

KEY ISSUES IN ESTATE PLANNING & PROBATE

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BY

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SHIFTING VALUE AND TRANSFERRING INTERESTS —

OVERVIEW OF FEDERAL ESTATE AND GIFT TAX LAWS

A. Generation-Skipping Transfer Tax, Estate and Gift Tax

1. Increases in Exemption and Rate Reductions

The Economic Growth and Tax Relief Reconciliation Act of 2001 (the "2001 Tax Act") reduces the top estate,

gift, and generation skipping transfer ("GST") tax rates applicable before 2010 and increases the gift and GST exemptions and the applicable exclusion amount. Commencing in 2004, the amount of the GST exemption will be the same as the applicable exclusion amount. After 2002, however, the gift tax exemption remains \$1 million, while the estate and GST tax exemptions increase in stages, up to \$3.5 million in 2009. The top marginal estate and gift tax rate (also the single GST tax rate) and the estate, gift, and GST exemptions will be altered between 2002 and 2009 pursuant to the following schedule:

Taxable

Estates in: Top Rate Exemption

2001 55%, plus 5% surtax on \$675,000 for estate and gift

certain estates or gifts taxes; \$1,060,000 for

over \$10 million GST tax

2002 50% (surtax repealed) \$1 million estate and gift

tax; \$1,060,000 (with

indexing for the GST

exemption)

2003 49% \$1 million estate and gift

tax; \$1,060,000 (with

indexing for the GST

exemption)

2004 48% \$1.5 million for estate and

GST taxes; \$1 million for

gift tax

2005 47% \$1.5 million for estate and

GST taxes; \$1 million for

gift tax

2006 46% \$2 million for estate and

GST taxes; \$1 million for

gift tax

2007 45% \$2 million for estate and

GST taxes; \$1 million for

gift tax

2008 45% \$2 million for estate and

GST taxes; \$1 million for

gift tax

2009 45% \$3.5 million for estate and

GST taxes; \$1 million for

gift tax

2010 Full repeal of estate and \$1 million for gift taxes

GST taxes; gift tax

retained at top income tax rate

2. Carryover Basis for Property Received From a Decedent

a. Under current law, a person who receives property from a decedent takes an adjusted income tax basis in that property equal to the fair market value of the property on the date of death or, if elected, the alternate valuation date. Thus, both appreciation and depreciation in the value of property received from a decedent (up to the value of the property on the date of death or alternate valuation date) is eliminated. Even under current law, however, certain assets, such as items of income in respect of a decedent, do not qualify for this basis adjustment.

In contrast, a donee's basis in property received by lifetime gift is equal to the donor's basis in the asset at the time of the gift. If, however, the fair market value of the property is lower than the donor's adjusted basis at the time of the gift, the donee's basis in the property solely for purposes of determining loss on the subsequent disposition of the asset is equal to the fair market value of the property.

b. Carryover Basis in 2010

The 2001 Tax Act gives a person who receives property from a decedent who dies after December 31, 2009 an adjusted basis in the property equal to the lesser of their fair market value of the property on the date of the decedent's death or the adjusted basis of the property in the hands of the decedent. Thus, the step up in basis for appreciated assets received from a decedent is eliminated, but the step down in basis for loss assets is preserved.

Example

Joe dies on January 2, 2010, leaving an estate that includes the following assets:

FMV on

Asset Joe's Basis Date of Death

XYZ Co. stock \$100,000 \$200,000

ABC limited \$300,000 \$250,000

partnership interest

Joe's Will leaves his estate to his son, Allan. Allan takes Joe's \$100,000 basis in the stock, but he takes a \$250,000 basis in the ABC partnership interest (the lesser of Joe's basis or its fair market value on the date of death).

c. Adjustments to Basis

The 2001 Tax Act permits the executor of a decedent's estate to allocate additional basis to and among a decedent's assets. The two basis adjustments are the \$1.3 million aggregate basis increase and the \$3 million spousal property basis increase.

i. \$1.3 million aggregate basis increase.

The 2001 Tax Act permits the executor of a decedent's estate to allocate among the decedent's assets a \$1.3 million aggregate basis increase. The allocation of the aggregate basis increase is made by the executor on an asset by asset basis, and cannot raise the basis of any asset above its fair market value on the date of the decedent's death.

Example

Joe dies on January 2, 2010, leaving his estate to his son, Allan. Joe's estate includes the following assets:

FMV on

Asset Joe's Basis Date of Death

XYZ Co. stock \$ 300,000 \$1,000,000

ABC LP interest \$ 500,000 \$ 750,000

GHI stock \$ 500,000 \$ 750,000

Residence \$ 400,000 \$ 500,000

Total \$1,700,000 \$3,000,000

The executor of Joe's estate can allocate the \$1.3 million aggregate basis increase among these assets, thereby increasing the basis of each asset to its fair market value. This will raise the total basis of Joe's assets from \$1.7 million to \$3 million. Joe's estate or Allan can now sell the assets for their fair market value on the date of Joe's death without recognizing any gains for federal income tax purposes.

The \$1.3 million limitation on the aggregate basis increase is increased by two types of unused losses. First, the executor adds to the \$1.3 million aggregate basis increase the sum of (1) the amount of any capital loss carryover (under Section 1212(b)) and (2) the amount of any net operating loss carryover (under Section 172), which would (but for the decedent's death) have been carried forward from the decedent's last taxable year to a later taxable year of the decedent. Second, the trustee adds to the \$1.3 million aggregate basis increase the sum of the amount of any losses that would have been allowable (under Section 165) had the property acquired from the decedent been sold at fair market value immediately before the decedent's death.

(Note: Estates of nonresidents who are not U.S. citizens will be limited to an aggregate basis increase of only \$60,000, rather than \$1.3 million. Additionally, the aggregate basis increase for estates of nonresident aliens is determined without the capital loss and net operating loss carryover adjustments.)

The \$1.3 million (and \$60,000) figure(s) are indexed for inflation after 2009. The \$1.3 million figure will be increased in increments of \$100,000, and the \$60,000 figure in increments of \$5,000.

ii. Spousal property basis increase.

The 2001 Tax Act permits the executor of a decedent's estate to increase the basis of property acquired from the decedent by the decedent's surviving spouse by \$3 million, in addition to any adjustments made by the \$1.3 million aggregate basis increase. This is referred to as the spousal property basis increase. The amount allocated to the property received from a decedent by the surviving spouse cannot increase its basis above the fair market value of the property on the date of the decedent's death.

iii. Carryover basis potentially worse than estate tax.

The substitution of carryover basis for the estate tax can substantially increase the total taxes imposed on a surviving spouse receiving an estate in which there is more than \$4.3 million of net appreciation. Currently, the unlimited estate tax marital deduction eliminates all estate taxes on property received from a decedent by a surviving spouse who is a U.S. citizen. The present tax law also increases the adjusted basis of all assets includible in the gross estate to the value of such assets on the date of the decedent's death or the alternate valuation date. The 2001 Tax Act eliminates the estate and GST taxes on such an estate after 2009, but it also eliminates the basis increase at death. Therefore, if there is more than \$4.3 million of appreciation in the value of the assets owned by the decedent, the carryover basis rules will increase the potential income taxes.

Example

Joe leaves his entire \$20 million estate to Jean. Joe's basis in the assets in his estate is \$2 million. Joe dies on December 30, 2001, and the estate tax marital deduction eliminates any estate tax with respect to his estate, and the basis rules give Jean a \$20 million basis in the assets she receives from Joe's estate. Therefore, Jean receives the entire \$20 million with neither an estate tax liability nor any potential income tax liability.

Under the 2001 Tax Act, however, if Joe dies in 2010, Jean owes no estate tax because the estate tax will have been repealed. Jean will, however, take Joe's adjusted basis in the assets, increased by the aggregate basis increase and spousal property basis increase. This gives Jean a total \$6.3 million basis in the assets received from Joe's estate. The sale of Joe's assets by Jean will result in realization and recognition of a \$13.7 million capital gain, on which there would be an income tax liability of approximately \$2,740,000 (20% of \$13.7 million). Thus, the Tax Act of 2001 will have increased the tax cost of passing Joe's estate to Jean by \$2,740,000.

3. Sunset Provisions

The estate, gift, and GST tax provisions of the 2001 Tax Act will expire on December 31, 2010. This change was required to comply with the Congressional Budget Acts of 1974 and 1990. The sunset provision means that, unless Congress reenacts these changes, (1) the estate and GST taxes will be repealed only with respect to estates of decedents dying in 2010 and taxable events in 2010, and (2) the estate, gift, and GST tax laws will be restored to their 2001 status on January 1, 2011.

If the 2001 Tax Act's estate, gift, and GST tax provisions are not re-enacted, the estate and GST taxes will be resurrected on January 1, 2011, with a top estate and gift tax rate (and the only GST tax rate) of 55% and a 5% surtax on certain transfers of over \$10 million. The estate tax applicable exclusion amount would be \$1 million. Carryover basis would disappear and the present basis rules would be returned. Finally, the state death tax credit and qualified family-owned business interest (QFOBI) exclusion would be resurrected, and the technical changes made in 2001 to the conservation easement rules and the GST exemption allocation rules would expire.

Congress may have believed that these changes would ultimately be made permanent. A subsequent Congress, however, might find that economic or political conditions have changed enough to decline an extension of these provisions. Consequently, the repeal of the estate and GST taxes, as well as the increases in exemptions and reductions in rates, and other related changes, will be immaterial after December 31, 2010, unless Congress acts to continue such provisions.

On March 5, 2004, the Senate Budget Committee issued its proposed federal budget, including a non-binding request that the Senate Finance Committee produce legislation repealing the federal estate tax in 2009, rather than in 2010. On March 9th, Senator Grassley, the chairman of the Senate Finance Committee, replied that he has no plans to report legislation accelerating the repeal of the estate tax and that he would prefer increasing exemptions and lowering rates over outright repeal. This seems to be the general direction that legislators are moving. There is no telling where the exemption may end up, but it is likely to be between \$2 million to \$3 million per person.

A. Methods of Effectuating Lifetime Transfers

1. In General

Gifts during lifetime are generally made either outright or in trust, or in the case of gifts to minors through the medium of a custodian account under the Uniform Gifts to Minors Act, the Uniform Transfers to Minors Act, or other state gift to minors law.

Outright gifts are effective to shift the tax on income from the gift property to the donee. But outright gifts have practical disadvantages, in many situations, and where this is the case, a trust or custodian gift is often preferable.

Whether a gift to a trust will achieve income tax savings depends on the provisions of the trust. Many trust gifts are effective to shift tax on income from the donor to the trust or to the trust beneficiary, while other trust gifts will not shift tax on the income. This generally turns on the extent to which the donor of the trust gift retains powers over, or interests in, the trust property and it is an important aspect of lifetime planning to determine the extent to which such powers or interests should be retained and how such retention affects the income tax savings which can be obtained. In light of the high income tax rates which currently apply to trusts, it is unlikely to be advantageous to shift the tax on income of the transferred property from the estate owner to the trust itself. Thus income should not be accumulated in a trust unless the donor retains sufficient powers over or interests in the trust property so that the income will be taxable to the donor. See the discussion below regarding Grantor Retained Annuity Trusts and sales to a defective grantor trust.

