said, is this taxable or is this not, I would render an opinion. That opinion would then be published. We would take out the tax-

payers' names, but all that stuff is available on the IRS' website.

Another tool to use are private letter rulings. Mainly these are used by big corporations who are trying to determine whether or not a particular merger was a tax-free merger under IRC 368(a)(1)(A). They would say, okay, let's get a preliminary ruling from the IRS. So they would write down the facts, write a letter and say, IRS, based upon these facts, is this a tax-free transaction? And the IRS would respond. Based upon these facts, yes or no. Normally you tailored it so it was a yes and if it wasn't, you can go back and forth and this is like the old days. You go back and forth. What if I changed this? Finally, they would help you structure the transaction to what you needed to have in order to have it approved. Well, that's great. You get your blessing before-hand. You go ahead, you do the merger, you just attach this letter to it. The IRS says they are not bound by it. They'll disclose that all over the place. They're not bound by it. The reason they wouldn't be bound by it is because if you left out a certain fact. Now, how does that help you? Well, the private letter ruling process also deals with estate planning. If you're thinking about doing some kind of an organization, family limited partnership or something, and you're just not sure if this is going to work, you can go to the IRS and ask them.

Business transactions. You're trying to set up a retirement plan or something, and the IRS gives you forms about how you can set up your own retirement plans for your company, but you're not sure if it will qualify. You can request IRS advice. I'm going to pass it off to Duke now, because he has had some experience with using a letter ruling to save a client a large amount of tax.

Duke Schneider: Sure. Just to follow-up on what Jim was saying. Private letter rulings can be used in what I would view as being pro-active or re-active. So you can say, you know what, I want to do something, but I'm a little cautious about this. It seems like a really good idea, but I'm concerned that we may do something wrong and run afoul of a certain tax regulation and really get into trouble, as there's a lot of liability if we're wrong. If we're right, that's good news and actually the IRS is there to give us help and offer us guidance. An example of that would be I do a lot of charitable tax advantage planning. Let's say I want to do a charitable trust and I have a client, oftentimes they are putting securities or land or something in. Let's say we have some sort of unique asset or they want to trade options or something like that inside a charitable trust. You could actually go to the IRS and say, if I have client X who wants to create a charitable trust, the charitable trust wants to hold this type of securities, is that okay, and the IRS will tell you, well, under these fact circumstances, that's okay. And then the client can do it. Now, one of the issues you have though, it better be for a big money type thing because a cheap private letter ruling would have to be seven grand. To go through that process with your accountant, with your attorney, it's going to be an expensive process so usually you're not going to do it if it's just some small issue or the dollar amounts involved in the transaction aren't that big because it is an expensive process. The reactive situation, I ran into a big one where, I'll be talking about choice of entity next, this is a nice lead in, that we had a Subchapter S Corporation. Your Subchapter S Corporation offers a lot of good tax advantages, which we'll get into, but one of the negatives of an S Corporation is that it has limitations. There can only be so many shareholders and the shareholders can only be certain types, so you can't have certain types of entities own S Corporation stock. One of the examples here was trusts. A trust may not be a shareholder of a corporation unless, of course, there's always an exception, it's one that's called a QSST (Qualified Subchapter S Trust) and there's various things that trust has to allow and has to be drafted in order to hold S Corporation stock. So, I had a situation where - I inherited this. Thank God I was not the one who did this. But transfers of an S Corporation were made into a series of trusts for the benefit of client's children. When I reviewed the trusts, I had that "uh-oh" moment, and said uh-oh, we've got a problem. We were concerned that we hay have blown the S election. The resultant tax liability in this case was about $3.5 million if the S election were blown. Now the good news is there's a regulation which gives you a five year window where you can automatically go and say, oops. It's called the inadvertent election or inadvertent termination. You can fix it. Of course, we were two years beyond that, so like every other

