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Personal Planning Strategies

A report for clients and friends of the firm

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In this issue:

January 2005 Update — Federal and State Estate and GST Tax Changes 1

Family Limited Partnerships Update 4

Irrevocable Life Insurance Trusts: An Important Component in Many Estate Plans 5

January 2005 Update – Federal and State Estate and GST Tax Changes

Federal Estate and GST Tax Changes

As we reported in our June 2001 and December 2003 issues, the Economic Growth and Tax Relief Reconciliation Act of 2001 (the "Act") made significant changes to the federal estate, gift and generation-skipping transfer ("GST") taxes.

Beginning in 2005, the top federal estate and gift tax rates decrease from 48% to 47%. The federal estate and GST tax exemptions remain at $1.5 million, the gift tax exemption remains at $1 million, and the annual gift tax exclusion remains at $11,000 ($22,000 in the case of a married couple). Although the reduced federal estate tax rate is good news, many states (such as New York, New Jersey and Massachusetts) are not following the federal changes, as discussed later in this issue.

The following table summarizes changes in the federal estate, gift and GST taxes from 2005 through 2010, when the estate tax is scheduled for repeal (before being reinstated in 2011):

Calendar Year	Top Federal Estate and Gift Tax Rate	Federal Estate Tax Exemption	Federal GST Tax Exemption	Federal Gift Tax Exemption
2005	47%	$1.5 million	$1.5 million	$1 million
2006	46%	$2 million	$2 million	$1 million
2007	45%	$2 million	$2 million	$1 million
2008	45%	$2 million	$2 million	$1 million
2009	45%	$3.5 million	$3.5 million	$1 million
2010	Gift Tax Rate Equals Top Individual Income Tax Rate	Estate Tax Repealed	GST Tax Repealed	$1 million
2011	55%	Estate Tax Returns With $1 million Exemption	GST Tax Returns With $1,060,000 Exemption Plus Inflation Adjustment	$1 million

State Estate Tax Changes

Despite the reduction in the maximum federal estate tax rate, some decedent's estates (including those of New York, New Jersey and Massachusetts residents) will have to pay a state estate tax in addition to any federal estate tax.

The combined top federal and New York estate tax rate in 2005 has declined from 60% to 55.48%. However, this amount actually exceeds the combined rate in effect prior to the Act. For instance, a New York decedent dying in 2005 is subject to a New York estate tax at a top rate of 16% in addition to the federal estate tax as reflected in the chart below.

Prior to the Act, a state death tax credit (up to a statutory maximum amount) was allowed for death taxes paid to a state. Most states capped their own estate tax at the maximum federal credit amount. Therefore, paying state estate taxes did not cause an increase in estate taxes because the federal government gave each estate a credit for taxes paid to the state.

Under the Act, the state death tax credit has been phased out. Beginning in 2005, it is repealed entirely and replaced by a deduction in computing the federal estate tax for state death taxes actually paid.

What this means is that states (such as California, Connecticut and Florida) that follow the federal changes made by the Act will lose revenue due to the repeal of the state death tax credit. The good news for taxpayers in these states is that, unless these states change their laws, beginning in 2005 they will not pay any state estate taxes.

Several states concerned with this loss of revenue have "decoupled" from the federal system in order to preserve

Year of Death	Former State Death Tax Credit Rate	Allowable Federal State Death Tax Credit (replaced in 2005 by a federal estate tax deduction for state death taxes actually paid)	Top New York State Estate Tax Rate (allowed as a deduction in 2005 from federal estate tax due)	Top Federal Estate Tax Rate	Combined Top Federal and New York State Tax Rate
2005	16%	0%	16%	47%	55.48%

State	Top State Estate Tax Rate	Maximum Federal Exemption for 2005 Allowable by States	Actual Maximum Federal Exemption for 2005
California	0%	N/A	$1,500,000
Connecticut	0%	N/A	$1,500,000
Florida	0%	N/A	$1,500,000
Massachusetts	16%	$950,000	$1,500,000
New Jersey	16%	$675,000	$1,500,000
New York	16%	$1,000,000	$1,500,000

the tax dollars they would otherwise have lost by the repeal of the state death tax credit. For instance, as shown in the chart above, Massachusetts, New Jersey and New York have "decoupled" from the federal system and impose an estate tax calculated with reference to a maximum federal exemption that is lower than the actual maximum federal exemption available that year for federal purposes.

