

# Impact

An Overview of Current Legal Events of Concern and Interest

Spring 2004

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## The Real Estate Escalator

By: William V. Strauss



Getting involved in a commercial real estate loan transaction is like riding up an escalator: First Floor, term sheet; Second Floor, letter of intent; Third Floor, commitment; Fourth Floor, contract documents.

Our goal is to get you safely to the fourth floor, to close your transaction, and to avoid the fifth floor altogether (Fifth Floor, Litigation!). This article addresses this process from the standpoint of the borrower/developer, so I must request that any lenders stop reading here. Their interests will be addressed in a subsequent article.

### First Floor: The Term Sheet

It is smart to outline the basic terms of the deal in the very early stages of the negotiations (first or second floor), just to be sure the parties have a meeting of the minds. A "term sheet" is really just a piece of paper that outlines the fundamentals; in a real estate financing transaction, it should include the interest rate, term of the loan, collateral, and "recourse" provisions (i.e., the circumstances under which the lender can pursue remedies directly against one or more principals of the borrower entity in the event of a default).

The recourse issue requires particular attention early in a real estate loan transaction. In cases where the borrower is an entity formed just for this one transaction (a "single purpose entity"), the lender likely will require some person or entity other than the borrower to be liable for certain exceptions (called "carveouts,") to the otherwise non-recourse nature of the loan. The borrower should seek certainty regarding the extent and types of any recourse obligations requested by the lender. The borrower should also attempt to limit exposure to actual costs and expenses incurred by the lender, and only where the lender's losses are caused by preventable actions of the borrower.

### Second Floor: The Letter of Intent

A letter of intent is used occasionally in real estate financings, and may be referred to as a "loan proposal." A letter of intent is a more formal, complete version

of the term sheet. Like a term sheet, a letter of intent can flush out any major problems with the transaction relatively early, saving all parties time and expense. It serves to focus the parties on the material terms of the deal, providing lawyers with an outline from which full documentation can be drafted. Sometimes, the letter of intent commits the parties to the transaction psychologically (if not legally). Although parties often discount the letter of intent as preliminary and generally unenforceable, they may encounter unwanted surprises later if they underestimate this document's importance and consequences.

In deciding on the type of letter of intent to draft, the lawyer must know the client's goals. For example, a client may want certain provisions to be legally binding, such as confidentiality provisions or important business terms to which the parties have already agreed. In any event, a clear statement regarding the binding (or non-binding) intent of the parties is crucial.

### Third Floor: The Commitment

Once the loan commitment is signed, there is no longer any mystery about whether the parties are legally bound. This conclusion is based on: (1) settled principles of contract law, and (2) the unmistakable clatter of somebody's money (the borrower's) landing in a cash register (the lender's).

The borrower and its counsel should review all the major issues *before* signing the loan application or loan commitment. Remember, the bargaining power of the borrower is strongest before the parties are legally bound; the best time to secure concessions from the lender is when the lender is soliciting the borrower's loan business. Most commercial real estate mortgages are bundled together, then sliced and diced into securities that are sold to investors. In this "securitized" market place, lenders insist on using standard loan documents, and any changes are hard-won, especially after the loan commitment is signed and the fees paid.

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If there are any unusual issues in the loan transaction, the borrower should try to get the lender to sign off on them before the commitment is issued. For example, if the borrower believes the loan underwriter may have problems with respect to valuation, engineering, leases or environmental issues, it should raise these concerns with the lender before agreeing to the deal. Otherwise, the lender may demand aggressive holdbacks (or even refuse to fund) based upon these concerns.

Once the commitment is signed the business deal has been cut. The next step, Fourth Floor, "contract documents," is beyond the scope of this article.

### **Conclusion**

The use of the escalator metaphor is not meant to imply that this is a long, tedious process – there's no requirement to stop on every floor. The different floors simply represent the increasing level of psychological and legal commitment as the deal moves forward. By understanding the different stages (floors) you should be more aware of when and how you choose to become legally obligated to go forward with the deal.

*Bill Strauss is the President of Strauss & Troy. He represents individuals, trusts and estates, and closely-held companies in real estate and general business matters.*

## The Ins and Outs of Family Limited Partnerships

By: Thomas C. Rink



This is an update of an article that first appeared in 1999. Since that time, the IRS has continued to attack family limited partnerships and has had recent success using Internal Revenue Code Section 2036. Since 1993, when the IRS changed its position regarding the availability of certain discounts in valuing transfers to family members, one technique that has become quite popular is the use of the family limited partnership (FLP) as an estate planning tool. (In some instances, a family limited liability company (FLLC) may be substituted for the FLP.) Although the IRS has frequently attacked the valuation discounts claimed for FLP interests, it has also been successful in denying any discount and bringing the assets in the FLP back into the decedent's estate. However, in the proper situation, the FLP may be a viable option, and it is possible to obtain discounts ranging from 15% to 40% or more. In general, the size of the discount has been related to the assets inside the FLP. For example, there are lower discounts for marketable securities and higher discounts for income-producing real estate.