Custodian gifts are frequently utilized where the donee is a minor. Use of this method can effectively shift the tax on income from the gift property from the donor to the minor donee. But the rate at which the child will be taxed depends upon whether he has attained age fourteen (14) when the gifts are made. See discussion of "Kiddie Tax" below.

2. Below-Market Gift Loans.

Certain interest-free and below-market interest rate loans result in a gift from the lender to the borrower for gift tax purposes. Generally, the amount of the gift is determined by comparing the interest payable on the loan to the Applicable Federal Rate (AFR). The lender is treated as transferring to the borrower an amount equal to the foregone interest, generally on the last day of the year. There is an exception provided for certain de minimis loans (i.e. gift loans) directly between individuals where the aggregate outstanding loans between the individuals does not exceed \$10,000.

C. Alternative Methods of Transfer

1. Creation of Joint Tenancy — Real Property

When persons other than spouses transfer separately owned real property to joint ownership or buy property in joint name, there is usually a gift from one to the other if they make unequal contributions. For example, if a dad buys a vacation home with his own funds for \$500,000 and takes title in joint tenancy with his son, he has made a gift of \$250,000 to his son.

Where the donee joint tenant dies before the donor joint tenant, property given away by the donor, at the price of using some of his unified credit or paying a tax, passes back to his sole ownership as surviving joint tenant, and if retained until his death will be included in his estate and subject to estate tax therein.

2. Joint Tenancy — Bank Accounts

There is no gift when one co-owner deposits funds in a joint bank account which permits the depositor to regain the entire amount without the other co-owner's consent. There is a gift when the non-depositing co-owner makes withdrawals without obligation to account for the withdrawn funds to the depositor. IRC Reg § 25.2511-1(h)(4).

Therefore, the delivery of joint bank account books to the non-depositing co-owner is not a completed gift where the depositor keeps her name on the accounts and retains the power to withdraw the funds and use them for her own purposes. The exercise of the non-depositor's right to withdraw would complete the gift (subject to the annual exclusion).

3. Powers of Appointment

When a trust is created, the grantor dictates its terms (e.g., to whom the income is payable, whether, on what conditions and for whose benefit the principal may be invaded, and to whom, when, and in what form (outright or in further trust) the principal is to be ultimately distributed). Tax considerations may require that an inter vivos trust be made irrevocable and its original terms not subject to amendment. Because trusts often last for many years, the provisions made by the grantor for the ultimate disposition of the trust property may be rendered inappropriate by events and changing circumstances which arise during the trust term. A "power of appointment" provides a flexible solution. In its most common usage, the term "power of appointment" refers to a right given by the grantor to a beneficiary of the trust to name, either during the beneficiary's life or in his will, the ultimate recipients of the trust property. The power of appointment permits the original plan for the distribution of the trust's property to be altered by the beneficiary in the light of circumstances which arise during the term of the trust.

There are two types of powers of appointment: "general" and "special." A "general" power of appointment gives the holder the right to appoint the property subject to his power to anyone at all, including himself, his creditors, or his estate. The value of property over which a person has a general power of appointment is included in his gross estate when he dies.

A "special" power of appointment permits the holder to appoint among the persons designated by the grantor of the trust, but in no event can the holder of the power appoint the property to himself, his creditors or his estate. Since the holder of a special power cannot appoint to himself, his creditors, or his estate, the value of the property subject to his power is not included in his estate at his death.

The exercise of a general power of appointment is treated as a transfer of property by the powerholder. IRC Section 2514(a) and (b). The release or lapse of a general power of appointment is also treated as a transfer of property (exceptions include a qualified disclaimer and a "5 and 5" power").

Property transferred through a general power of appointment will be subject to gift tax. Property transferred pursuant to a special power of appointment will not be subject to gift tax. IRS Section 2514(b).

4. Disclaimers

A bequest or lifetime gift to a person is presumed to be accepted unless it is expressly refused. However, the person who is the intended donee of an interest in property may decide for any reason that she does not want that interest. If she refuses to take it by disclaimer, and her disclaimer is not a qualified disclaimer, the disclaimer is disregarded and she is treated as having received the interest. IRC Reg § 25.2518-1(b). The interest will ordinarily pass to some other person as a result of her disclaimer and will therefore be treated as a gift transfer by her to the other person. Therefore, the unqualified disclaimer of a contingent future interest in a trust is an indirect gift.

In the case of a transfer creating an interest in property (within the meaning of IRC Reg § 25.2518-2(c)(3) and(4), a qualified disclaimer) made after December 31, 1976, there is no indirect gift if the interest passes to a different donee as a result of a qualified disclaimer by the donee.

i. Planning Advantage

Where a beneficiary owns substantial assets, an inheritance received by her may be subject to estate tax again on her death, or gift tax if the beneficiary disposes of the property during her lifetime. By disclaiming the inheritance, the beneficiary can avoid having the inheritance taxed as part of her wealth transfer base without increasing the tax on the her estate.

Example

Two daughters, one well provided for and the other not, inherit their mother's estate equally. The daughter who is well off wishes her sister to receive all of her mother's assets. By disclaiming her share of her mother's estate, the wealthier daughter avoids having the inheritance taxed in her wealth transfer base, without increasing the tax on her mother's estate.

Example

Two daughters, both with significant estates, inherit their mother's estate equally. One of the daughters is married and has children. She wishes her children to receive some of her mother's estate to avoid having the property taxed again in her own estate. This may be done by the daughter disclaiming part of her inheritance. Although the daughter's disclaimer results in a direct skip subject to the GST tax, if mother's estate has sufficient GST exemption to allocate to the transfer, the disclaimer will not increase the taxes on mother's estate.

I. PROTECTING THE PASSAGE OF WEALTH

A. Techniques to Decrease Transfer Taxes

1. Split Interest Techniques.

a. In General.

i. Some of the most effective estate planning techniques to leverage the benefits of the annual exclusion, applicable credit amount, and GST exemption involve dividing the ownership of one or more of the client's assets among the client and the client's beneficiaries. The ownership of assets can be divided on a time basis. The division of the ownership of an asset on a temporal basis is referred to as a "split interest" technique.

ii. A client can divide the temporal ownership of an asset based on a term of years, the life of the client, the life of an individual other than the client, or a combination of a term of years and the life of an individual. The IRS has published the method of measurement of the present value of an interest based on a term of years (using interest rate assumptions) and the life of one or more individuals (using interest rate and mortality assumptions). Thus, split interest techniques can be grouped in two categories: (1) Techniques based primarily on interest rate assumptions; and (2) Techniques based primarily on mortality assumptions.

b. Split Interest Techniques Based Primarily on Interest Rate Assumptions.

i. Split interest estate planning techniques based primarily on interest rate assumptions include: GRATs, QPRTs, term of years charitable trusts and installment sales.

ii. The two primary Internal Revenue Code sections prescribing the interest rates to be used in valuing temporal interests are sections 1274 and 7520.

1. Interest Rate Assumptions Used in Valuation of Split Interest

Techniques.

a. Section 1274.

i. IRC section 1274 prescribes a table of interest rates, called the "applicable federal rates" ("AFR"), that are used to determine the value of payments on certain debt instruments. The AFR for a debt instrument is based on the term of the instrument (i.e., short-term, mid-term, or long-term). The Internal Revenue Service publishes the AFRs monthly in the Internal Revenue Bulletin.

ii. Estate planners frequently encounter section 1274 (AFR) in below-market family loans, intra-family sales, and other straight debt transactions.

iii. In selecting the appropriate split interest technique, it is important to remember that section 1274 rates (AFR) are almost always lower than the section 7520 rate.

b. Section 7520.

i. IRC section 7520 provides a term of years shall be valued under tables issued by the Internal Revenue Service. The section 7520 rate is 120% of the section 1274 midterm rate. If an income, estate, or gift tax charitable deduction is allowable for any part of the property transferred, the taxpayer may elect to use the section 7520 rate for either of the two months preceding the month in which the valuation date falls. (This is only applicable to charitable remainder trusts and charitable lead trusts.)

c. Mortality Assumptions Used in Valuation of Split Interest Techniques.

i. Some of the techniques based on mortality assumptions include: self-canceling installment notes and private annuities, transfers of life estates and remainder interests, joint purchases, and split interest charitable trusts based on one or more lives.

ii. There are two factors necessary to determine the value of a life estate or other interest based on an individual's life expectancy, a discount factor and a mortality assumption.

iii. The mortality component of the actuarial tables is determined by reference to Table 90CM. Based on the 1990 census, Table 90CM shows the number of individuals alive at every age beginning at age zero and ending at age 110.

iv. There are some instances where the Regulations to section 7520 do not allow the use of the mortality tables under section 7520. The Regulations to section 7520 make it clear that the mortality component prescribed under section 7520 may not be used to determine the present value of an annuity, income interest, remainder interest, or reversionary interest if an individual who is a measuring life is terminally ill at the time of the transaction.

v. For purposes of the Regulations, an individual who is known to have an incurable illness or other deteriorating physical condition is considered terminally ill if there is at least a 50 percent probability that the individual will die within one year. However, if the individual survives for eighteen months or longer after the date of the transaction, that individual shall be presumed to have not been terminally ill at the time of the transaction unless the contrary is established by clear and convincing evidence.

a. Effect of Changes in Section 7520 Rate.

i. Changes in the section 7520 rate have a significant impact on the valuation of split interest transfers.

ii. An increase in the section 7520 rate increases the value of life estates and term of years, thereby increasing the charitable deduction for charitable remainder annuity trusts, fixed annuities, and deferred annuities.

iii. On the other hand, an increase in the section 7520 rate decreases the charitable deductions for charitable lead annuity interests and gifts of remainder interests in personal residences and farms.

iv. The charitable deductions for charitable lead unitrusts and charitable remainder unitrusts are generally not significantly affected by changes in the section 7520 rate.

