

# Wealth Preservation Advisor

Volume 2, Number 2

Winter 2004

*We are pleased to enclose our second issue of the Advisor. The year 2003 has been a busy year for Moses & Singer's Private Client Services Group.*

***Gideon Rothschild** gave presentations to numerous professional groups throughout the year including the Practicing Law Institute, American Bar Association, and the American Institute of CPA's and he was quoted in The Wall Street Journal, Tax Hotline, Money, Bloomberg Wealth Manager, and Time Magazine. His Tax Management Portfolio on Asset Protection Planning was published by BNA.*

***Daniel Rubin** was invited to speak during the year by a number of physician organizations and other professional groups and has authored numerous articles for professional journals.*

*You are invited to visit our web site or contact our marketing department to obtain copies of these articles. If you wish to have us make a presentation to colleagues or an organization of which you are a member, please contact Keri Keane at 212.554.7531 or [kkeane@mosessinger.com](mailto:kkeane@mosessinger.com)*

*We are pleased to receive referrals from our clients and friends and thank you for your continued support. We wish you a Healthy and Prosperous New Year.*

## Recent Developments Concerning "Family" Limited Partnerships

The "family" limited partnership (or "FLP") has long been an effective way to transfer wealth to one's family (or to trusts for their benefit) at a reduced transfer tax cost while at the same time providing for centralized management and creditor protection. A limited partnership consists of one or more general partners who have sole control over the operation of the partnership (including the power to invest and reinvest the partnership property and the power to determine when and if distributions should be made) and one or more limited partners who may own the majority of the equity interests of the partnership but who have no voice in the operation of the partnership.

A limited partner's inability to control the operation of the partnership results in a discounted valuation of the limited partner's partnership interest for gift and estate tax purposes. In addition, the fact that a "family" limited partnership interest does not have a ready public market results in a further valuation discount. A prop-

erly structured partnership can commonly achieve aggregate discounts in excess of 30% of the value of the partnership's underlying assets, potentially resulting in significant gift and estate tax savings.

Although the Internal Revenue Service has conceded the legitimacy of these discounts, it has continued to challenge what it considers to be abusive family limited partnership arrangements. The majority of these situations have involved taxpayers who failed to properly maintain and administer their partnerships by not opening separate partnership bank accounts, by commingling partnership property with personal property, by transferring personal use property (such as a personal residence) to the partnership and not paying fair market rent to the partnership for the use of such property, by making non *pro-rata* distributions to the partners and by using partnership funds to pay personal expenses. In addition, many of these cases had other "bad facts"; namely, the taxpayers tended to be elderly, tended to

transfer a majority of their assets to the family limited partnership, and tended to die shortly after the partnership's creation. In these family limited partnership cases, the courts have concluded that the entire value of the property transferred to the family limited partnership was includible in the transferor's estate because the transferor retained the beneficial enjoyment of the "transferred" property.

These "abusive" partnership cases, however, have not posed a significant threat to taxpayers who take the time to understand the appropriate methodology for administering their partnerships. Significantly more troubling is the recent Tax Court Memorandum decision in *Strangi v. Commissioner*, which presents a challenge to the viability of many family limited partnerships even though the taxpayer might be meticulous in administering the partnership.

In *Strangi*, the Internal Revenue Service challenged the decedent's limited partnership on two grounds. First, the Internal Revenue Service argued that an implied agreement existed for the taxpayer to retain possession and enjoyment over the property transferred. The fact that the Internal Revenue Service succeeded in challenging the family limited partnership on this

front is hardly surprising inasmuch as the taxpayer made many of the mistakes discussed above (i.e., the taxpayer transferred a majority of his assets to the partnership, including his home, which he continued to live in without paying rent, and partnership distributions were made in accordance with the needs of the taxpayer and later, those of his estate). The troubling part of the Tax Court's decision was its inclusion in the decedent's estate for estate tax purposes of 100% of the property transferred by the decedent to the partnership based on the Tax Court's finding that the decedent-limited partner retained certain impermissible rights including the right as a limited partner to join with the other partners to vote on a liquidation of the partnership.