The purpose of this article is to introduce you to the basics of this estate planning technique and to alert you to potential pitfalls to avoid. Of course, before you make any decisions concerning your estate, you should consult with an experienced estate planning attorney.

### **FLPs and FLLCs: What Are They?**

An FLP is simply an ordinary limited partnership (LP) – with one distinction: most of the partners are related to each other. Similarly, an FLLC is a limited liability company (LLC) in which the members are in

the same family. Here's a brief rundown of the primary differences between these two entities:

- **Management.** The LP has general partners who run the business, and limited partners who are merely passive investors (the law does not permit them to participate in managing the business). The LLC has members who may choose to manage the company themselves or appoint managers to do it for them.
- **Liability.** In the LP, general partners are personally liable for partnership debts; limited partners are not. In the LLC, no member is personally liable for company debts. Limited liability for all owners, without sacrificing the ability to participate in management, is the chief advantage of the LLC over the LP.

For simplicity, we will only discuss the FLP in the following paragraphs, but our observations will also apply to the use of the FLLC.

### **Death and Taxes: A Few Estate Planning Basics**

An important component of estate planning is minimizing the taxes your estate will have to pay when you die. Generally speaking, all gifts of property, during life or at death, are subject to taxation under the federal gift and estate tax system. Under that system, large estates can be subject to a tax rate as high as 48%. However, as with all tax systems, a variety of exceptions is available for certain transfers. For example:

**The \$11,000 annual exclusion.** An individual may give lifetime gifts up to \$11,000 per year per recipient. If the gift qualifies under tax code rules, it will not be subject to gift tax. Nor will it be considered part of the donor's estate when the donor dies (and, thus, it will not be subject to estate tax).

**The lifetime exemption.** In addition to the annual exclusion, the tax code also allows an individual to cumulatively transfer a certain amount of property, either during life or at death, without paying gift or estate taxes on that amount. For transfers made during 2004, the exemption amount is \$1.0 million for lifetime transfers subject to gift tax. The exemption for lifetime gifts will remain \$1.0 million, but the unified credit for estate taxes provides for an increase of the applicable credit amount to \$1.5 million in 2004, \$2.0 million in 2006, and \$3.5 million in 2009.

### **Using FLPs and FLLCs in Estate Planning**

The FLP can be used to lessen transfer taxes by decreasing the valuation of the property being transferred. An FLP can be used to own any type or types of property. We will assume that it is going to be used to hold some income producing real estate such as a farm or apartment building. Here's how it often works:

Parents create the FLP to own and operate the property, with 100 ownership units of one percent each – two general partner (GP) units and 98 limited partner (LP) units. The parents initially own all of the units. Over time, they give many of the LP units to their children. These gifts may be limited to \$22,000 in value per year per child (\$11,000 from each parent) to take advantage of the \$11,000 annual exclusion or they may be larger gifts, with the excess protected from tax by the lifetime exemption (up to \$1.0 million).

By keeping the GP units, the parents (individually or through a corporation or LLC) retain full control of the property. And by giving LP units

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# News of the Firm

## Attorneys on the Move



Marilyn J. Maag

**Marilyn Maag** addressed a meeting of the Cincinnati Paralegal Association, speaking about recent developments in federal and state estate tax law and Ohio probate law. Marilyn also authored an article summarizing Ohio's new probate legislation in the January/February issue of the Probate Law Journal of Ohio.



Charles H. Melville

**Charlie Melville** was the guest speaker at a luncheon meeting of the Manufacturers' Agents of Cincinnati. Mr. Melville spoke about the Ohio Commission Protection Act and litigation and alternative dispute resolution options for manufacturers' agents.



Paul B. Calico

**Paul Calico** was one of 44 members inducted into the Ohio State Bar Foundation Fellows Class of 2004. Membership is limited to judges, law school professors, and lawyers whose careers have demonstrated dedication to the highest ideals of the legal profession. Ohio Supreme Court Chief Justice Thomas Moyer (also an OSBF Fellow) presented Paul's membership pin. Paul was also the featured guest on WVXU's Law Talk, a weekly public radio show dealing with timely legal topics. He spoke on the topic of Alternative Dispute Resolution, with an emphasis on mediation and arbitration.