fact in this case, it was getting worse and worse. So, we were left really with no choice but to go get a private letter ruling and say, here's what we'd like to do. I went to court. It was an irrevocable trust, so I petitioned to amend the irrevocable trust just to make them qualify as QSSTs. That was granted. We then got a private letter ruling with the IRS saying here's everything we've done, it was inadvertent, could you please tell us that we've not blown our S election. We paid a pretty price, because I also had in my corner the top Subchapter S person in the country. One of the guys who wrote the Subchapter S regulations works for a big four accounting firm. They keep getting fewer. Big three. I had this guy as co-counsel on the side just for his name and expertise. His office is right across from the national office in DC. Because of the huge numbers involved, it was that significant a case. The good news is we got a positive private letter ruling. So we were able to fix everything and not be treated like we'd blown the S election. So, there's an instance where we had to pay a little bit of money, but it was a heck of a lot better than just letting it go and it being caught on audit some time in the future. And you say, gee, how would they ever know? Well, the risk here was on death because on death all those trusts would have been disclosed. Someone peaking through could have put the trusts own stock in this company but waited and if that had come up, it could have permeated through everything and just been really quite terrible. So, there's a situation where we used it, is a reactive measure saying, uh-oh, something happened, we need to fix it, can we fix it, and it actually worked out real well. The process itself is actually interesting and per IRS procedures is pretty streamlined. It was reasonably quick. The people we dealt with at the IRS were really good. So, maybe at that level things work out pretty well.

Question: In a more simple case, same situation, say they want to own a valuable piece of art. That comes up again. Can you either use that first one as a guideline?

Duke Schneider: It depends. We in practice use private letter rulings to say, look, here's ten private letter rulings Mr. Client, right on point. So, you have a choice. You can pay $7,000 and we can get an identical private letter ruling and I would have a client sign a letter saying, I've told you that these private letter rulings are not precedential, meaning they can't be used to say, well, look IRS, you said this here and it should apply for me because I have the exact same circumstances. So you can ask the IRS on one day the same facts mean this, well the next day it changes. And they are allowed to change their mind. So, what you do is you have a ton of private letter rulings right on point, I would advise the client that, hey, it looks good. Yes, you should get a private letter ruling, but that's going to cost money. Are you comfortable going forward on this and what are the pros and cons? What are the risks of doing that because you have to be careful. Again, you may not cite a private letter ruling as precedent for an action you're taking, but in practice people use it to sort of monitor which way the IRS is going. And, if you've got a ton of private letter rulings on point, a lot of practitioners are at least comfortable in proceeding with the strategy.

Jim Urie: Just to add onto that, the IRS actually looks at them too. When I was there, there was a big push by the Chief Counsel toward public guidance. He was very into informing taxpayers to know everything they need to know about the tax. He said if you have an interesting question that you think might be just here, bring it up to our level, down in Washington, D.C., the national level, and we'll do a public ruling.

Duke Schneider: You'd do a TAM, right?

Jim Urie: Yeah. A TAM, a TEAM. That was the new one.

Duke Schneider: The Technical Advice Memorandums. Those you may cite as precedent, right?

Jim Urie: Right. And part of that was private letter rulings. The IRS says we're not bound by these, so on and so forth, but in practice they really were because that's published guidance. It's guidance out to public to say, hey, this is how it's supposed to happen. This is what we think it would be, and with that particular Chief Counsel, he wanted us at the IRS, to rely on them. We needed to look at our own guidance to make sure that we were following what we said we

were going to follow at that particular time.

Duke Schneider: The other shift I've seen, which I've liked, is the toughest thing to do as a planner is to plan with uncertainty and you see stuff all over the place. So, the one thing I do like for example, in the charitable world and I do a lot of charitable tax advantage planning for clients, is there was a lot of abuses going on with I'll call them scams with setting up certain insurance things and different things with charities. And the IRS, knew it was borderline, you knew as a practitioner, you knew they were going to come after this. Well, the IRS came out just in the infancy of this and said, look, we can't do anything to stop this now, but we want you to know we are putting together the strike force. We're coming after this and not only will we, from the day we enact it, we will absolutely look back and we'll go after anything from the beginning of time so it's out there world. We're coming after you and it really sort of kyboshed this technique right in its infancy and that's sort of one of the first times I'd ever seen them come out and say, we're coming. We're going to be rolling out hot on this and if you think you can sneak it in before the window closes, you're wrong because we're going to open the window back up and grab you and really hammer you. So, it actually made planning a lot easier. I have no problem with aggressive planning within certain parameters, but this idea did not pass the smell test at all. And all of a sudden our clients started calling us saying, hey, we've heard about this great idea and you don't have the two hour conversation, you know, is it good, is it bad. You can say here the IRS is pronounced, they're going to hammer this. So, it's nice in our area of practice to actually have guidance from the IRS so we can advise clients what to do. Choice of entity?

