The Guttenberg Press

Preserving Your Assets ... Planning Your Future

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Spring 2004

Dear Friend:

There is much good news on the estate planning front for 2004. Most importantly, the estate and generation-skipping exemptions have been increased to $1.5 million. This increase creates many opportunities and your Wills and Revocable Trusts should be carefully reviewed to ensure that your plan for disposition of assets is in line with your goals. Take a look at the article and chart on Page 3 of this issue.

Also, we provide clarification as to the practical aspects of 529 Plans in response to questions and concerns.

Finally, Family Limited Partnerships and Family Limited Liability Companies have been dealt a temporary blow (but not a fatal one) by a recent court decision. The lead article discusses this development and offers general guidance as to what can be done to preserve the benefits of using this technique.

Let's stay in touch!

Family Limited Partnerships Under Attack: Strategies for Cure and Resuscitation

Family Limited Partnerships (FLP's) and Family Limited Liability Companies (FLLC's) have for years offered creative tools for saving significant income and estate taxes and protecting assets from creditors. It has been a particularly effective strategy for high-net worth individuals. But the strategy has been vulnerable to recent attack. Here's some background of the technique, a discussion of the recent *Strangi* case and some possible solutions.

Workings and Benefits of "Typical FLP"

Here is how a typical FLP typically works. (While the technique is probably equally as effective using an LLC, we will refer to the more traditional "FLP" in this article.) The parents create a partnership (FLP) with themselves as general partners and their children and/or grandchildren as limited partners. As general partners, the parents control the partnership and initially own most of its interests. But over the years, the parents gradually transfer the interests in the partnership to children/grandchildren through annual gifts that can amount to as much as $22,000 per donee (the most a married couple can transfer annually without federal gift tax effect).

Discounts and Tax Benefits

Under generally accepted valuation principles, the limited partnership interests can be valued at a discount. This is due to their lack of marketability and lack of control. These discounts allow the parents to shift significant amounts of wealth at a discount - while still keeping control. For years it was clear that transfers of interests in an FLP qualified for the annual gift tax exclusion, qualified for a discount, cleared the "anti-estate freeze" hurdles, and would not be included in the grantor's estate because of any prohibited retained powers. In addition to reducing estate taxes, FLP's are effective in splitting income among family members.

Creditor Protection

The FLP also offers protection against creditors and divorce. The general partner controls the partnership's investments and income. If a limited partner is sued, the creditor must obtain a "charging order" against partnership. This order entitles a creditor only to the stream of income from the partnership and not the partnership assets. In fact, should the general partner refuse to distribute the partnership's stream of income, the creditor is forced to pay income tax on phantom income. See chart on the following page summarizing these benefits.

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TRADITIONAL ADVANTAGES OF AN FLP

Valuation discounts producing significant estate tax savings

Facilitation of intra family wealth transfers

Income shifting to lower bracket children/grandchildren

Grantor's retained control over assets (subject to *Strangi II*)

Protection of partnership assets from creditors

PLANNING TIPS IN LIGHT OF *STRANGI II*

Strangi in no way signals the death knell of FLP's and FLLC's. First, it is on appeal and may well be reversed. Indeed, it is clearly a viable strategy even after *Strangi* with certain precautions. "Good facts" are now more important. While there is no hard and fast cure-all that will "bulletproof" a FLP or FLLC from IRS attack, the following protections are among those that could be considered for both new and existing FLP's or FLLC's. (The list will refer to FLP's although there are compelling reasons for using a FLLC). These considerations are by no means exhaustive but are reasonable guideposts for prudent planning:

Complete Divestiture. Do not transfer substantially all of your assets to the FLP. There should be sufficient assets in the donor's name to meet person needs.

Pro-rata Distributions. Ensure that distributions are made pro-rata among partners/members. Disproportionate distributions should be avoided.

Personal-Use Assets. Do not transfer personal use assets, such as a residence, to the FLP. (If such assets are used, ensure that fair rental value is paid in a timely manner.)

Grantor's Personal Expenses. FLP should not be used to pay the grantor's personal expenses.

Commingling. Grantor should not commingle FLP assets with personal assets.

Recordkeeping. Grantor must keep accurate and up to date books for the FLP.

Health of Grantor. FLP should be set up when the grantor is in good health.

Continuation after Death. FLP should be continued after grantor's death.

Exclusively Marketable Securities. If possible, assets other than marketable securities should be contributed to the FLP.

Business Purpose. Business rationale for the formation of the FLP, as well as all material decisions, should be well-documented.

Voting Control. Optimally, consider divesting all of grantor's interest and control, *i.e.*, consider naming children as general partners.

Possible 3rd Party Control. If the above is not feasible, consider introducing real, independent control akin to a trust structure.