Therefore, for a New York decedent dying in 2005 with a taxable estate under $1.5 million, a federal estate tax return is not required to be filed; however, a New York estate tax return must be filed and a New York estate tax would be due if the taxable estate exceeds $1 million. Likewise, a New Jersey estate tax return must be filed and a New Jersey estate tax would be due for a New Jersey decedent if his or her taxable estate exceeds $675,000, and a Massachusetts estate tax return must be filed and a Massachusetts estate tax would be due for a Massachusetts decedent if his or her taxable estate exceeds $950,000.

Connecticut briefly "decoupled" from the federal system for a six-month period that started on July 1, 2004. For decedents dying between July 1, 2004 through December 31, 2004, Connecticut only recognizes an estate tax exemption of $1 million and imposes an estate tax calculated by multiplying the allowable federal credit by 1.3. However, beginning in 2005, Connecticut follows the federal changes and does not impose a state estate tax for residents dying on or after January 1, 2005. As of press time, no new Connecticut estate tax has been enacted. However, based on Connecticut's enactment of a six-month estate tax and its need to raise revenues, it is quite possible that new legislation will be enacted to reinstate a Connecticut estate tax. Additionally, Connecticut has an inheritance tax but spouses and descendants are not subject to the inheritance tax.

As illustrated in the following charts, the estate of a decedent dying in 2005 with a $1.5 million estate would pay no federal estate tax, since the federal estate tax exemption is $1.5 million. If the decedent were a resident of California, Connecticut or Florida, his or her estate would not pay state estate tax either.

Year of Death	Value of Gross Estate	Federal Estate Tax	California Estate Tax	Connecticut Estate Tax	Florida Estate Tax
2005	$1,500,000	$0	$0	$0	$0

However, if the decedent were a resident of Massachusetts, New York or New Jersey, his or her estate would have to pay a $64,400 state estate tax since those states do not conform to the federal changes. Therefore, whether or not a state follows the federal estate tax changes introduced by the Act can affect the total amount of estate taxes due.

Year of Death	Value of Gross Estate	Federal Estate Tax	Massachusetts Estate Tax	New York Estate Tax	New Jersey Estate Tax
2005	$1,500,000	$0	$64,400	$64,400	$64,400

The amount of state estate taxes due becomes substantial in large estates. In 2005, the estate of a decedent with a taxable estate of $15 million will pay federal and state estate taxes totaling $7,324,404 if the decedent were domiciled in Massachusetts, New Jersey or New York, but only $6,335,000 if the decedent were domiciled in California, Connecticut or Florida. Accordingly, individuals with a residence in Massachusetts, New Jersey or New York and a second residence in California, Connecticut or Florida should consider establishing their primary residence in California, Connecticut or Florida. However, it should be noted that even if one changes their primary residence to a state without an estate tax, if their secondary residence is in a state with an estate tax that secondary residence will be subject to state estate tax.

Family Limited Partnerships Update

In the January 2000 issue of *Personal Planning Strategies*, we discussed the family limited partnership, or "FLP," and the fact that the Internal Revenue Service has issued several rulings attempting to limit their use (and abuse). Since that time, the Internal Revenue Service has continued to challenge the validity of FLPs and has attempted to expand the basis for its attacks. This is an update of where we've been, where we are and where we might be headed.

Mechanics of the FLP

A FLP is a form of partnership with two kinds of ownership interests—"general partners" and "limited partners." (A FLP also can take the form of a limited liability company rather than a partnership, but for purposes of this article we are using the partnership structure for discussion.) The general partners control the business decisions of the partnership, and the limited partners share in profits and losses, often at the discretion of the general partners, but have no control over partnership operations.

One example of using a FLP in a family setting would have a husband and wife create a FLP by contributing assets (such as real estate, securities, etc.) to the FLP in exchange for partnership interests. Each spouse could retain a 1% general partnership interest and a 49% limited partnership interest. The FLP's partnership agreement could severely restrict the limited partnership interests so that no limited partner would have a mandatory right to receive FLP income or profits and the limited partnership interests would be subject to very limited transfer and liquidation rights. After the FLP's formation, each spouse could make a gift of a portion of his or her limited partnership interest to their children or other donees. The restrictions placed on the limited partnership interests in the FLP agreement could cause the value of the gifted limited partnership interests to be reduced for gift tax purposes due to the fact that a limited partner has no control over the FLP and there is a limited market (if any) for the sale of a limited partnership interest under those circumstances.