Duke Schneider: Okay, choice of entity. Whether we're talking estate planning, tax planning, which is usually sort of all intermingled. What we choose as our business entity has very big effects for the type of planning we're going to do. Just to take you on a brief little, and again this is going to be…a lot of you are going to sort of know this already. But by way of review, one of the first ways people operate business is as a sole proprietorship. If you are a sole proprietorship, everything runs through your personal income tax return. You're going to file Schedule C. What's the good news about sole proprietorship. No separate tax return. Everything is on your personal return. From a planning a corporation standpoint, what we worry about are there liability issues. Are you transporting gasoline which could explode? If you're in a more dangerous business where there's liability issues, well, gee, you might not want to expose yourself personally to liability and what a corporation gives you is limited liability, because if everyone had personal unlimited liability, business in this country would have never prospered because no one would take risks. No one would risk everything they had by exposing them if their business they could look through. On a sole proprietorship you can have that unlimited liability. So there is riskiness with being a sole proprietorship. But, from an income tax standpoint, life's easy because it all passes through on your personal return.

If we look to incorporate, why do people incorporate? Well, one of the obvious main reasons is that liability protection. A corporation gives you limited liability. In other words, your liability is limited to the assets of the corporation. So, if we're going to decide well, gee, we want to incorporate, is there any other estate planning advantages? And the answer is yes because I have clients who have actually significant multi-million dollars worth of a proprietorship and now we have a son or a daughter involved in the business and we want to start bringing son or daughter in the business and giving some of the business. Well, if you have a fleet of oil trucks, for example, and you're selling fuel oil, what do you do? Put a few trucks in his or her name? It's hard to gift away a proprietorship. So, what a corporate entity does is, of course, now your assets are represented by a piece of paper, whether it's a stock certificate, a membership certificate in an LLC or a limited partnership interest. We can actually fractionalize our gifts, meaning I can give my son three percent and my daughter three percent of my entity. So we can start to do gifting, whether it's on an annual basis, whether it's much larger gifts, it lets us do that. So, from an estate planning perspective, we certainly like planning with corporations better than proprietorships. It also lets us, and I don't want to get too into this because it's not for today's

focus, but it lets us, when we do those gifts, when you give minority interests in corporations or partnerships down to other generations, we can discount that. In other words, the IRS knows that if I have a company worth a million dollars and I give someone 10% of that, that's not worth a hundred thousand dollars. Unbundled it would be. If you took 10% of the assets and sold them, that's worth a hundred thousand dollars. But, if I'm a 10% shareholder in a corporation, I can vote, but I'm a minority shareholder. So you can get a minority interest discount. If you're in a family held business, it's probably not very marketable. Not your 10%. So you can get discounts that range anywhere from 15% to 50% depending on a whole host of factors, but we can leverage our gifting. So now, if I'm allowed to give $11,000 per year per person, I can give $20,000 for a value of eleven, so this is an area that the IRS hates and the discounting valuation, there are whole units at the IRS that do nothing but wage war against the light side who helps families work and discount their gifts and pass businesses down inter-generationally so the bad guy can't get us. That's the whole little game that the dance that we sort of hybrid corporate estate planning attorneys play with the IRS.