3. GRANTOR RETAINED ANNUITY TRUSTS (GRAT)

a. Description of GRAT.

i. A GRAT is a trust that pays an annuity to the grantor for a specified time period. At the end of the term reserved by the grantor, the trust assets are distributed to the beneficiaries selected by the grantor. The grantor's retained annuity interest is determined under the valuation rules of section 7520. The purpose of these rules is to prevent the shifting of economic enjoyment between income and remainder beneficiaries based on investment decisions made by the trustee. The grantor is entitled to receive the annuity regardless of the income produced by the trust assets. Accordingly, a trustee would have no incentive to maximize principal growth at the expense of income. The trustee's objective is to maximize the total return of the trust assets, regardless whether it is from income or appreciation.

ii. Example: Assume that parent funds an irrevocable trust with \$1,000,000. Under the terms of the trust, parent receives an annual annuity for 10 years of \$50,000. If the section 7520 rate is 4.2 percent, the value of parent's retained interest is valued at \$373,825 and the remainder interest is valued at \$626,175. Thus, the right to receive a \$50,000 annuity for 10 years is worth \$373,825 and the right to receive the remainder at the end of 10 years is worth \$626,175.

a. The Annuity Amount of a GRAT.

i. The trust instrument must require that the annuity amount be payable for each taxable year of the trust and proration of the annuity amount in taxable years of less than 12 months.

ii. The annuity must be paid to the grantor regardless whether the trust has produced income equal to the annuity. If trust income is insufficient, the trustee must be required to invade principal to pay the annuity. An annuity amount may be paid in the subsequent year as long as the annuity is paid by the date on which the trustee must file the income tax return for the trust determined without regard to extensions. The trust instrument must require that the trustee actually pay the annuity amount to or for the benefit of the grantor and it is not sufficient for the grantor to have the annual right to withdraw the annuity amount.

iii. The annuity amount must be a fixed amount expressed either in the terms of a fixed dollar amount or a fixed percentage of initial fair market value of the property transferred to the trust as finally determined for federal tax purposes.

iv. Under the Regulations, the fixed amount does not have to be the same amount for each year. But, variations in the annuity amount from year to year may not exceed 120% of the amount payable in the previous year.

v. An example of a qualified payment in a GRAT is as follows. Parent transfers 100 shares of XYZ, Inc. to a 3-year GRAT. Under the terms of the trust, the trustee is to pay parent an annuity equal to 10% of the initial value of the trust assets in the first year with the annuity payment increasing 20% in the second year and 20% in the third year. In each case the value is to be the value as finally determined for federal tax purposes. After the third payment has been made to parent, the trustee is to distribute the remaining trust assets to child. By expressing the annuity payment in a formula, the gift tax exposure of parent is less than it would be if the payment were expressed in a fixed dollar amount.

vi. If the trust property will appreciate over the term of the trust at a uniform rate, increasing annuity payments will produce more value for the beneficiaries at the end of a term than would constant annuity payments.

vii. The trust instrument must prohibit additional contributions to a GRAT.

viii. The trust instrument must prohibit commutation, or the prepayment by the trustee of the grantor's annuity interest. The purpose of prohibiting commutation is to prevent termination of a GRAT when the grantor's life expectancy is short. If a grantor dies during the term of the GRAT, a portion of the GRAT will be included in the grantor's estate under section 2036. This amount could be reduced if the trustee could terminate the GRAT before the grantor's death by paying the grantor an amount equal to the actuarial value of the grantor's remaining interest and delivering the balance of the trust assets to the remainder beneficiaries.

ix. The trust instrument must prohibit payments from the trust before the expiration of the qualified interest to or for the benefit of any person other than the annuitant. This requirement is similar to the requirement in the Regulations applicable to charitable lead trusts.

b. Value of the Annuity - Zeroed-Out GRAT.

i. The term of the annuity must be fixed and the trust instrument must be for the life of the annuitant, a specified term of years, or the shorter of those two periods. Under the Regulations, the value of an annuity payable over a term to the grantor and following the grantor's death to the grantor's estate is limited to the value of the annuity payable to the grantor. (Regulation section 25.2702-3(e) Example 5.) The Internal Revenue Service took the position that the value of an annuity must be recalculated on the present value of the right to receive annuity payments for the shorter of the period to exhaust the trust assets or the grantor's death. The Service's revaluation rule meant that the annuity could not be extended for a term of years following the life of an individual. Thus, it was not possible to craft a GRAT so that the remainder interest was zero. Under the Service's position, there would always be a taxable gift with a GRAT.

ii. The Tax Court addressed this issue in Walton v. Commissioner, 115 T.C. 589 (2000). In Walton, the Tax Court rejected the Service's position that a noncontingent annuity interest

payable for a term of years is not a qualified interest under section 2702 and ruled that Regulation section 25-2702-3(e), Example 5, was invalid. The taxpayer could deduct the value of a retained term annuity interest in calculating the amount of the taxable gift.

iii. The Internal Revenue Service has acquiesced in Walton (Notice 2003- 72, 2003-44 I.R.B. 964). Thus, estate planners should now be able to craft a GRAT so that the taxable gift is either zero or relatively small.

iv. It is important to structure a Walton GRAT so that any annuity interest following the grantor's death qualify for the federal estate tax marital deduction.

d. Value of the Annuity - Revocable Spousal Interest.

i. One mechanism for reducing the amount of the taxable gift is to provide for a spousal annuity following the grantor's death that could be revoked by the grantor. The contingent spousal annuity reduces the value of the taxable gift of the remainder.

ii. In Cooke v. Commissioner, 115 T.C. 15, aff'd 269 F.3d 854 (7th Cir. 2001), the Tax Court held that under section 2702 only interests that are fixed and ascertainable at the creation of the trust can reduce the value of the remainder. Thus, the Tax Court takes the position that a revocable spousal interest cannot reduce the value of the remainder interest in a GRAT.

iii. The Tax Court took a similar position in Schott v. Commissioner, 81 TCM 1600 (2001) and held that the value of a revocable spousal annuity interest which commences upon the grantor's death is not a qualified interest under section 2702. The taxpayer appealed the Tax Court's decision. The Ninth Circuit Court of Appeals reversed the Tax Court's determination in Schott v., Commissioner, 2003 TNT 34-21. The Ninth Circuit held that the revocable spousal annuity qualified under section 2702 and should be deducted in determining the value of the remainder interest.

iv. Although taxpayers in the Ninth Circuit may rely on deducting the value of a revocable spousal annuity, estate planners outside the Ninth Circuit can rely on Walton to minimize the value of GRAT remainder interests.

e. Payment of Annuity with Debt.

i. Clients should keep assets in a GRAT as long as possible to maximize the performance of the GRAT. Making the annuity payments with a promissory note issued by the GRAT accomplishes this purpose. Unfortunately, the Internal Revenue Service takes the position that paying the annuity with debt is not a qualified payment. In Technical Advice Memorandum 9604005, the Internal Revenue Service ruled that it is not permissible for a trust to use promissory notes to satisfy the annuity payment. Under this Technical Advice Memorandum, the issuance of a promissory note is not the payment of an annuity amount. Thus, the annuity would not be treated as paid until the promissory note is satisfied.

ii. The Internal Revenue Service issued proposed

Regulations (REG-108287-98) and then final regulations (T.D. 8899, September 6, 2000) that prohibit GRATs from allowing notes, debt instruments, or other financial instruments as payment for purposes of beneficial gift tax treatment.

f. Transfer Tax Aspects of GRAT.

i. Under section 2702(a)(2)(B), the value of a qualified annuity interest is determined under section 7520. Thus, the value of a gift to a GRAT will be determined by subtracting from the value of the assets transferred to the GRAT an amount equal to the actuarial value of the retained annuity. If the annuity would exhaust the trust funds before the last annuity payment is to be made, the annuity is not considered payable for the entire period.

ii. As the section 7520 rate decreases, the value of the retained interest in a GRAT will increase. This occurs because a decrease in the assumed rate of return makes the right to receive fixed amounts in the future more valuable.

iii. There should be no gift tax consequences upon the termination of the GRAT. Because the grantor's gift was complete for gift tax purposes when the trust was created, the trust assets remaining in the GRAT upon the expiration of the annuity term are paid to the remainder beneficiaries without any additional gift tax imposed on the grantor.

iv. If the trust property generates income and appreciation in excess of the section 7520 rate used to value the annuity interest when the GRAT was created, property will be transferred to the remainder beneficiaries without being subject to gift tax.

v. If the grantor dies during the term of the GRAT and has the right to receive further annuity payments, a portion of the GRAT will be included in the grantor's gross estate for federal estate tax purposes under section 2036. Under section 2036, the value of property transferred during the transferor's life is included in the transferor's gross estate if the transferor retained for life or for a period that did not end before the transferor's death, the right to receive the income from the transferred property.

vi. Under a GRAT, the grantor does not explicitly retain the right to receive income, rather, the grantor retains the right to an annuity. The Internal Revenue Service treats an annuity as if it were the right to receive the income from a portion of the principal of the trust. The included portion is that fraction of the trust which would be required to be invested at the section 7520 rate in effect on the date of the grantor's death to produce income equal to the required annuity payment.

vii. A GRAT is not an appropriate device to use in a generation-skipping transfer. The generation-skipping transfer occurs when the grantor's interest in the GRAT terminates. Thus, GST exemption must be applied when the GRAT terminates and the ability to leverage the client's GST exemption is lost. In most instances it is better to vest the remainder interest in children and cure any inequities with other assets.

a. Income Tax Consequences of a GRAT.

i. If the grantor retains an annuity interest worth more than 5% of the value of the trust assets, the trust will be classified a grantor type trust for federal income tax purposes. If a trust is classified as a grantor type trust, all items of the trust's income, deduction, and credits are reported by the grantor in calculating the grantor's income tax liability, regardless of the distributions to the grantor from the trust.

ii. A GRAT should be structured to be a grantor trust for both principal and income purposes. This provides several benefits. First, if the GRAT is a grantor trust for all purposes, the GRAT may be a shareholder in an S corporation. Next, if the GRAT is grantor trust for all purposes, transactions between the grantor and the trust are ignored. Thus, no gain or loss is recognized when the grantor sells assets to a GRAT, or the GRAT sells assets to the grantor.

h. Where is a GRAT Appropriate?

i. A GRAT allows a client to leverage transfers to children. As long as the asset appreciates more than the section 7520 rate, the children win. If the asset does not beat the section 7520 rate, then the client receives back the asset with no tax repercussion.

ii. Some clients have made unified credit gifts and are reluctant to make additional gifts because of the aversion to paying gift tax. The client in this situation should consider a zero-out GRAT. A zero-out GRAT does not result in a taxable gift to the remainder beneficiaries and the client does not pay gift tax. If the trust assets beat the section 7520 rate, the client has made a transfer to children or other beneficiaries outside the transfer tax system.

iii. A GRAT may be an ideal vehicle for the transfer of significant appreciation on an asset. Assume the client owns an interest in a business that may go public in the near future. If the client transfers the business interest to a short-term zero-out GRAT, most of the appreciation will be transferred tax free. If the client has more than one asset with this potential, it is wise to use a separate GRAT for each asset so as not to dilute the appreciation.

iv. The key to using a GRAT to leverage transfers is selecting assets that will outperform the section 7520 rate. Since 1990, the section 7520 rate has ranged from a low of 3 percent (July 2003) to a high of 11 percent (June 1990). During that same time period there have been numerous security issues trading on national exchanges that have far exceeded the section 7520 rate. If a client, age 60, had transferred a \$1,000,000 portfolio of securities to a three-year GRAT, with a 30 percent annuity increasing 20 percent annually in February 2004 (the section 7520 rate was 4.2 percent), and the securities increased 10 percent annually the results would be as follows. The grantor's retained annuity interest was valued at \$980,970 and the taxable gift to the remainder beneficiaries was \$19,030. Until the GRAT terminated in January 2007, the grantor received annuity payments totaling \$1,092,000. The remainder beneficiaries received \$140,000. A gift of \$19,030 was leveraged to \$140,000.

i. Summary.

i. The potential transfer tax advantages of a GRAT derive from the assumptions used to value the income and remainder interests under section 7520. In determining the present value of the interests, section 7520 assumes that the transferred property will produce income equal to a prescribed interest rate and the principal value of the property will not increase or decrease.

ii. If the total of the income and appreciation from the property is greater than the section 7520 rate, the remainder interest will have been undervalued for federal transfer tax purposes and any excess value passes to the remainder beneficiaries free of transfer tax. If the income and appreciation from the property do not outperform the section 7520 rate, the taxable gift is greater than the remainder interest passing to the remainder beneficiaries. If the GRAT is structured so that the remainder interest is relatively small, the downside of a GRAT is slight and the upside is large.