Other Uses of FLPs

In addition to reducing transfer taxes as described in the preceding paragraph, individuals have used FLPs for some or all of the following:

- To create a layer of insulation between an individual and his or her unknown future creditors (i.e., asset protection);

- To transfer wealth to younger generations without divesting the general partners of the FLP (i.e., the parents) of control over the FLP's underlying assets (e.g., an investment portfolio);

- To avoid ancillary probate (an additional probate proceeding for non-residents) in a state where an individual owns real property but which state is not that individual's "domicile";

- For individuals owning family businesses, a FLP may help the parents to fix or "freeze" the value of their interest in the business for federal estate and gift tax purposes, while shifting future appreciation free of transfer taxes to younger generations; and

- For Florida residents, FLPs have been used to reduce the resident's annual intangibles tax.

IRS Continues to Attack Abusive FLPs

The IRS continues to challenge the validity of FLPs that appear to be designed and created solely for a tax avoidance purpose. The IRS's focus has been on improperly administered FLPs transferring the majority of one's assets into the FLP without retaining sufficient assets for support; transferring personal use property, such as a home, to the FLP and continuing to reside in it rent-free; making non-pro rata distributions to the partners; using FLP assets to satisfy personal needs; and commingling personal and FLP property. In general, the IRS has attacked FLPs where it appears the FLP itself was really treated as the "alter ego" of the taxpayer rather than a separate and independent entity. The technical theory behind their argument is that the individual who created the FLP really retained the possession or enjoyment or the income from the property transferred to the FLP.

More recently, the IRS has attacked FLPs on a different theory—that the individual who created and funded the FLP retained the right to affect who can enjoy or possess the property. In the *Strangi* case, the IRS successfully challenged the validity of a decedent's FLP using this theory (among others). The Tax Court held that the full value of the property transferred by the decedent to his FLP was included in his estate for federal estate tax purposes (a very bad result for the taxpayer). First, the Tax Court found that during the decedent's life, he had an implied agreement to retain possession and enjoyment of the FLP property. The IRS reasoned that because the decedent transferred the majority of his assets, including his home, to the FLP, continued to live in his home rent-free, commingled personal and FLP assets, and received distributions from the FLP, based on need, disproportionate to the other partners, that the FLP was really, in essence, the decedent's alter ego. Moreover, partnership distributions were entirely in the discretion of the general partner, which was a corporation run by the decedent's son-in-law, who was acting on the decedent's behalf through a power of attorney. In *Strangi*, the Court viewed the FLP as a device to reduce estate taxes while keeping the FLP's assets available to the decedent rather than a means in which to conduct a "real" business.

Second, the Tax Court found that the decedent, as a limited partner, had retained impermissible rights, including the right to join with other partners to vote on the FLP's liquidation, which, the Court reasoned, enabled him to designate who would possess or enjoy the transferred property. *Strangi* is currently being appealed. Many professional advisors believe that, until further guidance is provided in this area, it is advisable (in addition to not retaining other impermissible rights) that an individual transferring property to a FLP does not retain control of the FLP.

In *Kimbell*, a case decided after *Strangi*, a decedent's estate defeated the IRS's attempt to ignore the FLP structure when valuing the decedent's estate for federal estate tax purposes. The decedent's estate tax return reported the decedent's interest in the FLP on a discounted basis. The IRS argued that the FLP should be ignored and the undiscounted value of the actual assets owned by the FLP (rather than Mrs. Kimbell's interest in the FLP entity) should be included in her estate because the transfer of the decedent's assets to the FLP (before Mrs. Kimbell died) was not a bona fide sale for adequate and full consideration. The Fifth Circuit in *Kimbell*, however, concluded that "in order for the sale to be for adequate and full consideration, the exchange of assets for partnership interests must be roughly equivalent so the transfer does not deplete the estate." The decedent had indeed retained sufficient assets outside the FLP for her support, she did not commingle FLP and personal assets, partnership formalities were respected, contributed assets were assigned to the FLP and there were credible non-tax reasons for the FLP's formation. The Court concluded that the creation of the FLP was done for substantial business and other non-tax reasons, showing once again how FLP cases are extremely fact-specific.

