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WHAT IS HAPPENING WITH THE FEDERAL ESTATE TAX?

By David M. Watts, Jr.

George Steinbrenner, owner of the New York Yankees, recently died leaving an estate worth $1.15 billion. How much in the way of death taxes is Mr. Steinbrenner's estate going to pay? In all likelihood, his estate will pass to his heirs free of any death taxes, which otherwise could have approached $500,000,000. This is because during 2010 there is no federal estate tax, and his state of residence, Florida, has no inheritance taxes. 2010 is proving to be a good year to die for very wealthy people who want to minimize their death taxes.

At this point, it is unlikely that Congress is going to impose any federal estate tax during 2010. In part this is because of constitutional issues relating to retroactive application of taxes, but also because Congress seems to be unable to take any action, and with elections approaching, the situation is only likely to get worse. The downside of Congressional inaction is that the federal estate tax returns on January 1, 2011, at the 55% rate, and a $1 million exemption. Thus, it is somewhat premature to be eliminating the unified credit trust planning that many of you have in your estate planning documents.

The lack of a federal estate tax in 2010 is not entirely a good thing for some estates, because this comes at the price of a limited date of death basis increase with a single person entitled to a $1,300,000 basis increase and married people entitled to another $3 million basis increase at the first death. However, there are some estates that will have insufficient basis increase to allocate among the estate assets, and there is a complicated process for allocation of the basis increase, particularly if there are non-probate assets. Further, in some cases, the lack of the basis increase will cause an estate to pay more in the way of capital gains tax than it would have paid in the way of federal estate tax.

Notwithstanding the lack of a federal estate tax in 2010, there is still a $1 million limit on the amount of gifts that can be made during one's lifetime. Nevertheless, with the virtually certain return of the federal estate tax, lifetime gifting in excess of $1 million may prove to be advantageous because of the current relatively low 35% gift tax rate, and because the payment of gift tax further reduces the amount of the taxable estate (unlike the case with respect to the federal estate tax, which does not reduce the taxable estate) And, of course, it is always prudent to make full use of the annual $13,000 per person gift tax exclusion.

The current federal estate tax situation makes death tax planning very difficult. Nevertheless, it is important to review periodically the status of your executors, trustees, agents and guardians, to make sure that the persons designated for those tasks are still appropriate. In addition, Pennsylvania has recently updated its laws concerning health care powers of attorney and living wills, and everyone should consider bringing those documents up to date. Once Congress has made up its mind about the federal estate tax, we encourage you to have your documents reviewed, particularly if they are more than five or six years old. ■

David M. Watts, Jr. is chair of the McNees Asset Planning and Federal Taxation group.
717.237.5344 / dwatts@mwn.com

ESTATE PLANNING AND MARCELLUS SHALE

By J. Corey Reeder

It seems as though scarcely a day goes by without some commentary surrounding the Marcellus Shale formation and the extraction of the natural gas contained therein. However, in most of the articles, blogs, and postings, very little time is spent discussing the impact that drilling wells will have on a landowner's estate plan. It has always been good practice to review one's estate plan in light of either significant changes in the law and/or significant changes in one's personal life in order to make sure that the estate plan properly provides for the distribution of assets and minimizes any death attributable to the estate. Owning real property that contains desirable Marcellus Shale would certainly qualify as a significant change in a person's life given the potential increase in wealth both presently and in the future. From an estate planning perspective, one of the first items to determine is whether the ownership of the gas rights is properly structured to most efficiently distribute the real property and accompanying gas rights upon death and take advantage of estate and inheritance tax planning techniques. In Pennsylvania, gas rights are completely severable and thus can be separated from the rest of the real property. In many situations, it makes sense to form a limited liability company ("LLC") or a limited partnership ("LP") to own these rights with the landowner as the initial member or partner.

By utilizing either an LLC or LP as the owner of the gas rights, the transferor can control many facets of the ownership of the gas rights now and in the future. First, the transferor can determine the initial number of partners or members. Generally speaking, it makes sense for the property owners to be the sole member(s) or partner(s) in the LLC or LP that holds the gas rights. By utilizing the LLC or LP structure, the gas rights themselves remain fully intact within the LLC or LP rather than being divided among heirs, and the management of the gas rights is centered in the LLC or LP and governed according to the operating agreement (for the LLC) or the partnership agreement (for the LP). In addition to managing the rights, the use of an LLC or LP allows one to control how members or partners can transfer their membership interests or partnership interests to third parties. In addition, the operating or partnership agreements can limit the extent to which a member or partner can assign or pledge his or her interest in the LLC or LP, and whether or not said interest is devisable pursuant to the member or partner's Last Will and Testament. Finally, language can be included that allows the LLC or LP the right to buy back the membership or partnership interest upon a multitude of events. This last point is very important because it can often be used to restrict the rights of non-family members to acquire interests in the LLC or LP.

In conjunction with the control of ownership and management that an LLC or LP structure provides, membership or partnership interests are great assets to fund trusts for family members because the trusts can contain provisions controlling how the assets are distributed to family members and at what time. In situations where one is survived by minor children or young adult children, the passing of substantial assets outright upon the death may not be suitable given the age and/or maturity of the children. The transfer of membership or partnership interests into trusts is a perfect vehicle to provide limits, not only on the receipt by the beneficiary of both net income and principal generated from the membership or partnership interests, but also at what time frame the beneficiary may receive them.

In addition to the above benefits the LLC or LP structure provides in terms of funding trusts, membership and

continued on the back page

USING IRA PROCEEDS TO INVEST IN REAL ESTATE AND OTHER ALTERNATIVE INVESTMENT VEHICLES *By Salvatore J. Bauccio*

Funds in a self-directed IRA typically are invested in stocks, bonds and mutual funds. What you may not know is that you can use your self-directed IRA to invest in real estate, privately held companies and other alternative investment vehicles, and defer any tax gains associated with those investments until retirement. Sound too good to be true? This technique has been permissible under IRS rules since 1974.