**Richard Wayne** was Lead Counsel for the shareholders in the P&G Securities Litigation. As part of the settlement agreement, Strauss & Troy had the ability, after obtaining the consent of the Court, to distribute the unclaimed funds to educational and charitable organizations. At Mr. Wayne's request, the Court allowed these funds be used to establish a scholarship fund at the University of Cincinnati College of Law and the University of Dayton School of Law. He also directed contributions to Crayons to Computers, the Civic Garden Center Neighborhood Garden Program, the St. Bernard Public Library, the National Literacy Center and the Weston Art Gallery. Strauss & Troy is gratified that it was able to direct these funds to organizations that will continue to benefit our community.



Richard Wayne



Jeremy A. Hayden

**Jeremy Hayden, Michael Ruh, and Joe Braun** were featured speakers at a seminar sponsored by the Northern Kentucky University Small Business Development Center. The topic of the seminar was "Legal Issues for the Small Business Owner."



Michael A. Ruh



Joseph J. Braun

## Sponsorships

*Strauss & Troy has a long and rich tradition of giving to the Greater Cincinnati/Northern Kentucky community. As part of our continuing commitment to the communities in which we work and live, we are pleased to have supported the following organizations, programs, and events in the first quarter of 2004:*

- Black Lawyers Association of Cincinnati – 12th Annual Scholarship and Awards Banquet
- Brighton Center, Inc. – Tee Sponsor Golf Classic
- Cedar Village – Golf Classic
- Cincinnati Bar Association
- The Cincinnati Children's Choir
- Cincinnati Children's Hospital Medical Center – Laura Elizabeth Pease Memorial Golf Outing
- Cincinnati Classical Public Radio, Inc.
- Cincinnati Nature Center – Back to Nature 10th Annual Fundraising Event
- Covington Rotary Club – Behringer-Crawford Museum
- Diocesan Catholic Children's Home – Children's Home Partnership 2004 Program
- FBA Foundation – Judge Jack Sherman, Jr. Scholarship Fund
- The Friends of SCPA – School for Creative and Performing Arts
- The Mercantile Library
- New Perceptions, Inc. – Spring Gala Event
- Perks Unlimited, Inc. – Program Participation
- St. Xavier Lacrosse Team
- S.H.A.P.E. – Sycamore High School After Prom Event
- University of Cincinnati Foundation
- WGUC-FM
- WVXU-FM
- Yavneh Day School

(along with any future appreciation in the value of those units) to their children free of gift tax, they gradually reduce the amount of their estate that will be subject to estate tax. In addition, because the LP units are not readily marketable and do not come with management rights, their value for gift tax purposes may be discounted (yet the value of the underlying assets remains intact). This discounting reflects the reality of the market place that a limited partnership interest has a limited value to a third-party purchaser, because it is not readily marketable and because there is no control over the underlying assets in the partnership. It provides a method to “leverage” the annual exclusion and the lifetime exemption. For example, an interest in a FLP in the form of a 1% Unit with a pre-discount value of \$15,000 may only be valued at \$10,000 for gift tax purposes after the application of a 33% discount for lack of marketability and lack of control.

Too good to be true? Maybe, maybe not. A detailed analysis of the many intricacies of this estate planning technique are beyond the scope of this article, but here are a few basic do’s and don’ts to keep in mind:

- **Don’t put all of your assets in the FLP;** it is not your checkbook.
- **Transfer substantial limited partnership interests to other family members during your lifetime** and respect your fiduciary obligation to the limited partners.
- **Don’t ignore the existence of the FLP after it is formed.** If you decide to use an FLP, you must respect its existence. The property placed in the FLP must be managed according to the terms of the partnership agreement. It cannot continue to be treated as your own property.
- **Don’t try to cut corners when it comes to valuation.** Consult a qualified appraiser with experience in valuing family-owned entities to help you value the entity as a whole and to advise you on the nature and amount of any valuation discounts that may apply to gifts of LP interests.
- **Do consult with an estate planning attorney** to be sure this and other aspects of your estate plan are structured to achieve the best possible tax outcome should an IRS auditor come knocking.