The Fifth Circuit also dismissed the IRS's contention that family members are not able to enter into arm's-length transactions for adequate and full consideration, although noting that intra-familial transfers should be carefully scrutinized. The Court also rejected the IRS's argument that discounting the value of the decedent's FLP interest precluded a finding that the interest was for adequate consideration. The decedent received a partnership interest proportionate to the assets she contributed, her capital account was properly credited with the assets she contributed and she was entitled to a distribution equal to her capital account balance upon termination or dissolution of the FLP.

It is important to note that Courts have found that transfers which lack the *Kimbell* facts are not bona fide sales for full and adequate consideration. The Third Circuit in *Thompson* included the value of the underlying assets of the FLP (rather than the decedent's interest in the FLP) in the decedent's estate because the decedent did not retain sufficient assets outside the FLP for his support, he received disproportionate distributions from the FLP, and there were no credible non-tax reasons for the FLP's formation.

In summary, although the IRS has taken an aggressive stance against FLPs, if properly structured and managed, FLPs may continue to be an effective method to transfer wealth at a reduced transfer tax cost while offering many other non-tax uses and advantages. If you have an existing FLP, we recommend you contact a personal planning attorney to review it and to discuss strategies to assure that your FLP conforms to current standards. If you do not have an FLP, we would be happy to discuss this planning technique with you.

Irrevocable Life Insurance Trusts: An Important Component In Many Estate Plans

The proceeds from a life insurance policy owned in your own name will be subject to an estate tax at your death. In contrast, the proceeds from a life insurance policy owned by an irrevocable life insurance trust will pass free of estate taxation. Thus, irrevocable life insurance trusts are exceptionally useful estate planning devices for a number of reasons and should be a fundamental component of many estate plans.

The most significant benefits to using an irrevocable life insurance trust are the substantial estate tax savings achieved by removing life insurance proceeds from your gross estate and, if you are married, the estate of your surviving spouse, while preserving the availability of the proceeds to meet the needs of your family and your estate, and providing for the competent management of what may amount to significant sums for the benefit of trust beneficiaries (typically your spouse and children). If you live in California or another community property state, additional planning may be required to allow the surviving spouse to be the lifetime beneficiary of the trust and still insulate the remaining trust assets from the spouse's taxable estate at her or his subsequent death.

In the January 2000 and February 1992 issues of *Personal Planning Strategies*, we discussed how life insurance can be used in an estate plan to pass wealth free of estate and income taxes to family members and how it can be used to provide the liquidity necessary to pay estate taxes. We also discussed the various kinds of insurance available to accomplish these goals.

This article focuses on the mechanics and benefits of an irrevocable life insurance trust, after briefly reviewing how life insurance proceeds are taxed in an estate. Although the discussion is geared to a life insurance trust holding a policy insuring the life of one person, it also applies to a trust holding a second-to-die policy (a policy insuring the lives of two people, usually a husband and wife).

Estate Taxation of Life Insurance Proceeds

Under the Internal Revenue Code ("IRC"), upon your death life insurance proceeds will be included in your gross estate and subject to an estate tax if the proceeds are payable to your estate or if you were the owner of, or possessed any "incidents of ownership" in, the policy. The term "incidents of ownership" means rights to an economic benefit from the policy. Some examples of economic benefits are the power to change the beneficiary, the power to surrender or cancel the policy, the power to assign or revoke an assignment, the right to borrow against the policy and the right to elect settlement options.

For example, if you own a life insurance policy insuring your life, and your child or some other person (or your estate) is named as the beneficiary, upon your death, the proceeds of the policy will be included in your gross estate and subject to federal estate tax, assuming the value of your taxable estate (gross estate minus various deductions) exceeds the current federal estate tax exemption of $1,500,000.

If your spouse or a trust qualifying for the marital deduction is the designated beneficiary of the policy, the estate tax will be deferred until the death of your surviving spouse, because the policy proceeds will qualify for the marital deduction. While the marital deduction protects the proceeds of the policy from estate tax in your estate, the proceeds are still subject to estate tax on the death of your surviving spouse. Therefore, the benefit of using an irrevocable life insurance trust is that it provides a means of avoiding estate tax on the policy proceeds in both estates.