4. QUALIFIED PERSONAL RESIDENCE TRUST (QPRT)

a. General Overview of QPRTs.

i. A qualified personal residence trust is an irrevocable trust holding one or more personal residences under which the grantor reserves an interest lasting for a term of years.

ii. The Internal Revenue Service has published sample forms for a qualified personal residence trust. Revenue Procedure 2003-42, IRB 2003-23, at 993.

b. Planning with QPRTs.

i. Generally, the grantor should retain a reversionary interest in a QPRT. A reversion increases the interest retained by the owner and decreases the value of the gift. Because the value of the residence will be included in the grantor's estate under section 2036 if the grantor dies during the term of the QPRT, a reversion does not create any additional estate tax burden. In addition, a reversion allows the grantor to use the marital deduction to avoid estate tax at the grantor's death if the grantor dies before the end of the QPRT. A reversion also ensures grantor trust treatment for the principal portion of the trust which is important in obtaining nonrecognition of gain on repurchase of a replacement residence.

ii. If the grantor desires to reside in the residence after the end of the term of the QPRT, the estate planner must exercise care in avoiding inclusion of the residence under section 2036. If there is no written lease between the grantor and the owners of the residence, continued occupancy by the grantor following the term of the trust may be evidence of an implied retained life estate.

iii. A repurchase of the residence from the QPRT by the grantor shortly before the termination of the QPRT increases the tax benefits to the grantor's beneficiaries. For trusts created after May 16, 1996, the regulations require the governing instrument of a QPRT to prohibit the reacquisition of the residence by the grantor or the grantor's spouse (or an entity controlled by either of them) during the original term or at any time after the termination of the QPRT during which the trust continues to be a grantor trust for income tax purposes.

iv. If a grantor transfers a residence subject to a mortgage to a QPRT, the issue arises as to what portion of the subsequent mortgage payments by the grantor is attributable to the remainder interest and therefore is an additional gift. Although not certain, it is possible that the interest and principal payments are apportioned to the term and remainder interests based on actuarial factors.

5. TERM OF YEARS CHARITABLE TRUSTS

a. Charitable Lead Trust.

i. A charitable lead trust is the reverse of a charitable remainder trust. The lead interest in a

charitable remainder trust is distributed to noncharitable beneficiaries, while the lead interest in a charitable lead trust is distributed to charity. The remainder interest in a charitable remainder trust is distributed to charity, while the remainder interest in a charitable lead trust is distributed to noncharitable beneficiaries. A charitable lead trust offers a way to benefit charity while keeping the capital in the donor's family.

ii. The qualifying charitable lead interest may either be in the form of an annuity interest or a unitrust interest and may be created during lifetime or at death.

iii. Because all types of split-interest charitable trusts result in a shifting of a portion of the donor's income or wealth to charity, charitable lead trusts are best suited for families that have a true desire to benefit charity.

iv. Leverage for transfer tax purposes is available through a gift or estate tax charitable deduction for the annuity or unitrust interest. A taxpayer can obtain additional leverage by funding the charitable lead trust with an asset such as a limited partnership interest with strong cash flow but which can be discounted for transfer tax purposes.

b. Types of Charitable Lead Trusts.

i. The qualifying charitable lead interest may either be in the form of an annuity interest or a unitrust interest and may be created during lifetime or at death.

ii. With a charitable lead annuity trust, a fixed dollar amount or fixed percentage of the initial net fair market value of the trust assets is payable to one or more charitable organizations for the term of the trust.

iii. With a charitable lead unitrust, a fixed percentage of the net fair market value of the trust assets redetermined annually is payable to one or more charitable organizations for the term of the trust.

iv. A charitable lead trust can be structured to be taxed as either a grantor or nongrantor type of trust. No income tax charitable deduction is allowed for the charitable lead interest unless it is in the form of a guaranteed annuity or unitrust interest and the grantor is treated as the owner of such interest for purposes of IRC section 671. The nongrantor charitable lead trust is allowed an unlimited income tax charitable deduction for amounts of gross income paid to charity.

v. A charitable lead trust can be structured to terminate upon a term of years or the death of an individual.

c. Generation-Skipping Transfer Tax Consequences of Charitable Lead Trusts.

i. The inclusion ratio for a charitable lead annuity trust is adjusted by increasing the numerator by an interest factor using the same rate used to determine the charitable deduction.

ii. Consequently, it may be best to delay allocating GST exemption until the end of the lead interest in a charitable lead annuity trust.

iii. In a charitable lead unitrust, the GST exemption can be precisely allocated at the outset when the trust is created. Thus, opportunities for leverage exist because the amount of the allocation necessary to produce a zero inclusion ratio is the calculated value of the remainder for gift and estate tax purposes.

d. Term of Years Charitable Remainder Trusts (CRTs).

i. Under section 664, a charitable remainder trust is a trust that provides for the distribution of a specified payment at least annually to one or more persons, at least one of which must be a noncharitable beneficiary. The payment period must be for the life or lives of the individual beneficiaries (all of whom must be living at the time the trust is created) or for a term of years, not in excess of 20 years. Upon the termination of the noncharitable interest or interests, the remainder must either be held in a continuing trust for charitable purposes or paid to or for the use of one or more charitable organizations described in section 170(c).

ii. A qualified charitable remainder trust is generally exempt from federal income tax. The grantor is entitled to an income tax charitable deduction and a gift or estate tax charitable deduction based on the present value of the remainder interest ultimately passing to charity. If the non-charitable beneficiary is an individual other than the grantor, the creation of a charitable remainder trust may have gift tax consequences.

iii. A term of years charitable remainder trust is popular in at least two planning situations. A term of years charitable remainder trust can be used where the individual for whom the trust is created is so young as to run afoul of the 10% rule (discussed below). If the donor has a need for set amount of income for a set period, a term of years charitable remainder trust can be used to satisfy the income need.

6. INSTALLMENT SALE TO GRANTOR TRUST

a. Overview.

i. An intentional grantor trust is a trust of which the grantor is treated as the owner for income tax purposes, but not for estate, gift or generation-skipping transfer tax purposes.

ii. If properly drafted, the Service takes the position that the trust is disregarded for income tax purposes and that transactions between the grantor and the trust have no income tax consequences. (See Rev. Rul. 85-13 1985-1 C.B. 184.)

iii. The sale of assets to an intentional grantor trust in exchange for a promissory note offers similar leverage and tax savings advantages as the GRAT; however, the sale to the intentional grantor trust produces superior results in many cases.

b. Structure of Transaction.

i. The structure of the typical transaction is not complicated. First, the grantor creates an intentional grantor trust and selects the beneficiaries of this trust (typically the grantor's descendants). Next, the grantor funds the trust with cash or other assets. The funding of the trust will be a taxable gift and the grantor will use some or all of the grantor's applicable credit amount, and where appropriate, some or all of the grantor's GST exemption.

ii. After the trust is funded, the grantor sells selected assets to the trust in exchange for a cash down payment and a promissory note representing the balance of the purchase price.

iii. To qualify as a sale rather than a gift, the purchase price must be for the fair market value of the transferred assets, and the promissory note must bear interest at the appropriate applicable federal rate (AFR) prescribed by section 1274.

c. Tax Consequences.

i. Because transactions between the grantor and the grantor trust have no income tax consequences, there is no gain or loss recognized on the sale of assets to the trust.

ii. Additionally, the grantor is not taxed separately on interest payments on the promissory note. The grantor continues to be taxed individually, however, on all items of income or loss generated by assets held by the trust as though the trust did not exist.

iii. The estate and gift tax (or GST tax) savings of this transaction result if the assets held by the trust have a total net return (i.e., income and capital appreciation) that exceeds the interest rate on the promissory note.

d. Advantages Over GRAT.

i. Although a GRAT and a sale to an intentional grantor trust offer similar planning opportunities, there are several reasons why a client may achieve greater leverage and transfer tax savings using the sale technique. Both a sale to an intentionally defective grantor trust and a GRAT achieve transfer tax savings to the extent the assets of the trust outperform the applicable interest rate.

ii. The applicable interest rate is the section 7520 rate, which is 120% of the federal mid-term rate in effect under section 1274. On the other hand, the applicable interest rate for a sale to the intentional grantor trust is the appropriate federal rate (i.e., short-, mid-, or long-term) under section 1274. The AFR is almost always less than the section 7520 rate. It is therefore more likely that property will pass to the trust beneficiaries free of transfer taxes under the sale technique.

iii. Another advantage of the sale technique is the ability to delay payments to the grantor. The regulations under Chapter 14 are designed to prevent delayed payments to the grantor by providing that any amount payable from a GRAT in any year may not exceed 120% of the amount paid to the grantor during the preceding year. (See, Treas. Reg. 25.2702-3(b)(1)(ii).)

iv. With the sale to the intentional grantor trust, it is theoretically possible to use a balloon promissory note in which the repayment of principal is deferred until the end of the term of the promissory note (15 years or longer), thereby allowing the greatest compounding of appreciation.

e. Disadvantage: Uncertain Transfer and Income Tax Consequences.

i. The potential advantages of a sale to an intentionally defective grantor trust are available because the transaction presumably is outside the restrictions of Chapter 14. Consequently, the practitioner must engage in such a transaction without the safety net of regulations defining qualifying and nonqualifying interests.

ii. Perhaps the most likely attack by the Service would be an argument that the payments from the promissory note constitute a transaction with a retained income interest. Consequently, the entire corpus of the trust would be included in the grantor's estate under section 2036. This attack is similar to the Service's attempt to recharacterize sales to trusts in exchange for fixed annuity payments as transfers with retained interests.

iii. Another uncertainty concerns the potential treatment of income tax payments made by the grantor with respect to trust income as additional taxable gifts.

iv. It is clear that during the grantor's lifetime, the grantor trust is disregarded for income tax purposes and transactions between the grantor and the trust have no income tax consequences. (See Rev. Rul. 85-13, 1985-1 C.B. 184.) At the grantor's death, however, the trust loses its grantor trust status.

v. The income tax impact, if any, that this might have if the grantor dies during the term of the note should be seriously considered by the practitioner when advising a client about such a transaction.

