Insight on estate planning

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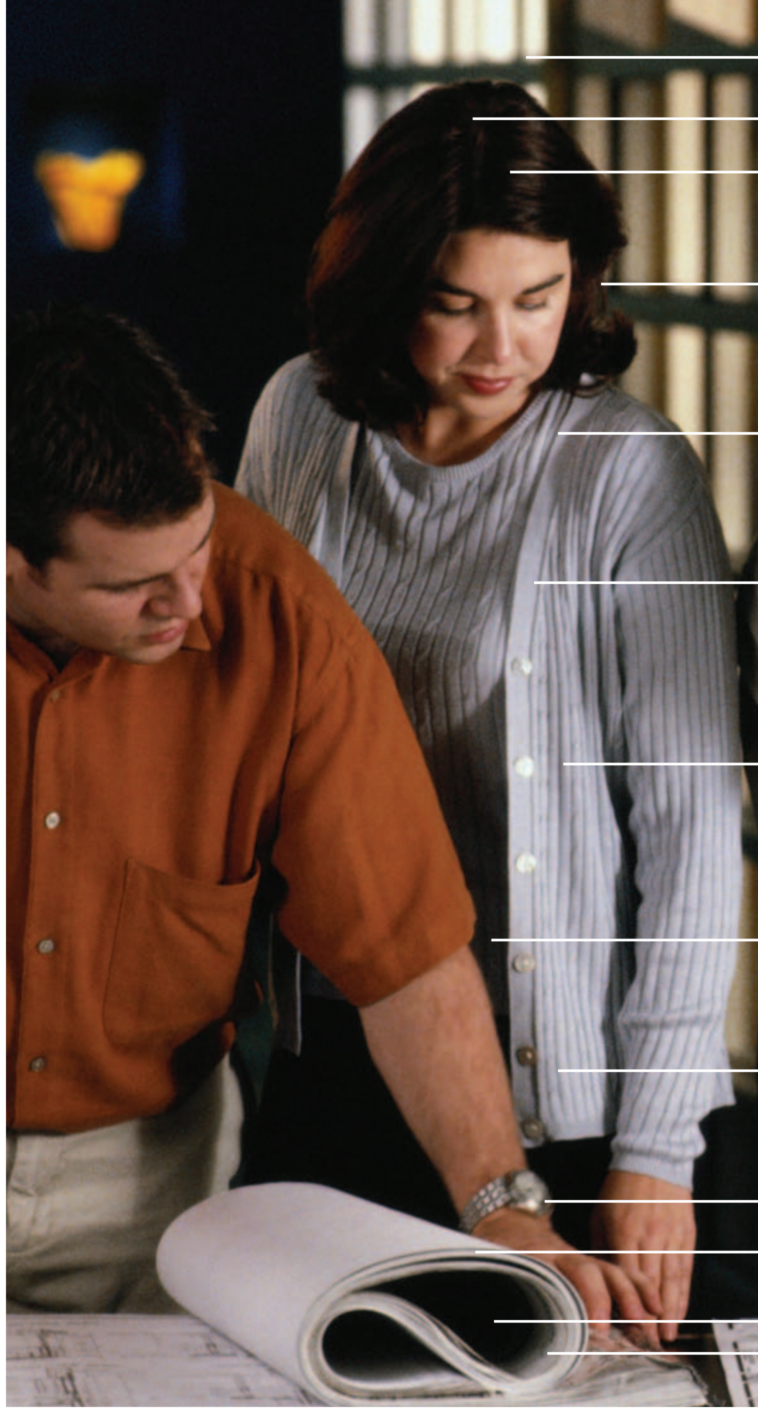

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Blueprint for an FLP that can withstand IRS attack

The family limited partnership (FLP) landscape is littered with the wreckage of numerous IRS attacks. Yet, like a phoenix rising from the ashes, the FLP continues to flourish as a powerful estate planning tool.

Still, the IRS continues to find new ways to challenge FLPs. The latest, and perhaps the most effective, IRS battle strategy is based on Internal Revenue Code Sec. 2036(a). Specifically, the assets that are transferred to the partnership are treated, for estate tax purposes, as being taxable in the estate of the older generation.