Non-family Members. Consider possible inclusion of non-family members in the FLP.

Fiduciary Duties of General Partners. The Partnership Agreement (or Operating Agreement for LLC) should include language that fiduciary duties under the state law binds the general partner.

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Strangi II: Bad Facts Make Bad Law

For years, the IRS has been tossing theories against the courthouse wall to attack discount-motivated FLP's. Until very recently, the IRS has been for the most part fighting a losing battle. The courts sided with the IRS only in cases with extreme and abusive fact patterns, such as where the partnership was set up immediately before the taxpayer's death with the taxpayer in a coma or life support or when the taxpayer-founder completely ignored the basic partnership formalities.

But a recent Tax Court decision in *Strangi v. Commissioner* (sometimes called "*Strangi II*" because it was the Court's second "crack" at the case), has engendered some concern with FLP's. In the *Strangi* case, the Tax Court held that the FLP should be ignored for transfer tax purposes and that all the interests which were transferred to family members were included in Mr. Strangi's estate because of Mr. Strangi's retained controls. The Court found an implied agreement between Mr. Strangi and his family that he could retain the right to the income from the assets contributed by him to the partnership – because he transferred virtually all of his assets to the partnership and had retained virtually no assets for his own support. His residence was among the assets contributed to the FLP and he paid no rent to the partnership for his use of the property. Furthermore, the partnership paid Mr. Strangi's personal expenses.

Where Do We Go from Here? Post-*Strangi* Thoughts

The Strangi Estate has appealed the Tax Court decision to the Fifth Circuit Court of Appeals, and we do not believe that this decision is the final word on the subject. Indeed, the decision may well be reversed. *Strangi* is a case of bad facts. The Tax Court was determined to find ways to include the assets in the decedent's estate due to the egregious nature of the facts in the case (although the facts did not denote clear abuse such as death bed transfers). The IRS will most likely challenge partnerships on the "retained control" issue under similar circumstances where the facts guarantee a win by the IRS. In this light, FLP's and FLLC's continue to be a significant, strategic estate planning tool. The *Strangi* decision did not signal the death knell of this strategy. The decision simply demands more careful planning, particularly regarding the formalities of the arrangement and infusing more substance to the FLP.

But the decision can be looked at in a positive framework because it may now be easier to obtain the discounts. We just need to be more careful in structuring the partnership. See, for example some recommendations in the adjacent left column. This goes for existing partnerships which may require some changes in light of *Strangi* as well as future partnerships. There's now more of a premium on good planning. Going forward, we encourage you to meet with us to review the FLP strategy in light of continuing developments so that we can discuss and determine what may be required to protect the integrity of the FLP and how the strategy could be utilized for you.

529 Plans: Practical Considerations and Common Scenarios

Section 529 Plans (also called Qualified Savings Plans) are on the front burner now as probably the most popular, and certainly tax advantageous, educational savings plan ever. There has been some uncertainty regarding how the tax effects of these plans actually work. Here is our response to some of the more common questions/scenarios relating to 529 Plans. We will employ a simple example to summarize the practical rules.

Example: In 2004, Michelle and Neil put $110,000 in a Section 529 Plan for son Ralph, age 13. When Ralph enters college in 2010, the fund has grown to $160,000. All the funds are used for Ralph's 4 years of college expenses (tuition, room and board, books and supplies). The $50,000 in earnings is <u>never</u> subject to federal tax.

Now let's look at some scenarios, questions and answers.

Q. *No Collage for Ralph* - What happens if Ralph decides to go straight to the NBA after high school? It's the same question, of course, if Ralph simply does not attend college for any reason.

A. Michelle and Neil have two choices: (1)pay tax on the $50,000 in earnings plus a 10% penalty or (2)"roll over" Ralph's account to an account for their daughter, Roberta.

Q. *Parents Want it Back* - What if Ralph does indeed attend college, but Michelle and Neil wish to use the $160,00 to buy a new home?

A. Same as in #1 - the parents are permitted to withdraw the funds. However, they would pay a Federal Income tax on the $50,000 earnings, plus a 10% penalty.

Q. *Grandparent Wants to Change Beneficiaries* - What if Ralph's grandfather, George, set up the account for Ralph and decides he would like to change the beneficiary to another grandchild (a first cousin of Ralph's)?

A. There are no tax implications to this "roll over." A Section 529 Plan can be transferred among cousins, as well as among siblings, with no tax .

Q. *Parents Premature Death* - What if Michelle and Neil die before Ralph goes to college?

A. The funds are <u>not</u> part of the parent's estate. (This should be contrasted with a custodial account opened by the parent who is also the custodian. In the latter case, the custodial property may be part of the parent's estate.)