7. SELF CANCELING INSTALLMENT NOTE (SCIN)

a. Overview of Private Annuities and SCINs.

1. A SCIN (self-canceling installment note) is a promissory note given in exchange for the purchase of property and payable until the first to occur of the death of the obligee or the date on which the balloon payment is due. Usually a SCIN is canceled upon the death of the seller of property but a SCIN can be canceled upon the death of any individual. Because the duration of the payments is dependent on the life of an individual, a SCIN is classified as a contingent payment installment sale.

2. The typical situation where a private annuity or a SCIN is appropriate involves an elderly parent owning property that the parent wishes to transfer to the younger generation but the parent has a need for cash flow while the parent is living. Some typical transactions with private annuities or SCINs involve farm property and stock in a closely held business.

b. Structure of SCINs.

i. With a SCIN, a client sells an asset to a beneficiary for the fair market value of the asset and receives from the beneficiary a debt obligation that is canceled automatically if the seller's death occurs before the note is paid. Self-canceling installment notes are subject to the installment sale rules and the interest rate on a SCIN must at least equal the appropriate AFR. A sale for a self-canceling installment note can be advantageous if the seller dies before the date predicted by the mortality tables.

ii. The fair market value of any unpaid installment obligation on the holder's death is included in the holder's estate. If the installment note contains a properly designed self-cancellation provision, the buyer is under no obligation to make any further payments after the seller's premature death leaving no unpaid balance to be included in the seller's estate. The self-canceling feature can be an effective means of transferring property to family members without estate or gift tax consequences if the death of the seller before the last potential payment has been made under the terms of the installment note.

iii. In general, the courts have held that a self-cancellation provision must meet the following requirements to be effective:

aa. The cancellation provision must be bargained for as part of the consideration for the sale,

bb. The purchase price must reflect this a bargain element either with a principal risk premium (the sales price must be above the fair market value of the property sold) or an interest rate premium (the interest rate must be above the market interest rate), and

cc. The seller may not retain any control after the sale over the property being sold.

iv. The parties must decide whether to reflect the risk premium as an increase in the sales price or as an increase in the interest rate. The resolution of this decision will depend on the tax situations of the buyer and seller. If the risk premium is reflected in the sales price the seller will report more of each payment as capital gain and less as interest income. The buyer will pay less interest (which is deductible if the interest is investment or trade or business interest and not personal interest), but his or her basis will be higher. If the property is depreciable and the buyer and seller are in similar tax brackets, the principal risk premium may be preferred to give the buyer a larger depreciable base. If the property is not depreciable, the buyer may prefer the interest rate premium where the basis is lower but deductible interest payments are higher.

v. If the self-cancellation provision is not effective, the Internal Revenue Service may take the position that the transaction is a part-sale part-gift. If the transaction is considered a part-gift, the value of the sold property, less the consideration actually paid, will be included in the decedent's gross estate.

c. Tax Considerations of SCINs.

i. Assuming a self-canceling installment note is properly designed, the unpaid balance of the installment note is not included in the seller's gross estate. A self-canceling installment note must contain a premium to reflect the risk element of the seller dying before the term of the note. This risk premium may be reflected in either the principal of the note or the interest rate. If the self-canceling installment note is not properly designed, the seller may be making a part-sale part-gift to the purchaser.

ii. The term of the note should not exceed the seller's life expectancy. Otherwise, the Internal Revenue Service may characterize the sale as a private annuity. Standard mortality tables can be used unless the measuring life is terminally ill.

d. SCIN Case Law.

i. One of the leading cases in this area is Estate of Moss v. Commissioner, 74 T.C. 1239 (1980), acquiesce in result 1981-2 C.B. 1. In Moss, the Tax Court held that the value of a bona fide self-canceling installment note is not includable in the gross estate of the holder of the note.

ii. The Tax Court reached a different result in Costanza v. Commissioner, 81 T.C.M. (CCH) 1693, but the Sixth Circuit Court of Appeals reversed the Tax Court's holding in Costanza v. Commissioner, 320 F.3d 595 (6th Cir. 2003).

e. Situation to Consider a SCIN.

i. A self-canceling installment note is useful where a client is in bad health and wishes to transfer an asset to a beneficiary.

ii. When using a self-canceling installment note, the purchaser should have sufficient assets (other than the purchased assets) to pay back the note. Otherwise, the Internal Revenue Service may take the position that the asset is includible in the seller's estate under section 2036.

f. Disadvantage of SCIN.

i. One of the primary disadvantages of a self-canceling installment note is the income tax liability associated with the transaction. The position of the Internal Revenue Service is that the unrecognized gain on date of death is taxable to the seller's estate as income in respect of a decedent under section 691(a)(5), rather than taxable to the seller which creates a debt for estate tax purposes.

ii. The Tax Court rejected the Internal Revenue Service's position but was reversed by the Eighth Circuit in Estate of Franev, Commissioner, 98 T.C. 341, affirmed in part and reversed in part, 998 F.2d 567 (8th Cir. 1993). This creates a significant disadvantage because of the loss of an estate tax deduction for the income tax liability and the bunching of income in the estate's income tax return.

A. Family Limited Partnerships

1. Generally, the family limited partnership provides for the management of family owned assets, the smooth succession of ownership and control, and the reduction of estate taxes.

2. The family limited partnership provides for the smooth management and succession of ownership and control because limited partnership interests can be restricted to the members of the family. In addition, it protects third parties from acquiring an interest in the partnership, even as a result of divorce. The general partners control the assets of the partnership to the degree outlined in the partnership agreement while the limited partners simply hold an interest without management authority in those assets. Methods for dispute resolution among the general partners can be organized in order to establish patterns to minimize family conflict over the management of the assets, especially for family assets such as rental real estate.

3. A basic precept in estate and gift tax law is that assets are valued for estate and gift tax purposes at their fair market value (i.e. the amount of money a willing buyer will pay a willing seller, neither being under any compulsion to buy or sell, both with reasonable knowledge of the facts). If the partnership is managed and operated as a true business, the family limited partnership could impact the legal ownership and management rights of the underlying partnership assets for estate and gift tax purposes. There is some case law and revenue rulings issued by the IRS which acknowledge that a family limited partnership interest owned by a person is worth less than if a person owned a percentage interest in the asset itself. This is because in an arms length transaction, a willing buyer of a limited partnership interest would pay less for that interest if the buyer were unable to remove the general partners who managed the partnership, must wait until the partnership ends to receive his or her share of the underlying partnership assets, cannot resell the purchased partnership interest to anyone except family members and cannot pledge the interest for a loan. These restrictions lead to substantial discounts in the value of the family limited partnership interest to be gifted for gift tax purposes or owned for death tax purposes. However,

there have been some cases recently in which the IRS has won and no discounts were allowed (see discussion below).

4. An annual gifting program may be developed using the limited partnership by gifting limited partnership interests to children and grandchildren. If the discounts are available in valuing minority and unmarketable limited partnership interests, the transfer of minority limited partnership interests could be accomplished with reduced transfer cost. For example, if you transferred a minority interest which, on a proportionate liquidating basis, has a value of \$100,000.00, the interest would be valued for tax purposes at a discount ranging from 15% to 45% of the liquidating value. Therefore, you may be able to transfer more value to your family while minimizing your gift taxes.

5. Once the partnership is formed, an annual tax return must be prepared. Each partner's share of items of income, gain, loss, deduction and credits are passed through the partnership to the partners and are reported on the partner's individual income tax return in accordance with the partner's interest in the partnership. For example, assuming mom and dad own a 90% partnership interest in the family limited partnership and each of their two (2) children owns a 5% partnership interest, 90% of the net income of the partnership will be income to mom and dad and 5% of the net income will be income to each of their two (2) children. In addition, all distributions of cash the partnership makes must be made on a pro rata basis. For example, at the end of the year, the partnership distributes \$100,000 to the partners. Holding a 90% percent interest, mom and dad are entitled to receive \$90,000 and each of their children are entitled to receive \$5,000. It is imperative that the partnership be operated as it otherwise would be between unrelated parties.

6. UPDATE ON FAMILY LIMITED PARTNERSHIPS

a. Estate of Thompson V. Comm'r, T.C. Memo 2002-246

i. Facts.

aa. The decedent formed two FLPs, one with himself and his son, and one with himself and his daughter's husband. The decedent was the 95.4% limited partner of one and a 65.27% limited partner of the other. Both FLPs had a corporate general partner (about a 1% interest), and the decedent held slightly less than one-half of the outstanding stock of the corporation that served as the general partner.

bb. The FLPs were formed about two years before the decedent's death. The reported case makes note of two arguments by the IRS: (1) that the partnerships should be disregarded for lack of economic substance and business purpose, and (2) that the partnership assets (not the retained partnership interest) should be included in the estate under section 2036(a).

i. Holding.

aa. The Tax Court held that Section 2036(a) applied. The effect was to include all assets in the FLPs at the decedent's death in his estate, other than the few assets contributed by his family to the FLPs. The Tax Court followed much of the same reasoning that it used in Estate of Harper, T.C. Memo 2002-121.

bb. Section 2036(a)(1) provides that the gross estate

includes the value of property which was transferred by the decedent (except a transfer that is a bona fide sale for an adequate and full consideration) under which he has retained for his life the possession or enjoyment of, or the right to income from the property.

ii. Observations.

aa. The IRS has argued that FLPs should be disregarded for lack of economic substance, and the courts have uniformly rejected that position. However, the IRS achieves the same result under its Section 2036(a) argument. The date-of-death values of the assets contributed to the partnership by the decedent, together with growth attributable to those assets, are included in the estate not the discounted value of the partnership interest.

bb. The IRS has repeatedly lost its lack of economic substance, gift on creation, Section 2703, and Section 2704 arguments. It now is focusing on (and achieving some success with) the Section 2036 attack.

cc. The court was primarily troubled by the fact that the decedent transferred the bulk of his assets into the FLPs, only keeping enough out of the FLPs to support himself for about two years. This gives rise to an implied agreement that the decedent would be able to get to the individual assets whenever he needed them for support or to continue the pattern of making cash gifts and loans to his children as in the past.

dd. Other Losing Facts.

i. Before the FLP was formed, the daughter asked to confirm that the decedent would be able to withdraw cash from the partnerships to make cash gifts each year.

ii. The decedent made various requests for distributions, which were made to him to make his annual exclusion cash gifts, and to pay his personal expenses whenever he was short of cash.

