the Estate PLANNER

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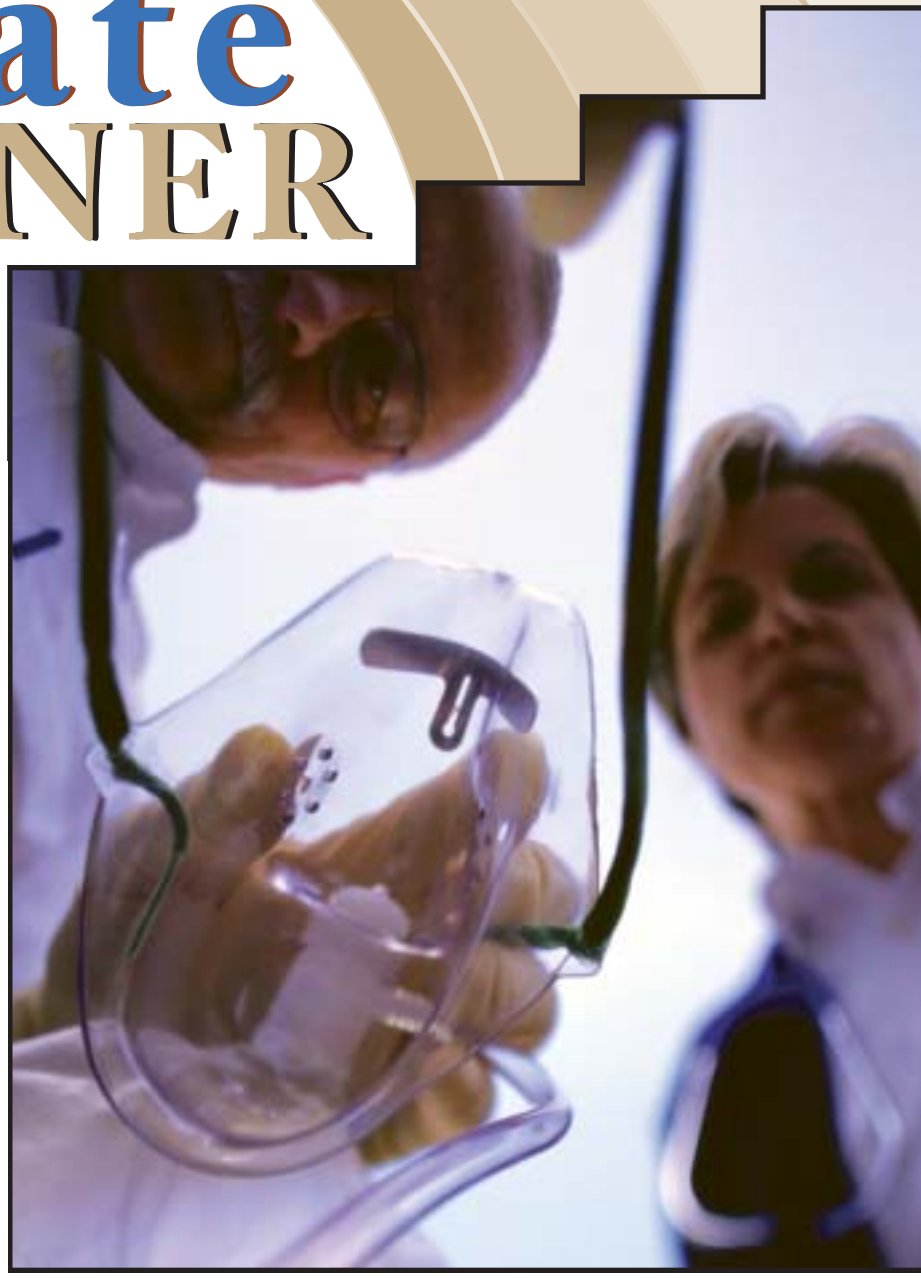

Court decision breathes new life into FLPs

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Court decision breathes new life into FLPs

In the continuing war over family limited partnerships (FLPs), taxpayers have won a critical battle. After last year's Tax Court decision in *Estate of Albert Strangi v. Commissioner,* some commentators pronounced the FLP dead as an estate planning strategy. But a recent decision by the Fifth U.S. Circuit Court of Appeals has revitalized the technique and casts doubt on the IRS's latest line of attack.

A powerful estate planning tool

During the last decade, FLPs have become a popular tool for transferring wealth to family members at deeply discounted gift and estate tax values. That's because the value of limited partnership interests — which are relatively unmarketable and provide the owner with little control over partnership affairs — is often discounted by 30% to 40% from the value of the underlying assets.