The IRS has used this attack, or at least some derivation of it, in numerous Tax Court cases. The good news is that, as a result, there is a fairly reliable blueprint for success — and failure — if you're forming an FLP.

FLPs in action

FLPs first gained popularity as a vehicle for transferring assets at a discounted value to family members. The typical scenario is that the older generation:

- Has significant assets, such as investments or real property, that could logically be centrally managed,
- Transfers those assets to a family partnership, creating general partnership shares and limited partnership shares,
- Gifts limited interests to the younger generation, claiming a discount on the gifts' value because the assets gifted are minority, noncontrolling interests, and
- Has divested itself of the assets, thus reducing estate tax liability.

Even though the IRS initially rejected the validity of claiming discounts for gifts to family members, in Revenue Ruling 93-12 the IRS acquiesced, albeit reluctantly. But

accepting the fact that discounts are appropriate didn't necessarily translate to accepting the FLP concept.

The Sec. 2036(a) battle strategy

The IRS has seen more success with its Sec. 2036(a) battle strategy. Sec. 2036(a) sets out the principle that, if you give something away during your lifetime but retain the right to use it or to designate who shall use it, you really haven't given it away — you have a "retained life estate."

More often, the IRS is using the argument that the person making the gift of FLP interests really gave away nothing and, therefore, the assets of the partnership should be includible in his or her estate. The premise often is that there has been no change in the relation of the taxpayer to the assets ostensibly given away. The success is largely a result of how the FLP was used — or *mis*used — by the decedent and family before death.

Sec. 2036(a) does provide a notable exception for assets that are transferred in a "bona fide sale for adequate consideration." But in a typical situation, the bona fide sale exception isn't going to apply because there has been no sale. So the taxpayer must rely on the facts and circumstances of his or her situation to determine whether the FLP is likely to be subject to attack.

Strangi: What not to do

Probably the most infamous case in this area is in actuality a series of cases involving the Albert Strangi estate. Thus, the cases often are referred to as *Strangi, Strangi II* and *Strangi III.*

The facts of the *Strangi* cases give a good example of what not to do when setting up an FLP. The most germane are that 1) Strangi contributed nearly all of his assets to the partnership, including his personal residence, and 2) the partnership form was not respected by the family. Indeed, the partnership's assets were largely treated as if they were still Strangi's assets.

This proved to be most telling from the standpoint of the Tax Court. The court found that Sec. 2036(a) applied under both subsections. It applied because 1) there was an implied agreement that Strangi retained the right to the enjoyment of the property, and 2) he could name who had the right to designate who would enjoy the property.

Estate of Stone: What to do

In the *Estate of Stone,* the facts were more favorable to the taxpayers and, thus, the IRS argument under Sec. 2036(a) wasn't successful. There, the taxpayers retained sufficient assets outside the FLP to maintain their lifestyle. In addition, there were negotiations with respect to creation of the partnership. Each party to the negotiations (the taxpayers and their children) had independent representation.

Furthering the argument was the fact that the FLPs were treated as real businesses. The Tax Court in *Stone* provided guidance for taxpayers contemplating forming an FLP:

- Have a clear business purpose.
- Operate the FLP as a business.
- Don't commingle FLP funds and personal funds.
- Have sufficient outside assets so FLP funds aren't needed to maintain lifestyle.
- If making distributions, make them proportionate to ownership.

Other cases that have been decided seem to turn more on the question of whether the taxpayer retained sufficient assets outside of the FLP. This should provide even stronger proof that the FLP is able to withstand attack so long as the facts and circumstances warrant it.

Thompson and *Kimbell*: More guidance

In a case that was decided in late 2004, *Thompson,* the facts show that a 95-year-old transferred nearly all of his assets to an FLP. Not only did he not retain sufficient assets outside of the partnership to maintain his lifestyle, but his children testified that they often anticipated his requests for distributions from the partnership so that he could meet his daily living expenses.

Thompson, the court concluded, retained the right to the possession or enjoyment of the property under Sec. 2036(a) and the FLP assets were includible in his estate. In this case, the taxpayer didn't respect the FLP concept, so the result should not be surprising.