iii. The FLPs made loans to family members (continuing the decedent's practice before the FLPs were created). Interest payments were often either late or not paid at all.

iv. Any control of the other shareholders of the corporate general partners was "of little import"--the composition of the portfolio changed little prior to decedent's death.

v. The FLPs did not really operate as partnerships. Income and sale proceeds from assets contributed by each partner were set aside for that partner.

e. Transfer For Less Than Full Consideration Requirement. One might think that the transfer of assets to an FLP in return for limited partnership interests in the FLP would constitute a transfer for full and adequate consideration. Not so says the Tax

Court. The court interprets this exception not to apply if the assets were not invested in a business enterprise but were only "recycled." The court pointed to some of the factors described above in holding that the transactions were not motivated by legitimate business concerns that could furnish "adequate consideration".

f. Summary: Most importantly do not transfer the bulk of the estate into an FLP. Keep enough out of the FLP to provide the decedent's living expenses and amounts needed for gifts, loans, etc. Do not make withdrawals out of the FLP for routine living expenses of the limited partner. Recognize all of the formalities of operating as a partnership.

iv. Appeal.

aa. The case has been appealed to the 3rd Circuit Court of Appeals.

bb. Thompson Taxpayer Brief (October 14, 2003) (Very Brief Synopsis)

i. Partnership interests received on formation of the partnership constitute the receipt of full and adequate consideration for purposes of Section 2036.

ii. Even if the full consideration test is not met, the decedent did not retain an interest in the "property" (i.e., the assets contributed to the partnership) that triggers inclusion under Section 2036(a)(1).

b. Kimbell v. U.S., 91 AFTR2d 2003-585 (N.D. Tex. 2003)

i. Facts

aa. The decedent, at age 96, formed an FLP. Decedent retained a 99% limited partnership interest. A LLC held the 1% general partner interest. The LLC was owned 50% by decedent, 25% by her son, and 25% by her daughter-in-law. The son was manager of the LLC. The decedent died two months after creating the partnership. The partnership had a term of 40 years (which the court noted was when the decedent would have been 136 years old.)

bb. The partnership agreement provided that 70% in interest of the limited partners could remove the general partner. The partnership agreement also provided that the general partner "will not owe a fiduciary duty to the partnership or to any partner."

cc. The estate reported the value of the limited partnership interests on the estate tax return at a discount. The IRS assessed additional taxes, which the estate paid and filed an action seeking a refund.

dd. The estate and the IRS both filed motions for partial summary judgment as to the application of section 2036(a) to the transfer of assets to the partnership.

ii. Holding.

aa. The Tax Court held that Section 2036(a) applied.

bb. Section 2036(a)(1) provides that the gross estate includes the value of property which was transferred by the decedent (except a transfer that is a bona fide sale for an adequate and full consideration) under which he has retained for his life the possession or enjoyment of, or the right to income from the property.

cc. The Bona Fide Sale exception requires both (1) a bona fide sale, meaning an arm's-length transaction, and (2) adequate and full consideration. Neither of these requirements was satisfied. (1) As to the first requirement, the transfer to the partnership was not a bona fide sale. The court noted it could not even find two parties, let alone two parties conducting an arm's length negotiation. (2) As to the second requirement, the court agreed with the Harper reasoning that "adequate and full consideration" does not include paper transactions. It viewed the contribution of property to the partnership as "only a recycling of value and not a transfer of consideration."

dd. Retained Income or Rights Exception: The court found that the decedent retained the rights to possession of the economic benefits of the property (§ 2036(a)(1)) and the right to designate who would benefit from the income of the property (§2036(a)(2)). There is no need in this case to search for an implied agreement, because the decedent had the right under the agreement to remove the general partner at any time and appoint herself as the general partner. As the general partner, she could then control distributions. The estate contended that even if the decedent were the general partner, she still would not have sufficient powers to require inclusion under section 2036 because her powers would be held in a fiduciary capacity. The Supreme Court held in U.S. v. Byrum, 408 U.S. 125 (1972) that section 2036 did not apply to a decedent who retained voting interests in several corporations. The Kimbell court reasoned that "Byrum ... was expressly overruled by Congressional enactment of § 2036(b)." Furthermore, even if Byrum were applicable, the partnership agreement expressly provides that the general partner will not owe a fiduciary duty to the partnership or to any partner.

iii. Observations.

aa. Power to Remove General Partner and Lack of Fiduciary Duties of General Partner. The key factor in the opinion appears to be the decedent's ability to remove and replace herself as the general partner (under the 70% removal power provision), and the express denial of fiduciary duties by the general partner in the partnership agreement.

bb. The fact that the decedent transferred the bulk of the estate to the FLP was a major factor in the Thompson case but not mentioned in the Kimbell case.

cc. The court's statement that section 2036(b) overrules the Supreme Court's discussion in Byrum that fiduciary retention of powers does not trigger section 2036 is questionable. Section 2036(b) merely holds that retaining voting powers over transferred stock causes estate inclusion. The court made no attempt to analyze how section 2036(b) specifically applies to fiduciary powers held by a decedent in a limited partnership. That aspect of the opinion has been strongly criticized. This is, however, not critical to the court's conclusion, because the partnership agreement said that the general partner did not owe fiduciary duties in any event.

dd. The decedent does not have the unilateral power to remove and replace herself as the general partner. Also, the agreement should provide that the general partner owes fiduciary duties to the partnership and to the other partners.

iv. Appeal - Kimbell v. U.S., No. 03-10529, Fifth Circuit, (May 20, 2004). Bona fide sale exception applies.

b. Strangi v. Comm'r, T.C. Memo 2003-145 (May 20, 2003)

(Strangi II)

i. Background

aa. FLP created with corporation as 1% general partner and decedent as 99% limited partner. The corporation was owned 47% by the decedent and 53% by family members.

bb. The FLP and corporation (and the decedent's interest in them) were created on behalf of decedent by his son-in-law, who was acting for decedent under a durable power of attorney.

cc. Decedent died about two months after creating the FLP.

dd. After decedent's death, the FLP distributed funds to the estate for estate taxes, distributed funds to the children and extended lines of credit to them, and advanced funds to the estate to post bonds with the IRS and Texas.

ii. Facts Emphasized By Court

aa. 98% of decedent's wealth was contributed to partnership and corporation.

bb. 99% limited partnership interest was retained by decedent.

cc. 1% general partner was new corporation owned 47% by decedent and 53% by decedent's children. (Children subsequently gave 1% to a Foundation.)

dd. Corporation entered management agreement with decedent's son-in-law (who was also decedent's attorney-in-fact under a power of attorney) to manage day-to-day business of the corporation and partnership which the court interpreted to include making all distribution decisions.

ee. Partnership agreement provided that income, after deducting certain listed expenses "shall be distributed at such times and in such amounts as the Managing General Partner, in its sole discretion, shall determine, taking into account the reasonable business needs of the Partnership (including plan for expansion of the Partnership's business)."

ff. Various distributions were made to or for decedent or decedent's estate including home health care, medical expenses of health care provider, funeral expenses, estate

administration expenses, debts of decedent, specific bequest, and estate and inheritance taxes.

iii. Holdings and Analysis.

aa. Section 2036(a)(1) applies to the corporation and partnership created by decedent. Circumstances that generally suggest an implicit retained interest under §2036(a)(1) include: "transfer of the majority of the decedent's assets, continued occupation of transferred property, commingling of personal and entity assets, disproportionate distributions, use of entity funds for personal expenses, and testamentary characteristics of the arrangement." Facts in this case indicating implicit retention of economic benefit:

i. Decedent contributed 98% of his wealth, including his residence. The fact that decedent possessed "liquefiable" assets to cover decedent's anticipated living needs over his short life expectancy did not matter. The nonexistence of liquefied as opposed to "liquefiable" assets reflect that the partnership and corporation would be the primary source of decedent's liquidity.

ii. The decedent continued physical possession of his residence. The partnership charged rent to the decedent, but the court observed that the fact that the rent was merely accrued and not actually paid until over 2 years after decedent's death reflects that the rent was not arm's length. The court concluded that "accounting entries alone are of small moment in belying the existence of an agreement for retained possession and enjoyment."

iii. While prorata distributions were made to all partners, because interests held by others are de minimis, "a pro rata payment is hardly more than a token in nature."

iv. Actual distributions reflect "a conclusion that those involved understood that the decedent's assets would be made available as needs materialized."

v. The partnership/corporation arrangement has more testamentary characteristics than a joint investment vehicle for management of assets. Factors supporting this conclusion include the unilateral nature of the formation, the fact that contributed property included the majority of decedent's assets, and the decedent's advanced age and serious health condition.

vi. "The crucial characteristic is that virtually nothing beyond formal title changed in decedent's relationship to his assets." The children did not have a meaningful economic stake in the property during decedent's life and made no objections or concerns when large sums were advanced to decedent or his estate.

bb. Section 2036(a)(2) applies to transfers to the corporation and partnership.

i. Factors Causing 2036(a)(2) Inclusion. The court analyzed in detail the facts of this case compared to the Byrum case.

aaa. Decedent retained legally enforceable rights to designate who shall enjoy property and income from the partnership and corporation. The court emphasized that it is immaterial whether

the documents and relationships create rights exercisable by decedent alone or in conjunction with other corporate shareholders and the corporation's president.

bbb. The agreement gave the general partner "sole discretion to determine distributions."

ccc. The decedent can act together with the other shareholders to dissolve the partnership. (Under the partnership agreement, the partnership is dissolved by unanimous vote of limited partners and general partner. Under the corporation's bylaws, all of the corporation's shareholders must consent to dissolution of the partnership. Thus, decedent could act in his capacity as a limited partner and shareholder with the other owners to dissolve the partnership.)

ddd. Corporation property and income-decedent "held the right, in conjunction with one or more other Stranco directors, to declare dividends."

ii. Observations Regarding Fiduciary Duties.

aaa. The IRS made the argument that fiduciary duties negate the application of section 2036 only if there are unrelated parties to enforce the duties in Letter Ruling 8038014 ("interests of family members, employees, agents or other related or non-adverse persons do not represent minority interests, since whatever legal rights they may be perceived to have under Byrum are apt not to be exercised. Conversely, the presence of a single truly adverse minority interest would make the Byrum rationale applicable.")

bbb. Holding that fiduciary duties provide a limit on the right to designate who enjoys or possesses transferred property only if there are unrelated persons who can enforce those duties is inconsistent with many cases that have held that very broad administrative powers retained by a donor as trustee do not invoke section 2036, primarily because of the restriction imposed by the fiduciary duties that were legally enforceable. Those cases involve trust transactions that do not involve any unrelated parties. (e.g. Old Colony Trust Co. v. U.S., 423 F.2d 601, 603 (1st Cir. 1970) (broad trustee administrative powers that could "very substantially shift the economic benefits of the trust" did not invoke section 2036(a)(2) because such powers were exercisable by the donor-trustee in the best interests of the trust and beneficiaries, and were subject to court review).

iii. Broad Application of "In Conjunction With".

aaa. Potential Effects of Analysis - The court, perhaps to a larger extent than any previous section 2036(a)(2) case, interpreted the "in conjunction with" language in the statute and regulations very broadly. The court's analysis, when pushed to its extreme, would mean that any family entity could be ignored under section 2036(a)(2) because the decedent regardless of how small an interest the decedent held-would hold the power, "in conjunction with others" to vote its interest as a member of the entity (i) to affect indirectly when income distributions would be made, and (ii) to liquidate the entity and distribute its assets. An extension of this analysis could ultimately lead to negating any discounts where the other interests in an asset are held by family members.

bbb. The Supreme Court in *Byrum* implicitly rejected this broad construction of the "in conjunction with" phrase in sections 2036(a)(2) and 2038. The IRS argued that the power to vote the stock in a way that could cause liquidation of the company caused section 2036(a)(2) to apply. The Supreme Court observed that even if the decedent had conveyed a majority interest in the corporation to the trust, the right to cause a liquidation through voting the transferred stock would have been too speculative and contingent for section 2036(a)(2) to apply.