In *Strangi,* the court seemed to suggest that Sec. 2036(a)(2) would apply whenever the transferor shares control of the FLP with family members.

Tax savings aren't the only benefits. FLPs serve a number of important business and investment purposes, such as:

- Allowing parents to give children interests in valuable assets without relinquishing managerial control,
- Protecting family assets from creditors' claims,
- Maintaining family control from generation to generation and avoiding potential disruption in the event a family member divorces,
- Consolidating ownership and management of assets, particularly real estate and other assets held in fractional interests, and

- Preserving family harmony by requiring mediation or arbitration of disputes among partners.

The IRS offensive

The IRS began challenging FLPs almost from the moment taxpayers started using them. In the IRS's view, FLPs are nothing more than tax-avoidance devices — mechanisms for sheltering assets from gift and estate taxes merely by changing the form of ownership. The courts generally rejected these attacks, recognizing that there are many legitimate reasons for forming an FLP besides reducing taxes.

Recently, however, the IRS has had some success with a new weapon: Internal Revenue Code Section 2036(a). Under that section, the full, undiscounted value of property transferred to an FLP can be brought back into the transferor's taxable estate if he or she retains a direct benefit from the right to determine who shall benefit from the property being transferred.

The courts have applied Sec. 2036(a) in cases where the transferor retains too much control over assets transferred to an FLP. In other words, if the transferor's relationship to the assets doesn't substantially change, despite the change in formal title, then the courts will disregard the FLP for estate tax purposes.

In *Strangi,* the decedent transferred virtually all of his assets to an FLP. The IRS convinced the Tax Court that all of the assets should be included in Strangi's estate under Sec. 2036(a) because he retained control over them after he transferred them to the FLP. Strangi continued to live in his home without paying rent and relied on the partnership assets to pay his medical bills and other living expenses. The court concluded that the FLP didn't operate as a legitimate business, but merely served to "recycle" Strangi's assets.

The court's findings provided it with ample grounds to bring the FLP assets back into Strangi's taxable estate under Sec. 2036(a)(1). But the court went further and said the FLP also could be disregarded under Sec. 2036(a)(2), which applies when the transferor retains the right to determine who benefits from the property being transferred.

The court seemed to suggest that Sec. 2036(a)(2) would apply whenever the transferor shares control of the FLP with family members. That, of course, would make it difficult, if not impossible, for *any* FLP to withstand IRS scrutiny.

The taxpayers strike back

The Fifth Circuit's recent decision in *Kimbell v. United States* eases the fears of many that *Strangi* dealt a fatal blow to the FLP.

Ruth Kimbell transferred about $2.5 million in oil and gas working interests and royalty interests, cash, securities, notes, and other assets in exchange for a 99% limited partner interest. When she died, the FLP assets were valued at about $2.4 million, and her estate claimed a 49% discount for lack of control and marketability. In the federal district court, the IRS succeeded in having the full value of the FLP assets included in Kimbell's taxable estate under Sec. 2036(a).

The Fifth Circuit reversed, citing Sec. 2036(a)'s exception for assets transferred in a "bona fide sale for an adequate and full consideration." The court found that Kimbell's limited partnership interest was adequate consideration for the assets she contributed, even though its value was depressed by marketability and control discounts. The key factor, the court said, was not the relative value of the partnership interest and the underlying assets, but whether each partner's interest was proportionate to the fair market value of the assets he or she contributed.

The Fifth Circuit also rejected the district court's conclusion that transfers among family members weren't at arm's length and therefore could never be bona fide sales. Several factors supported the conclusion that the transfer was a bona fide sale rather than a "recycling of value":

- Kimbell retained sufficient assets outside the FLP for her own support.
- There was no commingling of partnership and personal assets.
- The partners respected all partnership formalities and assigned the contributed assets to the FLP.
- The working oil and gas interests required active management.

FLP dos and don'ts

To help your family limited partnership (FLP) withstand an IRS challenge, consider these dos and don'ts:

Do

- Establish and document a legitimate nontax business purpose for the FLP,
- Keep enough assets outside the FLP to support yourself,
- Transfer legal title to all partnership property to the FLP,
- Respect all partnership formalities, including keeping accurate books and records,
- Have your children or other family members contribute assets to the FLP, and
- Distribute income pro rata according to each partner's interest in the FLP.

Don't

- Transfer your home or other personal assets to the FLP,
- Commingle personal and FLP funds, or
- Use FLP assets to pay your living expenses.