Contrast this result, however, with that of the *Kimbell* case, which was decided shortly before *Thompson*. Kimbell's estate prevailed largely because she had sufficient assets outside of those she transferred to the FLP. The FLP in *Kimbell* was set up to manage various investments, and the family showed several business reasons for creating the partnership.

Draw up your plans carefully

FLPs are indeed alive and well. The most important factor, as has become readily apparent from past Tax Court cases, is how you use the FLP as an estate planning tool. The IRS will undoubtedly continue to fight and find new ways to challenge these vehicles, so it's important that when using an FLP you closely follow the rules. The more unusual your situation, the more likely the IRS will mount a challenge.

Making the grade with a 529 plan

There are only a handful of Internal Revenue Code sections that have attracted as much attention in the past few years as 529 plans have. They're popular as both college savings and income tax reduction vehicles. In addition, they're useful as estate planning tools.

Defining "college savings plan"

A college savings plan, under Sec. 529, is merely a specialized way to save money for college. Bear in mind that this doesn't refer to the prepaid tuition plan that also falls under Sec. 529. Those plans essentially are a way to pay for future tuition at today's prices.

In a 529 savings plan, the funds are invested in a plan sponsored by a state and managed by a reputable mutual fund company. Earnings on the investments are not taxed, so long as they remain in the plan. While this is a valuable feature, it's important to note that, as the law is currently written, starting in 2011 this benefit will no longer be available and the current earnings will be subject to income tax. The earnings instead will be taxed at the beneficiary's income tax rate, which is likely lower than yours.

Until 2011, distributions from the plan are tax free as long as you use them for qualified educational expense purposes. Essentially, qualified expenses include tuition, fees, books, room and board, and other related items.

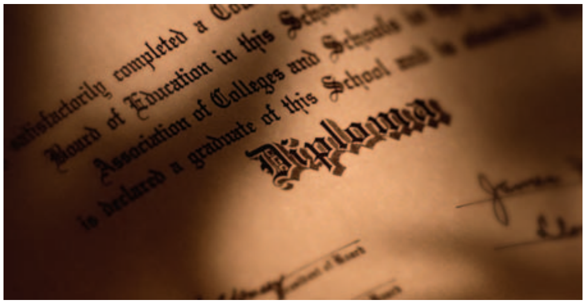
Estate planning benefits

A 529 plan offers significant benefits from an estate planning perspective. First, transfers to these accounts are eligible for the annual exclusion. Thus, in 2005 you can contribute up to $11,000 ($22,000 if you split gifts with your spouse) per beneficiary without using up any of your $1 million lifetime gift tax exemption.

Any amount you give is considered a completed gift and is immediately removed from your estate. This is so even though you retain the right to control the funds and to change the beneficiary, which in most other situations would cause assets to be included in your estate.

But there is an even more powerful estate planning benefit of 529 plans: The law was written to allow you to make five years' worth of gifts at one time and still have those gifts qualify as annual exclusion gifts. So you can make a gift of up to $55,000 ($110,000 if splitting gifts with your spouse) per beneficiary and treat it as being attributable to the current year and each of the next four years. Any growth on those funds also will be outside of your estate.

There are two caveats regarding the front-loading of gifts in this manner. First, any additional gifts you make during the five years would not qualify for the annual exclusion. Thus, if you were to make a $55,000 gift to your grandchild's 529 plan this year, any extra gifts you make between now and the end of 2009 would exceed the available annual exclusion amount. Those gifts would reduce your available $1 million lifetime exemption, or, if you've already used



up your lifetime exemption, they would be subject to gift tax.

Second, if you die before the fourth year following the gift, the portion of the gift that was not eligible for the annual exclusion is included in your estate. Any growth on the amount gifted, though, would be outside of your estate.

529 plan flexibility

When using a 529 plan, you may change your beneficiary. So long as the new beneficiary is included in the definition of "member of the family," the transfer is permissible.