Thus, even though the decedent could participate in the process of getting cash to the trust, this participation was not treated as a right to effect distributions "in conjunction with" others.

c. Bona Fide Consideration Exception to Section 2036.

i. Section 2036(a)(1) or (a)(2) only applies if the decedent has "made a transfer (except in the case of a bona fide sale for an adequate and full consideration in money or money's worth)."

i. Two-Step Analysis:

aa. The first requirement is that there is a bona fide sale, meaning an arm's length transaction. Having other partners (even family members) and having negotiations in the structure decisions would help meet this requirement. Observe that this requirement is a significant hurdle, giving the courts the leeway to disregard tax-driven transactions where there is no adversarial bargaining, even though the decedent experiences no depletion in his estate as a result of the transfer. A close reading of the cases cited by the Tax Court in *Harper* as supporting a separate "bona fide" test do not provide that only arms-length transactions can qualify, but merely that whether the full consideration test is met is based on whether the consideration is what would have been received in an arms-length transaction.

bb. The second requirement is that there is "full and adequate consideration." The court holds that the receipt by the donor of limited partnership interests in return for the transfer of assets to the partnership is not "adequate and full consideration" even though the Tax Court has held on various occasions (including the initial *Strangi* decision) that the creation of the partnership does not result in a "gift on creation" for gift tax purposes.

iii. The Fifth Circuit has rejected a separate bona fide test for heightened scrutiny of intrafamily transfers and views "full consideration" the same as for gift tax purposes. The Fifth Circuit has followed the traditional approach of just requiring a transfer for full and adequate consideration to satisfy the exception. *Wheeler v. U.S.*, 116 F.3d 749 (5th Cir. 1997). That case involved the sale of a remainder interest for the full actuarial value of the remainder interest. The IRS argued that this did not satisfy the fair consideration exception under section 2036. The Fifth Circuit observed that all parties agreed that, for gift tax purposes, the value of the remainder interest was its actuarial value. The Fifth Circuit then concluded that the phrase "adequate and full consideration" must mean the same thing in both the gift and estate tax statutes, citing three U.S. Supreme Court cases (*Merrill v. Fahs*, *Estate of Sanford v. Commissioner*, and *Commissioner v. Wemyss*). The 5th Circuit specifically rejected the application of a separate strict "bona fide" test. The court clearly rejects a bona fide test that is more restrictive for intrafamily transfers.

iv. Planning Implications of *Strangi* II.

aa. On Appeal to 5th Circuit. The estate has appealed this decision to the 5th Circuit Court of Appeals, as discussed below. Any planning should take into consideration

that the 5th Circuit may change many of the legal principles discussed in the Tax Court memorandum decision.

bb. Section 2036(a)(1) Issues.

i. Observing formalities was not sufficient to avoid section 2036(a)(1). (Many of the prior section 2036(a)(1) cases involved the failure to observe corporate and partnership formalities. (e.g. Estate of Reichardt v. Commissioner, 114 T.C. 144 (2000); Estate of Schauerhamer v. Commissioner, T.C. Memo. 1997-242.)

ii. Retain sufficient liquid assets outside the partnership to provide for anticipated living expenses.

iii. Do not transfer the primary residence to partnership.

iv. If the taxpayer uses partnership assets, pay fair market value rental in an arm's length manner. Actually pay rent and do not just accrue rentals.

v. The purpose of distributions should be based on business reasons of the partnership and not on personal desires of the taxpayer to cover personal cash needs.

vi. Having significant contributions by others helps. Making pro rata distributions to multiple partners does not appear so much that taxpayer implicitly retained the ability to access partnership assets whenever desired. Avoiding a unilateral creation and seeking input from others about structural issues helps avoid a "testamentary" appearance.

cc. Section 2036(a)(2) Issues.

i. The partnership agreement gave the managing partner "sole discretion" over distributing income in excess of business needs rather than mandating distributions of all cash in excess of business needs. Structuring the partnership agreement to mandate distribution of "excess cash" would help with respect to retained powers over income, but would not seem to help rebut an argument over the retained powers to liquidate and distribute the entire assets of the entity "in connection with" the other owners.

ii. In light of the court's "in conjunction with" analysis, the most conservative structure to avoid section 2036(a)(2) would be for the taxpayer to own no interest in the general partner. (However, even that structure would not be immune from attack, under the court's reasoning, if the partnership can be liquidated with the consent of all partners; the decedent could then act "in conjunction with" other owners to liquidate the entity at any time and regain possession of his proportionate part of the assets in the entity.) Furthermore, if another individual serves as general partner, be wary of having the decedent give that individual a general power of attorney. The court gave little weight to fiduciary duties that the son-in-law held as manager of the partnership and corporation because he stood in a preexisting confidential relationship and owed fiduciary duties to decedent personally as his attorney in fact.

v. Appeal - This case has been appealed to the 5th Circuit Court of Appeals.

d. Stone v. Commissioner, T.C. Memo 2003-309 (November 7, 2003)

i. Facts and Issues.

aa. Five separate limited partnerships that were created in April 1997 primarily to resolve ongoing disputes and litigation among Mr. and Mrs. Stone's four children. Mr. Stone found out in March 1997 that he only had months to live. Mr. and Mrs. Stone, although still legally competent, were no longer taking part in the active management of their assets. Each child was a co-general partner of one of four of the FLPs holding specific assets. The Stones asked their accountants to perform detailed cash flow analyses to enable them to determine what assets they should retain to be able to provide their total monthly cash flow of between \$12,000 and \$15,000. The remaining assets of the Stones were held in the fifth partnership, and all four children joined in managing that partnership. Mr. Stone had made some gifts of specific assets to the children, which the children contributed to the respective partnerships. Mr. and Mrs. Stone died in 1997 and 1998 respectively, claiming average 43% valuation discounts.

bb. IRS argues inclusion of partnership assets pursuant to §2036(a)(1).

ii. Holding.

aa. Fair consideration test of Section 2036 applies to creation of partnership, so that Section 2036(a)(1) does not apply.

bb. The opinion posed a 3-part analysis. (1) Was there a transfer of property by the decedent? (2) Was the transfer other than a bona fide sale for adequate and full consideration in money or money's worth? (3) If the first two questions are answered in the positive, did the decedent retain possession or enjoyment of, or the right to income from, the property transferred?

cc. Fair Consideration Test. The emphasis of the opinion is on the second issue—whether the transfer was other than a bona fide sale for an adequate and full consideration. While the opinion does not specifically announce a two-part test, the analysis reviews (a) whether the transfer was a bona fide arm's length transfer, and (b) if so, was the transfer for full consideration.

i. Bona fide arms' length transfer:

aaa. The Stone partnerships were created as a result of arms' length negotiations in which each member of the Stone family (including the parents) was represented by his or her own independent counsel. The transfers to the partnerships "were motivated primarily by investment and business concerns relating to the management of certain of the respective assets of Mr. Stone and Mrs. Stone during their lives and thereafter and the resolution of the litigation among the children."

bbb. There was more than a mere change of form. The five partnerships had economic substance and operated as joint enterprises for profit through which the children actively participated in the management.

ccc. The respective transfers by the decedents did not constitute circuitous recycling of value.

ii. Adequate and full consideration:

aaa. The initial transfers to the partnerships by Mr. and Mrs. Stone were not gifts to the other partners.

bbb. Subsequent transfers to the partnerships by the decedents and other partners were made in exchange for respective partnership interests "that were adequate and full equivalents reducible to a money value." (The opinion detailed that the partnership interests were proportionate to the values of assets contributed, that the assets transferred by each partner were properly credited to capital accounts, and that upon termination or dissolution, the partners were entitled to distributions equal to their respective capital accounts.)

ccc. The IRS argued that the partnership interests received by the Stones did not constitute adequate and full consideration after taking into account appropriate discounts in the values of the partnership interests. The court rejected this argument.

e. Planning Implications For Existing Partnerships.

1. Potential Problems.

aa. Problematic Powers.

i. Various cases have suggested that the power to control distributions and the decision to liquidate triggers § 2036(a)(2).

ii. Arguably, the decedent's power under state law to join in amending the partnership agreement to grant distribution or liquidation powers may also trigger § 2036(a)(2).

iii. Strangi II reasons that the power to participate with others, perhaps even in a very minimal manner, can cause § 2036(a)(2) to apply.

bb. Effect.

i. The primary effect of applying § 2036 to the creation of the partnership is that the assets contributed to the partnership are brought back into the estate—without any discount.

ii. A more subtle effect is that any annual exclusion gifts of partnership interests would be wasted, because the transferred interest (whether just the transferred partnership interest or a pro rata portion of the partnership assets if the IRS is successful in making the integrated transaction argument) would be included in the estate, and there would be no offset under § 2001 (b) for gift tax payable, because no gift tax would be payable on an annual exclusion gift.

cc. Facts That Might Cause § 2036(a)(2) Inclusion.

i. Decedent as General Partner.

ii. Decedent Controlled General Partner - If the decedent controlled the general partner, and therefore had control over distributions and liquidations, § 2036(a)(2) arguably applies (if the reasoning of Kimbell and Strangi II is upheld).

iii. Minority Interest in General Partner- Even if the decedent has a minority interest in the general partner and cannot make any distribution or liquidation decisions at all, Strangi II holds that the "in conjunction with any other person" language in §2036(a)(2) would cause §2036(a)(2) to apply. While the decedent held 47% of the stock of the corporate general partner in Strangi, the reasoning of the opinion would also seem to apply if the decedent had merely held 1% of the stock of the corporate general partner.

iv. Even if the parent is merely a limited partner with no interest in the general partner and no direct ability to control distributions or liquidations, the reasoning of Strangi II would imply that §2036(a)(2) could still apply, because the decedent, as a limited partner (even if he or she only holds a very small limited partnership interest) could participate with the other partners in amending the partnership agreement to cause distributions or a liquidation of the partnership.