- There were many nontax business reasons to form an FLP, including protecting assets from creditor claims, simplifying management and ownership succession, reducing administrative costs, and keeping the assets in the family.

Because the bona fide sale exception applied, the court didn't address the application of Sec. 2036(a)(1) or (2) to the FLP assets. But that issue did arise with respect to assets Kimbell transferred to a limited liability company (LLC) that served as the FLP's general partner. The Fifth Circuit concluded that because Kimbell's interest in the LLC was only 50% and her son had sole management powers, she did not retain the right to enjoy or designate who would enjoy the LLC property.

Proper structure and use will keep your FLP healthy

Kimbell shows that FLPs are alive and well, but it also highlights the importance of careful planning to ensure that they are properly structured and serve legitimate nontax purposes. Bear in mind that the court's holding is binding only within the Fifth Circuit. The IRS can be expected to continue its assault on FLPs in other jurisdictions. ▮

Uncertainty over state death taxes complicates estate planning

As the federal estate tax is gradually phased out, state estate taxes are playing an increasingly important role. Why? Because most states' inheritance and estate taxes have been linked to the federal estate tax system, and in 2005 changes in federal estate tax law would result in the automatic elimination of the state death tax in many states. Rather than watching those revenues die, many cash-starved states have "decoupled" from the federal tax and established their own death taxes.

Because different states are taking different approaches, state death tax liability can now vary dramatically depending on your state of residency.

Repeal of the federal estate tax and elimination of the state credit

Under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), the top federal estate tax rate gradually declines while the estate tax exemption ($1.5 million in 2004 and 2005) increases to $3.5 million by 2009. In 2010, the estate tax will be repealed, only to be revived in 2011 without further congressional action.

EGTRRA also phases out the state estate tax credit, which allows estates to claim a dollar-for-dollar credit, up to 16% of federal estate tax liability, for death taxes paid to a state. This is significant because most states, instead of establishing separate estate taxes, imposed a tax equal to the amount of the federal credit. This is referred to as a "pick-up" tax because the state picks up the amount allocated as a credit under federal law.

EGTRRA reduced the state death tax credit amount to 75% of the state death tax paid in 2002, 50% in 2003 and 25% in 2004. In 2005, the credit will be eliminated, replaced by an estate tax deduction for state death taxes paid. The deduction will provide some assistance to estates, but will do nothing for ailing state coffers.

For states with pick-up taxes, no federal credit means no state estate taxes. Some states are letting their death taxes die along with the federal estate tax, while others are still considering how to respond. In a handful of states, decoupling from the federal estate tax requires a constitutional amendment, a potentially difficult and time-consuming process. As a result, the death tax may vanish in those states as well.

New focus on state taxes

How can these changes affect your estate plan? Before EGTRRA, estate planning focused on federal tax issues; state taxes were generally an afterthought. Now, state estate tax considerations play a more prominent role. For example, if you live in a state that has established its own estate tax, you could conceivably owe more tax than you would have before EGTRRA.

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Also, because state death taxes now vary dramatically from state to state, residency issues have become more critical. Some states now impose significant death taxes, while others impose no tax at all.

If you're retired and contemplating relocating to a warmer climate, or if you have residences in more than one state, you've probably already considered the effects of residency on income taxes. State income tax rates range from double-digit to none at all. Plus, some states tax retirement plan distributions while others don't. Now you need to add state death taxes to the mix. In some cases, income tax considerations may favor residency in one state, while death tax considerations favor another. Your tax advisor can help you analyze the relative tax costs and benefits of residing in various states.

Once you choose an appropriate state to reside in, it's more important than ever to take action to establish and document your residency. The methods states use to determine whether you really reside outside their jurisdiction have become quite sophisticated. In addition to asking for proof that you vote, register your automobiles and hold a driver's license in another state, states may also check Internet records to see which address you use for online purchases and where you own real estate or business interests.

Ultimately, to establish residency in a particular state, you'll need to prove that you spend the majority of your time there. And that can be a formidable task, especially if you have a long history in another state.

The state of state taxes

As the states continue to adapt their tax laws to changing economic circumstances, it's important to monitor the impact of both state death taxes and state income taxes. Consult your tax advisor to determine whether you'd benefit from a shift in residency now or in the future.

International estate planning 101

Learn the basics to avoid costly mistakes

Because of advances in telecommunications and the ease of international travel, people have become increasingly mobile. As they move about the globe accumulating wealth, a number of tax issues arise as different countries compete to claim a piece of the pie.