A member of the family includes the beneficiary's spouse, child or other descendant; a sibling, including a stepsibling; a parent, including a stepparent; and a niece, nephew, uncle, aunt, parent-in-law, child-in-law, and sibling-in-law, as well as the spouse of any of the aforementioned. And, as expanded under the 2001 tax act, first cousins are included in the definition.

But keep in mind that changing your beneficiary to someone who is one generation or more removed from the current beneficiary could cause gift or generation-skipping transfer tax issues.

For instance, let's say that you create 529 plan accounts for your grandchildren. If one grandchild receives a scholarship and doesn't need the money to pay for tuition, you could change the beneficiary to another grandchild. Whether the new beneficiary is the old beneficiary's sibling or first cousin, there should be no estate or gift tax liability. (Note that, in 2011, "family member" is scheduled to return to its narrower definition, which doesn't include cousins.)

Alternative uses of 529 plan funds

Keep in mind that having funds in a 529 plan doesn't mean you have to use them for education expenses. In fact, there is another tax-advantaged way to fund a loved one's education costs. You are permitted to pay unlimited tuition and certain other education expenses for someone else without using any of your $11,000 annual gift tax exclusion or $1 million lifetime gift tax exemption — so long as your payments are made directly to the educational institution.

Thus, if you've funded a 529 plan while your grandchildren were young and now wish to remove more assets from your estate gift-tax free you can pay their college expenses directly. Or, if in a given year you make an annual exclusion gift to a grandchild — whether to a 529 plan or otherwise — you also can pay his or her educational expenses without such additional payments being treated as taxable gifts.

What do you do with the 529 plan funds? You can distribute them to the beneficiary. The funds would be taxable to the beneficiary — at the beneficiary's income tax rate, which is likely low and also likely subject to a 10% penalty. (There are some limited exceptions to the 10% penalty that include matching the amount of scholarship funds that the beneficiary receives.) Even with the penalty and the income tax liability, the total tax paid could be less than your income tax rate at the time. Plus, there would be tax-deferred growth and estate tax benefits that had inured over the years.

Further, you have the right to determine how the assets are invested. Generally, the plan provides for various options and allows you to periodically revise your choices. For instance, while your beneficiary is young, you might prefer to invest the funds more aggressively. As he or she gets closer to college age, you may want to invest more conservatively.

Beware of 529 plan limitations

One of the few downsides of a 529 plan is that the total amount of contributions you can make to a plan for any one beneficiary is limited. That said, the limits, which vary by state, are generous enough that you can transfer significant wealth by using 529 plans.

Another downside is that the investment choices are generally narrow in scope. They do vary from plan to plan, and you can choose a plan from any state.

Good for students, parents and grandparents

As higher education costs continue to increase, a 529 plan can help ensure sufficient funds are available for your child's or grandchild's college expenses. In addition, a 529 plan provides a combination of income, gift and estate tax savings. ▮

Are you in good health?

If so, long-term care insurance may be a wise investment

Think of what a debilitating illness might do to you physically. Now, think about how it might add insult to injury by similarly decimating you financially. Keep in mind that Medicare covers only short-term care, while, for example, you're recovering from an illness or injury. Medicaid does cover long-term care, but you must be virtually destitute to qualify. Long-term care insurance can provide a hedge against the possibility that long-term care costs will erode your estate.

You may, however, be in a position to self-insure against such peril. Thus, it makes sense to investigate long-term care insurance and determine whether it makes financial sense for you.

What costs are covered?

A typical long-term care policy covers costs you may incur as a result of no longer being able to complete activities of daily living, such as bathing, dressing and feeding yourself. Policies also cover custodial care, whether in your home, an assisted living facility or a nursing home. Some policies also cover adult day care activities.

What factors determine a policy's premium?

As with any health-related insurance, there are many factors involved in determining a policy's cost. Specific factors to consider include your age, family health history, current physical condition and other personal issues such as whether you smoke or engage in "extreme" hobbies, such as skydiving. Even where you live plays a role in determining a policy's cost.

Beyond those somewhat intangible issues, there are policy-specific concerns that can greatly affect your premium amount. One factor is the elimination period, which is sometimes called the "waiting period," because it determines how long you must wait before coverage begins. Typical waiting periods can range from 30 to 90 or more days. During the elimination period, you're responsible for covering all of your health care costs.