*The FLP or FLLC may be one way to pass on your assets to future generations without incurring huge tax liabilities in the process. However, keep in mind that the IRS continues to attack both the discounts available to FLP interests as well as the very existence of the FLP itself. The law is in a state of flux, and several important cases are on appeal. This is a quickly evolving area of the law, and we cannot be sure if the use of an FLP will be a viable estate planning option in the future. For more information about forming one of these entities, or other estate planning techniques for you or your business, please contact Tom Rink.*

## Super Lawyers Abound at Strauss & Troy

Strauss & Troy is pleased to announce that the following attorneys were named as “Ohio Super Lawyers 2004” based on voting conducted by Cincinnati Magazine:

Claudia G. Allen	James G. Heldman	Thomas L. Stachler
Charles G. Atkins	William R. Jacobs	William V. Strauss
Ann W. Gerwin	Thomas C. Rink	Richard S. Wayne

## The Spouse’s Options as an IRA Beneficiary

By: Larry A. Neuman



Traditional Individual Retirement Accounts (IRAs) were designed to encourage taxpayers to save for retirement by providing income tax deductions for qualifying contributions and allowing the funds to grow tax-deferred until withdrawn. The longer the money accumulates, the greater the tax savings, but the IRS requires certain minimum withdrawals when the taxpayer reaches a specified age.

This article will address frequently asked questions arising in the situation in which one spouse (for simplicity, it is assumed to be the husband) designates his wife as the beneficiary of his IRA and predeceases her. As discussed herein, the minimum withdrawal requirements apply to the surviving wife, but the amounts and timing depend on the particular facts involved.

**My deceased husband had an IRA. When must I start receiving distributions?** The answer depends on two variables: (1) did your husband die before or after his Required Beginning Date and (2) were you the sole designated beneficiary.

**What is the Required Beginning Date?** The Required Beginning Date (RBD) is April 1 of the year immediately following the year your husband reached or would have reached age 70½. For example, if your husband turned 70½ on Dec. 31, 2003, his RBD would be April 1, 2004. If he turned 70½ on Jan. 1, 2004, his RBD would be April 1, 2005.

Required minimum distributions must commence by the RBD or a 50% federal excise tax is imposed on the amount of the required distribution not withdrawn. In other words, if the required distribution is \$3,000 but only \$2,000 is withdrawn, there is a 50% tax (\$500) on the \$1,000 that was not withdrawn. However, you can always draw down an IRA faster than these rules require, without penalty.

**What if my husband named me as the sole designated beneficiary of his IRA, but he died BEFORE his RBD?** You have three options. First, you may keep the inherited IRA in your husband’s name but have the payout measured over your life expectancy using the Single Life Table, with your life expectancy recalculated each year. You would elect this option if your husband’s RBD is later than yours and you want to delay distribution.

Second, you may roll your husband’s IRA into your own. Required minimum distributions from your IRA must commence by the later of your RBD or the end of the calendar year following the year of the rollover. You can use the more favorable Uniform Life Table with the right to recalculate your life expectancy each year, thereby extending the distribution period. Surviving spouses generally elect this option if they are substantially younger than the IRA owner or want their heirs to have a longer distribution period.

Third, you may elect to treat the inherited IRA as your own. This has the same consequences as if you had made a rollover.

**What if my husband named me as the sole designated beneficiary of his IRA, but he died AFTER his RBD?** You again have three options. First, you may receive distributions from the inherited IRA over your husband's remaining life expectancy using the single life totals, reduced by 1 for each succeeding year. You might elect this option instead of a rollover if you are substantially older than your husband or if you are substantially younger and want to receive distributions before age 59½ without paying a 10% premature distribution penalty.

The second and third options are that you may roll your husband's IRA into your own, or you may elect to treat it as your own. These options have the same consequences as discussed above. By making a rollover to your own IRA, payments would continue upon your death over the life expectancy of your oldest designated beneficiary. Thus, you can obtain a substantially longer deferral period for your heirs under the rollover option rather than under an inherited IRA using your husband's life expectancy.

**How much is required to be distributed annually?** Under the IRS formula, the amount required to be distributed annually is obtained by dividing the balance in the IRA on December 31 of the preceding year by the applicable distribution period based on your age using the applicable life table. For example, if the balance in your husband's IRA was \$100,000, and the applicable distribution period is 20 years, the required distribution would be \$5,000.

**If I am named as the sole designated beneficiary, will the marital deduction shield the IRA from federal estate taxes in my husband's estate?** Yes.

**What if my husband named more than one primary designated beneficiary (including me)?** If a non-spouse designated beneficiary has the right to receive IRA benefits during the spouse's lifetime, distributions are based on the life expectancy of the oldest of the designated beneficiaries. The less favorable Single Life Table is used, and there is no recalculation of your life expectancy even if you are the oldest beneficiary. However, if your husband died after his RBD and he had a longer distribution period than determined from the Single Life Table above, his distribution period will be used instead.