Having a corporation allows us to do estate planning transfers a lot easier. From an incorporation perspective, there are generally two/three types of corporations. From a traditional corporation, you have a Subchapter S or what we call a regular C Corporation. C Corporation is your traditional big companies are all C Corporations. Every corporation has shareholders, but here the taxation with a regular corporation or C Corporation, you have double taxation, meaning shareholders receive dividends. They are taxed ordinary income on their dividends. The corporation pays a corporate tax, so there's sort of two layers of taxation. That's bad. The quid pro quo is that a C Corporation, if you're going to incorporate, has an access to a whole plethora of benefits. In other words, they can get deductibility on any programs or benefits they want to put in. So, you can do all the health plans and this and that and the next thing, that's all there for a C Corp. and the IRS is going to let you take the deductions because they know they're getting you hit with the double tax. So, if I'm just a sole proprietor or two or three guys or gals wanting to form a business, what am I going to do? Do I want to be a C Corp.? Probably not, unless you're going to grow to 8,000 shareholders and it's going to be a company, but you can always convert later. What you want to do is incorporate and make the Subchapter S election. What that does is let you have flow-through taxation. So, what's going to happen is there is no layer of corporate tax, so Subchapter S tax returns says we earned a million dollars, we have ten shareholders. Each shareholder gets a K1 distribution of $100,000 and that goes on the shareholder's personal income tax return. I guess the IRS then want to match is are the K1 information on the 1120s, which are the S returns, are they matching the K1 information on your personal return and I guess sometimes, shockingly, those don't even match.

Jim Urie: You know, interestingly, they actually created a program right after ENRON because everybody had these leverage partnerships and K1s all over the place. They actually created a program, it's a K1 matching program, to do exactly that. But the IRS said the program doesn't work anymore. So, they really don't have the K1 matching program anymore. They do, but they don't. They actually now have to go get the return and they have to look at the K1 and make sure that they are actually flowing through everything. Whereas before they just had this little matching program and simply had to push a button.

Duke Schneider: So, the only thing with an S Corp., and that's why I've sort of harkened back to my private letter ruling, if you're an S Corporation, that is usually the best thing from an income tax perspective. But, from an estate planning perspective, you must be very careful when you plan with S Corporation stock. Usually if we're just giving stock down to children assuming we don't have 500 shareholders which couldn't happen if we're an S Corporation, but generally we can just give that to people. The issue becomes what if I want to gift it in trust for my children, then you just have to be more careful. You can definitely plan with it, it's just if you get someone who doesn't know what they're doing, you can run yourself into a real big problem which was part of my example. So, my only message to take out is if you're an S

Corporation and if you're going to do estate planning or transfers with an S Corporation, make sure you're talking with your accountant and your attorney prior to actually making any transfers.

Now, one corporate entity which everyone loves to talk to us about, that really has just exploded in popularity, is the limited liability company. Why is this sort of a win, win, win? Well, limited liability companies are very flexible. And the IRS will allow you to elect how you want to be taxed, and this is very unique. There used to be all these tests as to what type of entity you really were. Sort of a four-prong test. The four-prong test has been replaced with what they call the check-the-box regulations. So, say I'm a corporation. I'm going to be taxed as a corporation or as a partnership? So your LLC can actually be taxed as a corporation or check the box and elect to have that flow through taxation which, normally in 99.8% of the time, your LLCs are electing to be taxed as a partnership, which gives you that flow through, K1 taxation. The good news is it also gives you limited liability. So, everyone's using them and they have less corporate formalities, meaning there's not as strict requirements from a liability perspective that you keep annual corporate minutes, that you have certificates, that you have a corporate book. Just so you know, at least for our clients, we do all that. I think it's good practice, but technically the strict corporate requirements or corporate maintenance requirements are not there for an LLC like they are for a corporation. From a practice perspective, I'm pretty sure we all do that - treat it the same way. The LLC, from an estate planning standpoint, is awesome because anyone can own an LLC interest. So, it takes us out of that S Corporation worry and that's why, from an estate planning perspective, we use LLCs a lot.

Last thing with an LLC is that what if I'm a single person, not as in married or not married, but if I'm a sole person who wants to establish an LLC, can I do it? The answer is yes, you can. In Pennsylvania, especially, you can have a sole member LLC. Sole member LLCs can actually be treated as a disregarded entity and taxed through to your personal return. So you don't have to get a K1 or file a separate LLC tax return, you can just put it on your personal return. You can again treat it as a disregarded entity if you're a sole member. If you are a husband and wife, you can't do that. I get that question a lot. Husband and wife want to buy rental property. Duke we want to be 50/50 members. I say, oh, that's fine. We can definitely do that. They say, can we just pass it through our personal tax return? Can we disregard it? The answer is no. If you have two members, you got to file the tax return, so you may then want to have it just in the husband's name or the wife's name if that is okay with the couple. So, that's just sort of a planning consideration.