Mechanics of an Irrevocable Life Insurance Trust

To obtain the estate tax savings benefits afforded by a life insurance trust, you simply create an irrevocable trust during your life naming someone other than yourself as trustee of the trust. You should not be a trustee of the trust, because the powers you hold over the trust as trustee may be considered "incidents of ownership" that would cause the policy proceeds to be included in your estate.

The trust would be the applicant, owner and beneficiary of a new insurance policy, or, if it is an existing policy, you would assign the policy to the trust. If you assign an existing policy to the trust, you must survive three years after the transfer in order for the proceeds to escape estate taxation, since the IRC provides that the proceeds of a life insurance policy transferred by an insured-decedent within three years of death are includable in the decedent's estate. If you die within the three-year period, the trust may provide for a marital deduction qualifying disposition, which will, at least, defer the estate tax until the death of your surviving spouse. Note also that the transfer of an existing policy to the trust constitutes a gift to the trust. The amount of the gift for a term policy is negligible; the amount of the gift for a whole life policy is the cash value of the policy.

The trust is typically unfunded. An unfunded insurance trust holds only a life insurance policy. Each time a premium is due, you make a cash gift to the trust in the amount of the premium, and the Trustee uses that cash gift to pay the premium.

The IRC allows you to make annual gifts of up to $11,000, or $22,000 if your spouse consents to split the gift, to as many people as you wish in a given calendar year completely gift tax-free. This is referred to as the federal gift tax annual exclusion. Gifts to trusts, however, do not qualify for the exclusion unless the beneficiaries of the trust have present interests in the gifts. The beneficiaries have present interests only if they have the unrestricted right to the enjoyment of the gifts.

If premiums are paid directly to the insurance company, or if cash gifts are made to the trustee who then immediately pays the premium, the IRC considers the gifts to be future interests. In order to qualify these gifts for the annual exclusion and not be subject to gift taxes, a required present interest in the trust is created by giving the beneficiaries a limited withdrawal right with respect to the policies transferred and additions made to the trust to pay premiums (these withdrawal powers are known as "Crummey" powers, named for the case *Crummey v. Commissioner*).

Each time a gift is made to the trust, the trustee notifies the beneficiaries that they have a limited time within which to withdraw a proportionate share of the gift. The beneficiaries then may notify the trustee if they wish to withdraw their share of the gift. Beneficiaries typically do not exercise their withdrawal powers and the funds are then used to pay the policy premiums. If you live in California or another community property state, additional planning may be required to allow the surviving spouse to be the lifetime beneficiary of the trust and still insulate the remaining trust assets from the spouse's taxable estate at her or his subsequent death.

Upon your death, the proceeds of the policies owned by the trust will be paid to the trust, and the terms of the trust will dictate how those proceeds are distributed. The trust is usually designed so that the proceeds are available to your surviving spouse, but are not included in his or her estate for estate tax purposes. The typical trust will provide that the proceeds will continue to be held in trust for the benefit of your spouse during his or her lifetime.

Upon your spouse's death (or upon your death, if your spouse predeceases you), the trust usually will provide that the principal is payable to your children (or the descendants of a predeceased child), either outright or in further trust, usually with the same or similar terms as the trust(s) created for your descendants in your Will.

Whether you wish to provide for the outright distribution of principal to your children or a continuing trust for their benefit depends on your family circumstances. Continuing trusts may be created to prevent principal from being paid to minor children or to adult children lacking financial sophistication. The continuing trust usually will direct that income and principal distributions be made to your children at ages you deem appropriate.

An irrevocable life insurance trust also can be used to leverage your GST tax exemption, which offsets the tax liability arising from gifts made to grandchildren and more remote descendants. By situating the insurance trust in a jurisdiction that does not require that it be terminated and allocating your GST exemption to the contributions you make to the trust, you will be able to create a "dynasty" trust that may last indefinitely for successive generations and also is insulated from both estate and GST taxes upon your death.

Conclusion

The terms of an irrevocable life insurance trust can be tailored to your and your family's specific needs. Because of the estate tax savings you can achieve by having an insurance trust own your life insurance, you should seriously consider whether this is an appropriate vehicle for you.

Although some clients view the irrevocability of the trust as a drawback, because of loss of control over the policy and the inability to make modifications, with careful planning most clients' concerns can be addressed and alleviated.

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