**What if my husband named me and a charity or his estate as primary beneficiaries?** If a charity or estate has the right to receive IRA benefits during your lifetime and your husband died before his RBD, distributions must be completed before December 31 of the year in which the fifth anniversary of his death falls. If he died after his RBD, distributions may be paid over the distribution period in effect at the time of his death.

**Can non-spouse beneficiaries be eliminated after my husband's death?** If your husband named you and other beneficiaries, and if his IRA designation form or his will allows the executor to split the IRA, it should be possible to split the IRA among the beneficiaries, enabling you to obtain more favorable sole "designated beneficiary treatment" as to your share of the IRA. Under those circumstances, a charity or estate can receive its share immediately.

**Can a trust be an IRA beneficiary?** The rules that apply when a spouse is named as one of a number of designated beneficiaries also apply to a trust. For example, if you are not the sole designated beneficiary, the life expectancy of the oldest beneficiary of the trust is used to determine the

distribution period. In order for the spouse to be deemed a sole designated beneficiary, only she can receive distributions through the trust from the IRA during her lifetime. Designating a trust as a beneficiary is substantially more complex and should only be done upon advice of an experienced tax advisor.

**Do these rules apply to other retirement benefits?** The same or similar rules apply to pension plans, profit sharing plans, 401(k) plans, 403(b) annuities, governmental 457 plans, and Roth IRAs.

## "Reverse" Age Discrimination: An Update

By: Paul B. Calico



In the Fall 2002 issue of *Impact*, we reported on a Sixth Circuit Court of Appeals case in which the court ruled that the Age Discrimination in Employment Act (ADEA) prohibits age discrimination, even if it benefits an older worker. To review briefly, the ADEA protects employees ages 40 and over from employment discrimination "because of age." Although most age-based cases had focused on discrimination against older workers, the Equal Opportunity Employment Commission had held that the age discrimination prohibition protected all employees within the protected class (those at least 40 years old).

That interpretation was put to the test in the case of *Cline v. General Dynamics Land Systems, Inc.* General Dynamics enacted a policy limiting certain benefits to employees over the age of 50, even if younger workers had the same levels of seniority. A group of employees between the ages of 40 and 49 challenged the policy, alleging that it constituted discrimination on the basis of age. The Sixth Circuit, relying on the language of the ADEA and the EEOC's interpretation of the statute, declared the policy unlawful since it discriminated against the younger employees based solely on their age.

In light of the ruling, our prior *Impact* article advised employers in this Circuit not to take age into account — one way or the other — when making employment decisions. We predicted, however, that the United States Supreme Court would agree to hear the case and that it would be some time before a final decision. Our predictions were accurate. The Supreme Court did accept the case, and after a wait of nearly two years, the matter has been resolved.

The Supreme Court found that the EEOC's interpretation of the ADEA was "clearly wrong." Based on the language and history of the statute, the Court found that the ADEA does not prohibit an employer from favoring older workers at the expense of younger ones.

The Court based its holding on the fact that the "protected class" (all workers over age 40) were threatened by preferential treatment for *younger* workers, not by preferences favoring older employees. In other words, while older workers were frequently the victims of management's desire to get some "new blood" in the organization, management rarely victimized younger workers

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## “Reverse” Age Discrimination: An Update

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in favor of older employees. It characterized the protection of relatively younger employees as “outside the statutory concern.”

Thus, the Court found that General Dynamics’ policy of providing benefits that favored employees over age 50 did not violate the Age Discrimination in Employment Act. The Court’s decision is important to employers who must make difficult decisions regarding benefits and other terms and conditions of employment affecting workers of differing ages within the company. Companies may now make those decisions without fear that a paternalistic approach toward older workers will result in legal liability.

*Paul Calico is a member of the Strauss & Troy Litigation Department and devotes a substantial portion of his practice to issues relating to employment law.*

## STRAUSS & TROY Spring 2004 Real Estate Seminar *Building The Future Together*

### **New Developments in Greater Cincinnati and Northern Kentucky Real Estate**

Four key figures in downtown and riverfront development in Cincinnati and Northern Kentucky will share their visions for the future during Strauss & Troy’s Spring Real Estate Development Seminar. Scott Stiles, the Assistant City Manager of Cincinnati; Pam Middendorff, the Project Manager of the 3CDC Fountain Square Project; Greg Jarvis, the City Manager of Covington; and Wally Pagan, the President of South Bank Partners, will discuss projects planned for both sides of the Ohio River and their expected social and economic impact on Greater Cincinnati and Northern Kentucky.

The seminar will be held on Wednesday, June 23 from 11:30 A.M. to 1:30 P.M. at Strauss & Troy’s Cincinnati office in the Federal Reserve Building, 150 East Fourth Street.

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