As with any health-related insurance, there are many factors involved in determining a policy's cost.

Another factor is whether the benefits are determined on a daily, weekly or monthly basis. This can be relevant. For instance, let's say that your benefits are calculated at $100 per day, and you're living in an $80 per day facility. If, because of a short-term malady, your costs increase to $120, you'd be liable for the extra $20 per day. On the other hand, if your coverage provides for monthly benefits of, say, $3,000, and the extra costs would be within your policy limit, you'd have no extra out-of-pocket cost.

Also consider including inflation protection, which indexes the benefit amount. In the above example, your $100 per day coverage might grow to $200 or $300 by the time you need it. As health care costs continue to increase, this option may prove to be extremely valuable.

Plan now for long-term care

Once you've estimated the cost of your desired coverage, compare that to your potential costs of what you have to pay out of pocket and determine whether long-term care insurance is a wise investment. Be sure to take into account the potential tax benefits for the premiums paid.

Subject to certain age-based limits on eligible amounts, you can treat the expenses either as an itemized deduction along with other medical expenses or, if you qualify, as an adjustment to income in the form of the self-employed health insurance deduction.

While there is no way to accurately predict your future health care needs, a long-term care insurance policy that covers both nursing home and stay-at-home care may be a solution to preserving your estate for your heirs. If you're considering buying a policy, it's important to do so while you're still in good health.

Put your vacation home to work for you

If you own a vacation home, one potential estate tax savings strategy at your disposal is the qualified personal residence trust (QPRT). In fact, this same strategy also applies to your primary residence, but may be more palatable to use with a vacation home.

A QPRT can work well if you wish to transfer ownership of your vacation home to your children but don't want to gift it outright. You may transfer the home into the trust and retain the right to continue to occupy it for a specified period of time.

By making this gift, which, because it's a future interest, doesn't qualify for the $11,000 annual exclusion, you will use a portion of your $1 million lifetime gift tax exemption. The value of the transfer for gift tax purposes is the current value of your home less the value of your right to occupy it for the set period. If you survive to the end of the term, the ownership of the home either remains in the trust or is distributed according to the trust's terms.

Assuming you intend for the home to stay in the family after you're gone, this is one way to remove the home's value — and its future appreciation — from your estate. As an added benefit, your heirs avoid the potential cash flow issue that would be created by keeping such an illiquid asset in your estate.

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Comprehensive Estate Planning Services

Founded in 1960, Weinstock, Manion, Reisman, Shore & Neumann offers estate planning, probate and trust administration, general business and corporate law, taxation, real estate and litigation services. Because 12 of our 14 attorneys are actively involved in estate planning, we specialize in helping clients meet objectives like these:

- Dispose of assets in a tax-efficient manner by using revocable living trusts.
- Minimize estate taxes by using sophisticated lifetime giving techniques, such as Grantor Retained Interest Trusts and Charitable Remainder Trusts.
- Provide liquidity and save estate taxes by using life insurance and irrevocable life insurance trusts.
- Efficiently administer probate and trust estates.
- Transfer business interests to younger family members in a tax-efficient manner.
- Minimize generation-skipping transfer tax on transfers to grandchildren and great-grandchildren.
- Implement deferred compensation and qualified retirement plans, including pension and profit sharing plans.
- Reduce income and estate taxes on the receipt of benefits from retirement plans.
- Avoid court intervention if disability strikes.
- Maximize employee productivity through the use of stock options and other incentive programs.
- Dispose of business interests among co-owners.
- Save on income taxes, both now and in the future.
- Select and form business entities, such as corporations, limited liability companies and family limited partnerships.

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Many of our lawyers are instructors at UCLA Extension and highly sought after as speakers for professional organizations in the community. Because we are at the forefront of current developments in law, we excel in designing strategies which help clients balance their business and financial interests with their personal and professional objectives in order to preserve and transfer their wealth.

We welcome the opportunity to discuss your needs and help you meet your estate planning and wealth transfer objectives.

Please call us at 310-553-8844 to let us know how we can be of assistance.