Q. *Frontloaded Contributions* - What were the gift tax consequences for Michelle and Neil when they put $110,000 in the Section 529 Plan?

A. The gift qualifies for the annual exclusion which is $11,000 per donee for each parent. But, under a special 5-year "frontloading" rule, a married couple can put up to $110,000 into a plan for each child (or other beneficiaries) in one year.

Q. *Transfer from Custodial to 529* - Michelle and Neil currently hold assets for Ralph as custodian under the Uniform Transfers to Minors Act (UTMA) or under the Uniform Gift to Minors Act (UGMA) - can they shift those assets to a Section 529 Plan?

A. Obviously, the Section 529 Plan is more tax advantageous in avoiding income tax on future earnings. But, since only cash can be contributed to a Section 529 Plan, a capital gains tax may be incurred.

Estate, Generation-Skipping and Gift Tax Changes on Tap for 2004

Estate Tax. For the first time in two years, the estate tax exemption has increased. This exemption has increased from $1,000,000 in 2003 to $1,500,000 in 2004. With the increase in exemption is a slight decrease in the maximum estate tax rate. The rate dropped from 49% in 2003 to 48% in 2004. Throughout the decade, the estate tax exemption is scheduled to gradually increase to $3,500,000 in 2009 while the maximum estate tax rate is scheduled to decrease to 45% in 2009. In 2010, estate taxes are "scheduled " to be repealed with the 2001 exemption and rates "scheduled" to return in 2011.

Keep an Eye on the GST Tax. Beginning in 2004, the generation-skipping tax exemption will be equal to the increasing estate tax exemption. This is a significant jump from the $1,120,000 exemption amount for 2003.

The "Static" Gift Tax Exemption. While the estate and GST exemption increased to $1,500,000 in 2004, <u>the gift tax exemption is frozen at $1,000,000 for all years</u>. This divergence of the gift and estate exemptions is critical and a major trap for those considering structuring large lifetime gifts.

The increase in estate and GST exemption could have important effects on your estate planning. And, the static gift tax exemption poses a trap for the unwary. We encourage you to call us to ensure that your estate plan maximizes these exemptions.

See Chart below for a summary of these changes.

Transfer Tax Exemption Increases and Rate

Year	Gift Tax Exemption	Estate[1] and GST Tax Exemption	Highest Estate, GST and Gift Tax Rates
2003	$1 million	$1.12 million	49%
2004	$1 million	$1.5 million	48%
2005	$1 million	$1.5 million	47%
2006	$1 million	$2 million	46%
2007	$1 million	$2 million	45%
2008	$1 million	$2 million	45%
2009	$1 million	$3.5 million	45%
2010	$1 million	(repealed)	35% (gift tax only)
2011	$1 million	$1 million[2]	55%[3]

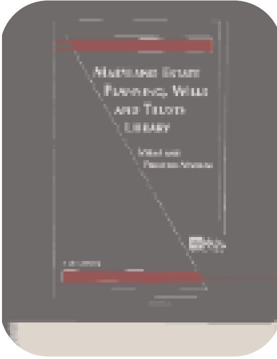
1 Less any gift tax exemption already used
2 The GST tax exemption is adjusted for inflation
3 The benefits of the graduated estate and gift tax rates and exemptions are phased out for estates/gifts over $10 million

Things We've Been Up to Lately

In two estates, we have successfully engineered post-mortem disclaimers of property after the death of the first spouse where both spouses died within a short time of each other. The disclaimers saved substantial estate taxes.

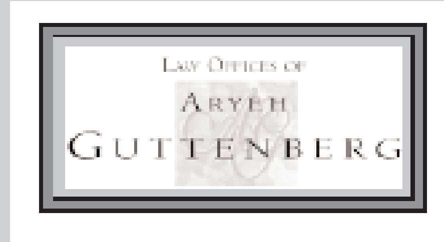
We are happy to announce that Elisabeth G. Lefkowitz has joined our office as a legal assistant. "Liz" has extensive experience in accounting and has served as a director of a program for seniors at the Jewish Family Services. Please introduce yourself to Liz when you call or visit our office.

Aryeh's Fourth Supplement of his 2-volume book "Maryland Estate Planning; Wills and Trusts Library" was released, containing extensive planning strategies and new forms for dealing with the fluctuating estate tax laws. The book is used by approximately 500 practitioners in Maryland.



Our office successfully engineered and administered a charitable remainder trust which eliminated virtually all estate taxes in an estate with sizable assets.

The privacy and disclosure laws contained in the new Health Insurance Portability and Accountability Act ("HIPAA") make it necessary that all General and Health Care Powers of Attorney be revised to include "HIPAA" language. We have drafted such language for our clients. Please call us to discuss.



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