Benefits of Alternative Investments

Besides deferring the tax gain on any "alternative" IRA investment until distribution, perhaps the biggest advantage of such an investment is that it allows the IRA owner to invest in a vehicle with respect to which he or she is most comfortable. For example, if the IRA owner is knowledgeable about real estate transactions, the IRA owner may prefer to invest his or her IRA assets in real estate instead of stocks and bonds. At the same time, however, when investing in illiquid assets, if the IRA owner is at or near retirement age, the IRA owner must be sure to leave sufficient liquidity in his or her IRA account in order satisfy the required minimum distribution rules.

Below is a list of example investments which an individual IRA owner may and may not make through his or her IRA.

Permissible Investments:

- Real estate (sole ownership or tenancy in common)
- Closely held C corporation stock
- LLC membership interests
- Limited partnership interests

Impermissible Investments:

- Privately held S corporation stock
- Life insurance
- Artwork and jewelry
- Any business where the IRA owner and/or his family owns 50% or more

Prohibited Transaction Rules

When making an alternative investment through an IRA, in addition to complying with the standard IRA rules (e.g., receiving required minimum distributions at retirement age), the IRA owner must also comply with the IRS's "prohibited transaction" rules. These rules are designed to prevent the IRA owner from receiving a current benefit from the use of IRA proceeds, even though such proceeds may not be distributed to the IRA owner until retirement age.

For example, the IRA owner may use IRA proceeds to invest in an investment property if the property is leased to a third party. However, an IRA owner may not use IRA proceeds to invest in a vacation home if the IRA owner or his family would use the home for personal enjoyment. By personally using the vacation home, the IRA owner is receiving a current benefit from the IRA, even though the IRA cannot make distributions to the IRA owner until retirement age. The IRA owner also needs to be careful of transactions with any closely held corporation, LLC or partnership in which his or her IRA has an ownership interest.

Tax Consequences of Failure to Comply

If an IRA violates the prohibited transaction rules, the IRA is deemed distributed as of the date of the prohibited transaction, resulting in taxable income for the IRA owner in the year of the transaction. In addition, there is a 10% penalty if the IRA owner has not attained the age 59-1/2.

Depending on the type of impermissible investment made, different or additional penalties and taxes may apply. For example, if the IRA invested in an S corporation, the S corporation would automatically be converted to a C corporation and would not be eligible to reapply for S corporation status for 5 years. Further, if the IRA invested in a business where the IRA owner and related parties (family members) owned 50% or more of the outstanding stock or partnership interests, there would be an additional tax equal to 15% of the amount invested.

Prior to making an alternative investment through an IRA, it is strongly recommended that the IRA owner consult with competent legal counsel, as well as an IRA custodian experienced with these types of transactions. Beware – alternative IRA investments are not for the unwary! ■

Salvatore J. Bauccio practices in the McNees Asset Planning and Federal Taxation, Business Counseling, Mergers and Acquisitions, and Securities groups.
717.237.5238 / sbauccio@mwn.com

partnership interests are also efficient assets to pass outright or into certain trusts for the purpose of removing them from one's estate and thus avoiding paying Federal estate tax. At the most basic level, the transferor can utilize his or her annual gift exclusion and transfer membership interests in the LLC or partnership interests in the LP to family members either outright or in trust via gifts of membership or partnership interests equal to the annual gift tax exclusion (currently $13K per person or $26K with spousal consent). In addition, the transferor can make gifts of membership and partnership interests either outright or into trusts by utilizing his or her lifetime gift tax exclusion (currently $1M).

If you are fortunate enough to have real property containing Marcellus Shale formations, you are encouraged to contact a member of the McNees Asset Planning and Federal Taxation Group so you can be given specific guidance on how best to address this opportunity as it relates to your estate plan. ■

J. Corey Reeder practices in the firm's Asset Planning and Federal Taxation, Business Counseling, Pennsylvania Oil and Gas, and Real Estate groups.
814.867.8500 / creeder@mwn.com

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McNees Asset Planning & Federal Taxation Group

David M. Watts, Jr., Chair 717.237.5344/dwatts@mwn.com	Donald B. Kaufman 717.237.5373/dkaufman@mwn.com	Bruce R. Spicer 717.237.5331/bspicer@mwn.com
Vance E. Antonacci 717.581.3701/vantonacci@mwn.com	Peter F. Kriete 717.237.5486/fkriete@mwn.com	Richard W. Stevenson 717.237.5208/rstevenson@mwn.com
Salvatore J. Bauccio 717.237.5238/sbauccio@mwn.com	Scott Alan Mitchell 717.581.3713/smitchell@mwn.com	Linda M. Eshelman, Paralegal 717.237.5210/leshelman@mwn.com
Frank C. Chesters 717.581.3702/fchesters@mwn.com	Gerald K. Morrison 717.237.5416/gmorrison@mwn.com	David E. Gruver, Paralegal 717.237.5362/dgruver@mwn.com
Timothy M. Finnerty 717.237.5394/tfinnerty@mwn.com	Elizabeth P. Mullaugh 717.237.5243/emullaugh@mwn.com	Dianna L. McSherry, Paralegal 717.581.3707/dmcsherry@mwn.com
Bradley J. Gunnison 717.237.5479/bgunnison@mwn.com	James K. Noel, IV 717.581.3709/jnoel@mwn.com	
Veronica R. Johnson 717.237.5417/vjohnson@mwn.com	J. Corey Reeder 814.867.8500/creeder@mwn.com	