2. Planning Approaches.

aa. Wait and See.

Do nothing, but "wait and see" what the Circuit Courts of Appeal hold. The §2036 issues are under consideration by the 3rd and 5th Circuit Courts of Appeal in Thompson, Kimbell, and Strangi. Many planners believe that the "full consideration exception" is likely to prevail, at least where there have been no gifts of limited partnership interests. Particularly if the client is unwilling to relinquish any control that he or she might have through the general partner interest, and if the client is in good health and death is not imminent, a viable approach that the client may choose after being advised of the recent developments may be to adopt a "wait and see" approach.

bb. Adopt Ascertainable Standard on Distributions.

Consider modifying the agreement to provide an ascertainable standard for distributions. However, this alone would not remove §2036(a)(2) claims if the decedent retains the power as general partner to liquidate the partnership. A relinquishment of the right to vote on liquidation may be treated as a taxable lapse of voting rights under §2704(a). Concentrating the voting rights into a small ownership interest and transferring that interest would not cause a taxable lapse of voting rights under §2704(a) because the voting rights would not disappear.

cc. Rely on Ascertainable Standard in Trust or Independent Trustee.

If the parent only owns a 1% general partner interest and if all partners other than the donor already hold or transfer their interests to trusts with an independent trustee or with the decedent as trustee as long as there are ascertainable standards on distributions, there should be no §2036(a)(2) inclusion of the limited partnership interests. The decedent's retained interests as general partner or other voting interests would be included in the gross estate under §2036(a)(2) (under the

reasoning of Strangi), but that would only represent a 1% (or less) interest in the partnership.

If the parent has not yet made any gifts of limited partnership interests, make the gifts to a trust rather than outright to donees. As long as there is an independent trustee, or as long as there are ascertainable standards on distributions if the parent serves as trustee, the parent should not have sufficient ability to control distributions to cause §2036(a)(2) to apply.

dd. Restructure to Concentrate "Voting" Rights and Make Gift of "Voting" Interests.

If the parent transfers all general and limited partnership interests to others, so that the decedent has absolutely no interest in the partnership, §2036(a)(2) would not apply. The primary problem with that approach is that huge gift taxes could result. To avoid that problem, the partnership interests will be restructured to create two different classes of limited partnership interests, one in which any voting rights of limited partners (such as the right to vote on a liquidation of the partnership or to vote on any amendment of the partnership agreement) would be concentrated, and the other having no such voting rights.

After the restructure, the parent would make a gift of the "voting" limited partnership interest and of any interest that the parent owns in the general partner. This would not constitute a taxable lapse of voting rights under §2704(a) because the voting rights are not eliminated. Treas. Reg. 25.2704-1 (f) Ex. 7. The parent would no longer hold any interest in the partnership granting any controls over distributions or liquidation, so §2036(a)(2) should not apply. However, a gift of those interests would invoke the three-year rule of §2035 if those interests caused §2036(a)(2) to apply when they were held by the parent.

ee. Sale of Limited Partnership and/or General Partnership Interests For Avoiding Gift Tax and Three-Year Rule Under Section 2035.

This is an additional wrinkle to the planning strategy described in the preceding paragraph, to concentrate all voting rights of limited partners and to transfer the concentrated voting positions. Instead of making a gift of the concentrated positions, the parent will sell those interests. A sale of the concentrated voting interests could minimize any gift consequences (if the incomplete gift trust approach is not used.) In addition, it might avoid application of the three-year rule of §2035.

f. Planning For New FLPs.

i. "Recycling" Theory: Contributions by Other Partners to Satisfy.

If other partners contribute substantial assets, the Tax Court's "recycling theory" for the full consideration test under §2036 should not apply, because the FLP would not just represent the same pool of assets. However, many families may not have substantial assets that could be contributed by other family members.

ii. Structure FLP to Concentrate Voting Rights into Interests Never Owned by Decedent.

This is similar to the strategy described above, except that the three year rule of §2035 would not

apply because the decedent would never hold the voting interests at any time. Furthermore, there would be no concern of taxable transfers under §2704.

iii. Plan for Gift or Sale of Limited Partnership Interests to Trusts (Could be Incomplete Gift Trusts) With Independent Trustee.

This is similar to the strategy described above. If the parent wants to keep the control interests in the partnership, Section 2036(a)(2) issues should not arise if a trust holds the limited partnership interests and either there is an independent trustee, or the decedent serves as trustee with an ascertainable standard on distributions.

iv. Incomplete Gift: Trust Owning Voting Interests and General Partnership Interest.

This is similar to the strategy described above. If the donor contributes all of the assets to the partnership and subsequently makes gifts of the concentrated "voting" limited partnership interest and general partnership interest to an incomplete gift trust, §2036(a)(2) should not apply to the limited partnership interests retained by the parent. The parent would have no controls or rights to participate in distribution or liquidation decisions for the partnership.

B. Strategies to Reduce Income Taxes

1. Transfer/Gift income producing assets to family members with lower income tax brackets utilizing any number of the gifting strategies discussed above.

a. One of the principal income tax planning techniques used in estate planning is income shifting, that is, causing income that would otherwise be taxable to the client to be taxed to a taxpayer in a lower bracket. With a progressive rate schedule for income tax purposes, it is obvious that such income shifting may increase substantially the amount remaining after the payment of federal taxes, to say nothing of applicable state and local taxes.

i. Benefits of Income Shifting

For years beginning in 2003, the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) and the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA) have reduced the top tax bracket to 35% and have, at least temporarily, reduced the rate for most capital gains to 15%. More intriguingly, the rate of tax on dividends paid by most domestic corporations and some foreign corporations has also been reduced, at least temporarily, to 15%.

ii. Income Shifting Techniques

Income-shifting techniques include both formal transfers of income-producing property and a variety of informal arrangements that divert income from a client to his beneficiaries (or to trusts for their benefit). Both methods merit consideration and comparison.

A variety of formal transfer/gift techniques are discussed above. Informal arrangements, for example, are gifts of services, interest-free or low-interest loans, and diversions of business or investment opportunities.

b. Deferring Payment of Income Tax

Deferral is one of the most important concepts in income tax planning. Because money not used to pay taxes can be invested until the tax is due, deferral of liability without interest can achieve a significant tax saving. Clients need sound advice to determine the value of deferral achieved through the use of estate planning techniques.

i. Valuing Deferred Taxes

In most cases, deferral is valuable because of the opportunity to invest the deferred taxes in the interim. The value of deferral thus depends on the after-tax rate the client can achieve on funds retained as a result of his postponement of liability and the length of time such funds remain in his hands. Assuming taxes could be postponed indefinitely, deferral would be equivalent to complete forgiveness of liability. Although instances of indefinite postponement are uncommon, even a short-term postponement may represent a significant reduction in the tax burden. If the purchasing power of money is declining, reflecting inflation, the value of the funds retained by the client will be reduced accordingly. Nevertheless, the client still retains funds he would otherwise not have had. In addition, inflation diminishes the burden of the deferred tax liability, just as it eats away at the purchasing power of the money saved. The client will never lose as a result of the tax deferral itself.

ii. Deferral Techniques

A taxpayer may postpone realization of taxable income in a variety of ways. For example, he may delay the sale of an asset that has appreciated in value or he may participate in deferred compensation arrangements that postpone the taxation of compensation income. This technique may not only defer payment of taxes, but may also reduce the amount paid if the client is in a lower tax bracket at the time either the asset is sold or the deferred compensation is paid.

Postponement combined with realization by another taxpayer can occur when income producing property is given to a donee that is subject to tax at a lower rate. Examples of this include an intrafamily installment sale of income producing property or as a private annuity. Also see the benefits of the contribution of appreciated assets to a Charitable Remainder Trust discussed above.

2. Addressing the Issue of Special Assets

A client's family wealth often includes one or more special types of property with unusual characteristics and the potential for unforeseen income, gift, estate, or GST tax problems. These special assets may be the only assets the individual can transfer. It is important that the transferor be aware of the tax and non-tax consequences of transferring these assets and that the transferor determine how to best implement the transfer.

a. Encumbered property

Real property is the asset most taxpayers with a significant estate should transfer by gift because real property typically offers significant appreciation that can be removed from their gross estate or income that can be taxed to a lower bracket donee. Many times this real property is subject to debt. Transfers of such property raise a number of serious income, gift, and estate tax issues.

i. Income Tax

The amount realized in a transfer of encumbered property includes the amount of the debt from which the transferor is relieved or subject to which the property is taken. The donor recognizes a taxable gain to the extent that the amount of liability from which the donor is relieved exceeds the donor's adjusted basis in the asset even when encumbered property is a gift for which no independent consideration is paid by the donee.

Example

Dad gives a house and lot to Son, who assumes the \$500,000 mortgage that Dad placed on the property. The amount Dad realizes on the transaction is \$500,000, the unpaid principal balance on the assumed mortgage from which Dad is now relieved. If Dad's adjusted income tax basis in the property was \$200,000, he recognizes a taxable gain of \$300,000 (\$500,000 debt relief less his \$200,000 adjusted basis). Dad receives no cash on the gift.

The appropriateness of a transfer of encumbered property depends greatly on the amount of the debt and the transferor's income tax basis (because a taxable gain results if the debt on the property exceeds the transferor's income tax basis). An individual who anticipates transferring a specific asset within a few years should try to establish a lower amount of debt in order to reduce or eliminate a taxable gain when the asset is transferred. It is advisable for such an individual to refrain from placing additional indebtedness on the property, since post acquisition indebtedness does not increase his or her income tax basis.

A transferor may be able to reduce the gain on a transfer of encumbered property by agreeing to remain liable on the debt. The amount of recourse liability on transferred property is not an amount realized by the transferor, even if the property is identified security, because the transferor remains liable on the debt. A transferor should, through a collateral agreement, be able to achieve the same result as on a transfer of property subject to nonrecourse debt.

ii. Gift Tax

A gift of encumbered property is a taxable gift if the property is transferred as a gift and the donee accepts the property subject to the debt. The taxable amount of the gift is computed by reducing the fair market value of the property by the amount of the debt. Any additional payments made by a donor who later makes payments on a debt for which he or she is no longer really obligated, are additional taxable gifts.

iii. Estate Tax

The amount of the gift related to a debt to which title is taken subject, or that the donee assumes, is determined by subtracting the debt from the value of the property. The estate receives no deduction for the debt under IRC Section 2053 unless the donor remains the primary source of the debt's payment after the gift, under a collateral agreement.

a. Closely held business interests

i. Family Limited Partnerships/LLCs (see discussion above)

ii. Non Family Entities

c. Life insurance policies (outright versus in trust)

d. Personal Residence (see QPRT discussion above)

e. Stock Options

3. Case Study (see supplement)