The last thing, which I just mentioned, is a partnership. There are generally two kinds. General partnership and a limited partnership. The general partnership, again, has that flow through taxation, but does not have limited liability. So, if you're a partner, you have complete liability for every liability or every issue of what happens with any of the partners. There are special types of limited liability partnerships and stuff, professional corporations, which try to take some of that liability away, but the best way to get out of that is to create a limited partnership where the limited partners have limited liability and flow through taxation. We tend, in Pennsylvania, to use limited partnerships to own real estate a whole lot. Just for that reason because we preserve all the good income tax deductions an individual gets with real estate, yet we have a nice liability, a protective shell, around real property. And, it is not subject to the capital stock tax which LLCs and corporations are. But, for an operation entity…if I'm running my company, we tend not to use limited partnerships, we tend to be using LLCs, S Corporations, on rare circumstances C Corporations, depending on when it's going to grow. The other thing is if you are working with a professional, it's always good I find to talk, where is your company going? Where is your three year, five year, ten year game plan, because you may start as a certain type of entity and want to convert and when you convert either from an S to a C or a C to an S there are definite tax issues which you have to face. So, it's always sort of good for your planner to know where you're sort of heading with this to make sure how we structure it won't sort of box us into a corner down the road.

Question: When you have a one person LLC, could you still

subcontract? Let's say you need some secretarial help, if they were part-time, could you still exclude them?

Duke Schneider: That's an expense of the LLC. Again, your withholding tax rules I guess depend on whether they truly are. You could do a three hour seminar on what is an employee, what is a subcontractor. The IRS has been all over that too. So, if you truly have a part-time person you are just paying a wage to, that's an expense, or I shouldn't use the word wage, that's just an expense of the LLC which you're going to deduct out and treat it as whatever - secretarial expense.

As we consider time, what we're going to do is I want to talk a little bit about succession planning. We're not going to talk about exempt organizations, but that's actually…that's why we put it at the end because of something's going to fall off, that's….

Lou Teti: About two minutes.

Duke Schneider: Okay, so I can give you the two minute course on succession planning.

Lou Teti: Actually, if I may, I'd like to interrupt. I'm sensitive to everyone's time, but if I could pick up succession planning for a second, it gives me an entrée into what I want to mention about the firm.

First of all, I wanted to thank the people at the firm who are here and helped put this together. Britt, John, thank you. We also have Tina Cortese, one of our esteemed paralegals who does a lot of our estate administration. Tina's with us. And also one of our law clerks, Duie Latta. They are back there too. You can meet them on the way out.

We talked about succession planning at other morning seminars, and, actually, many of the things that Jim and Duke talked about regarding succession planning raise certain issues that I wanted to point out in closing to you regarding our firm and the services that we provide. MacElree Harvey is a firm of 23 lawyers. We spent a lot of time in these meetings talking about the areas in which we practice. I mentioned Duke, Jim and myself, Joe Bellinghieri and Harry DiDonato, who many of you know. Harry is involved in the corporate side of the practice predominately, and does a lot of our corporate real estate work. We've got Pat Scott, one of our associates, who works with him. Plus, as I said, we've got approximately 12 or 13 other lawyers who do a full spectrum of things including general litigation matters, domestic matters, criminal matters, bankruptcy issues on the debtor's side and on the creditor's side. So we have a whole host of attorneys who can pretty much service anything that you would like us to service.