If you're a U.S. citizen who lives or owns property outside the United States or a noncitizen who lives or owns property in the United States, it's important to become familiar with international estate tax issues. Bear in mind that international estate planning is complex. This is only a brief introduction to the types of issues that may arise.

The long arm of the U.S. estate tax

The global reach of U.S. estate and gift taxes may surprise you. There are three ways you can fall within their grasp:

1. Citizenship. If you're a U.S. citizen, all of your assets are subject to U.S. transfer taxes, regardless of where you live or where the assets are located. You could conceivably be subject to these taxes even if you've never set foot in the United States. If you're born in the United States, even if your mother gave birth while vacationing in the States, you're considered a U.S. citizen. You're also a citizen if you were born outside the United States and one or both of your parents were U.S. citizens.

A double taxation risk exists if your assets also are subject to death taxes in another country. U.S. law contains a foreign death tax credit, but it doesn't always apply. The United States also has estate tax treaties with some countries that may provide some relief. Giving up your U.S. citizenship may be a solution, but that tactic raises other tax and nontax issues that are beyond the scope of this article.

2. Domicile. Even if you're not a U.S. citizen, you may still find yourself subject to U.S. estate taxes if your domicile — a residence with an intention to stay indefinitely — is in the United States. Once domicile is established, you're stuck with U.S. estate and gift taxes even if you leave the country temporarily or your assets are located outside the United States. Keep in mind that domicile is a subjective concept that takes into account your intent — that is, whether you intend to remain in the United States indefinitely.

3. Situs of assets. Even if you're not a U.S. citizen and you're not domiciled in the United States, you're liable for U.S. estate and gift taxes on transfers of assets "situated" in the United States, such as real estate. But many nonresident aliens (NRAs) are surprised to learn that corporate stock is deemed to be located in the company's state of incorporation. Unless an estate tax treaty provides otherwise, NRAs are entitled to only a $60,000 estate tax exemption, compared to a $1.5 million exemption for a U.S. citizen or domiciled person. (Special rules apply to NRAs who reside in a U.S. possession.)

For NRAs, general deposit accounts with U.S. banks are exempt from estate and gift taxes, as are most government and corporate bonds. Proceeds of life insurance policies owned by an NRA and issued by a U.S. insurer also are exempt.

Multijurisdictional planning issues

If your assets cross international borders, one potential tax trap is that some countries don't recognize trusts — a key component of most Americans' estate plans.

Using a trust to hold foreign assets can cause unpleasant consequences, including higher taxes in foreign countries. In many countries, the inheritance tax rate is determined by the relationship of the parties. Transfers to a trust with a nonfamily member as trustee may trigger the highest possible tax rate. Also, assets placed in trust may be treated as if they're owned by the trustee, possibly exposing the assets to claims of the trustee's creditors or heirs.

Foreign countries may also have forced heirship and other laws that override the terms of your will.

A basic understanding is key

If your wealth may be subject to estate taxes in more than one country, it's smart to have at least a general understanding of international estate tax issues. Even though international estate planning is complex, understanding the basics can help you avoid costly planning mistakes.

Estate planning red flag

Granting Crummey powers to charities

The annual gift tax exclusion allows you to transfer up to $11,000 (in 2004) per recipient per year tax-free without having to tap your $1 million lifetime gift tax exemption. But the annual exclusion applies only to gifts of present interests. The right to receive money or other assets in the future doesn't qualify. This presents an obstacle if you want to make gifts in trust because trust contributions are usually considered to be gifts of future interests.

Crummey powers allow you to get around this restriction. Named after the case that approved the technique, these powers give a trust beneficiary the right to withdraw trust contributions for a specified period — usually 30 days after you make them. This limited withdrawal right satisfies the present interest requirement and allows you to take advantage of the annual gift tax exclusion.

Although the use of Crummey powers is a well-accepted estate planning strategy, the IRS may challenge perceived abuses. In a recent ruling, the IRS said that a grantor was not entitled to the annual exclusion or charitable deductions for gifts made to a trust subject to Crummey powers held by four charities.

In this particular case, the trust was established for the benefit of the grantor's children, and the charities had contingent remainder interests. Because the trustee had the right to deplete the trust to meet the children's needs, there was a good chance the charities would end up with nothing. For each contribution to the trust, the charities had a choice between making a withdrawal and allowing the funds to remain in the trust, subject to distribution to the grantor's children.

Given strict prohibitions against the use of a charity's property for noncharitable purposes, the IRS concluded there was a legal impediment to the charities' participation in this arrangement and, therefore, that the Crummey powers were illusory. The ruling highlights the dangers of granting Crummey powers to charities or others who have no other economic interest in the trust.

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