With respect to succession planning, I wanted to mention that many of the things Jim and Duke talked about today generate questions that we didn't talk about. Duke was talking about gifting stock or gifting LLC interests, to future generations. Lots of things come up that you need to be sensitive to. You're going to give a child an interest in an LLC. Maybe the child lives in California and doesn't have anything to do with the LLC, but you want to start doing that wealth planning to try to get it out of your taxable estate tax. So you give it to a child. That child may be married. The child may be getting married and the child may be inheriting a lot of wealth from you. You may want to talk to the child about prenuptial agreements. They may not want to hear about it, but there are a lot of issues that go with giving that child an interest in your business or your entity. You may want to get the child to sign a buy/sell agreement. Most times, I would strongly encourage that you have something that says that if things go amuck, you've got a way to get that interest back, either through a purchase or some other method. The buy/sell agreement is a critical element. It's always wise to keep in mind that just as you go to the doctor to get a medical checkup every so often, it's a good idea to get a legal checkup. We don't advertise that, but we try to encourage our clients to do it and we send them a letter each year which says have you done this, have you done that? The reason why we're asking those questions is because, depending upon your answers to those questions, there are things that you should be doing, or think about doing, to make sure that you haven't run afoul of IRS regulations. You may have made a gift. We see it a lot of times in that regard. We talk to a client initially and then several years later they come in and say, by the way, I gifted the house to my children because they told me that I was going to do that because somebody said something about Medicaid, so I went to a title company and changed the deed. Without

even thinking about the ramifications of the gift tax, what the value of the house was, what the child's basis would be in the house when he/she sells it. There are many issues. But my point is that if you keep in mind the fact that when you do something like that, it's not a bad idea to touch base with an advisor to make sure you understand all of the ramifications. We're always happy to help in any way possible. The reason we bring it up is because, just as in medicine, preventative legal work can save you a lot of dollars down the road.

I will now ask Jim to select the winning entry here so that he can be blamed.

Duke Schneider: And you have to report it on your income tax return, Jim? Gambling winnings.

Lou Teti: What is our prize, by the way? Britt. A gift certificate to Turks Head Inn, a restaurant in West Chester. It's going to go to Albert Masciangelo. Congratulations.

Does anyone have any closing questions for Jim, Duke or me before we conclude?

Question: Is there a problem with commingling funds of an S Corp. or an LLC with an individual?

Jim Urie: From tax perspective?

Question: Either tax or accounting, maybe both. Is there a problem if you pierce the corporate veil of an S Corp. because they commingled funds?

Jim Urie: That's an absolute possibility because you're supposed to keep them separate. But from a tax perspective, it's also maybe not a good idea because if you are using the same account, then they can always, if there's personal liability here, they go after this account. I don't know if the account is titled in your name or in the corporation's name, but depending upon what's going on, they may levy one account for either reason. Liability for the corp or liability for the individual. That's why you would want to keep it separate. Also there are checklists with the corporate veil. Just forming companies, like Duke was saying, doesn't automatically mean that you're forever not liable. You have to follow the corporate formalities. You have to do corporate minutes, keep corporate records every year because that is part of the requirements under the statutes, depending upon what state you're in, for a corporation. So, if you're not following those, then you can always run the risk of perhaps that being pierced, piercing the corporate veil, and saying, okay, well it really wasn't a company. Now we'll go after the individual. So that's why you've got to keep the records separate and make sure you don't just incorporate and forget it. Like that guy on TV that said "Set it and forget it." You can't just incorporate and forget it. It is a separate entity. You've got to treat it as a separate entity or else they will be commingled. The IRS probably has a better shot at doing this than other people because, in my work a lot of people were doing that. They were commingling funds. They were constantly switching. The IRS was going after here. Well, they sent me a levy notice with respect to Jim Urie Enterprises, well, I'm going to set up JB, LLC and I just move the money over there. Well, they would just follow it there and they would just keep going and going and going. I really wasn't following any kind of formalities except for just try to keep ahead of the IRS. So you've got to make sure that the corporate formalities are followed.

Lou Teti: One last question.

Question: First of all I want to say thanks. I really like these sort of things. I heard about it through your e-mail notice. Do you do them regularly or do you plan them one a month?

Lou Teti: We do four a year, and generally they're held every three months. We do them in conjunction with the West Chester Chamber of Commerce, right here at this location. Thank you for reading the newsletter. We're getting some good comments about that. We try to keep everyone up to date.

I want to thank everyone for attending. We appreciate your support, and hopefully you found this to be interesting. If you have topics that you'd like to hear about, let us know and we'll consider those topics for future seminars.