While we believe that this case was incorrectly decided (and hopefully will be proven wrong on appeal), its holding must be given due consideration by clients who have created family limited partnerships. It is likely that the Internal Revenue Service's position in any future estate tax return audit will be to include the full value of any transferred assets where the decedent retained an interest as either a general or limited partner, unless those powers are appropriately circumscribed. Towards this end, we recommend that clients with existing family limited partnerships

## Rules to Follow to Help Keep Your FLP Out of Trouble

1. Have non-tax reasons for creating the FLP.
2. Re-title assets in the name of the FLP.
3. Maintain minutes of FLP meetings.
4. Maintain separate FLP bank and brokerage accounts.
5. File tax returns for the FLP.
6. Do not contribute a majority of your assets to the FLP.
7. Do not contribute personal use assets to the FLP.
8. Make *pro-rata* distributions among the FLP's partners.
9. Do not pay personal expenses with FLP monies.
10. Review the FLP's activities and design annually with experienced legal counsel.

revisit their structures with their Moses & Singer attorney as soon as possible. We have developed several strategies which we believe should be taken at this time in response to *Strangi*. Moreover, for those who have not yet considered the possibility of incorporating a family limited partnership structure into their overall estate plan, we continue to regard an appropriately structured family limited partnership as an excellent estate planning tool and strongly recommend that this technique be explored with us at the earliest possible time.

## **Estate Tax Exemption Rising**

**T**he federal estate tax exemption increased to \$1.5 million on January 1, 2004, and is scheduled to further increase to \$2 million on January 1, 2006, and to \$3.5 million on January 1, 2009, before disappearing in 2010 only to be resurrected in 2011 with a much reduced \$1 million exemption. Wills using a formula that allocate an amount of property to a credit shelter trust based on the exemption amount at the date of death may no longer be appropriate for all estates. Couples with mid-sized estates may prefer to cap the formula allocation to the credit shelter trust at a specified dollar amount. Others may choose to discontinue the

use of a credit shelter trust, while still others may opt for the flexibility offered by a disclaimer trust. Those who choose to retain their credit shelter trusts should confirm that the assets needed to fund the trusts are appropriately titled. Estate plans must be revisited regularly as the exemption increases and as the future of the federal estate tax further unfolds in coming years.

Although the federal estate tax exemption law increased, the gift tax exemption available for lifetime gifts remains frozen at \$1 million. The \$11,000 annual gift tax exclusion will remain unchanged in 2004.

## **But ... State Estate Tax Exemptions "Decouple"**

**T**he increased federal exemption noted above has impacted state revenues significantly. Accordingly many states have decoupled from the federal schedule by, generally, freezing the exemption amount at the levels in effect prior to the change in the law. For example, New York's exemption is frozen at \$1 million while New Jersey's exemption remains at \$675,000. What this means to you is that, although there may be a reduction in federal estate taxes, the state estate tax bite will increase. Furthermore,

married clients who have credit shelter trust formula clauses in their will that are key to the increased federal exemption and that are intended to result in zero federal estate tax at the first spouse's death will find that there may be a potentially significant state estate tax in those states which do not recognize the larger federal exemption.

## **And Federal Estate Tax Rate Drops**

**I**n 2004, the top federal estate and gift tax rate is reduced to 48%. It will be further reduced by 1% each year until 2007 when it will be 45%. However, due to the phase-out of the state death tax credit and decoupling by many states, the total federal estate and state estate tax may in fact be higher in some states than it was before these changes were enacted. For example, estates of decedents who are New York residents will be subject to estate tax in excess of 53% through 2009. In some cases, a New York resident may incur a lower tax by making lifetime gifts (which are not subject to New York gift tax) instead of death time transfers. In general, however, gifts in excess of one's available exemption amount should be avoided due to the possibility of estate tax repeal.

## But Planning Should Continue

Notwithstanding the uncertainty of estate tax repeal, the current low interest rate environment provides significant opportunities to "freeze" the value of one's estate. For example, if a parent loans cash to a child, the parent must charge interest of only 1.68% per annum (if the loan was made in January 2004) if the loan is for less than three years. If the child's earnings thereon exceed 1.68%, such excess, in effect, is transferred to the child gift-tax free. In addition, any capital gain the child realizes may be taxed at a lower income tax rate. Other techniques that are favorable at this time are Grantor Retained Annuity Trusts (GRATs), Charitable Lead Trusts, and Installment Sales to Grantor Trusts. Please do not hesitate to contact any of our Group's attorneys if you wish to explore how any of these planning techniques could reduce your estate taxes

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## Private Client Services

Moses & Singer LLP's Private Client Services Group provides a full range of legal services for the high net worth individual. In addition to substantial experience in the traditional areas of will and trust drafting and estate administration, the firm's attorneys utilize the latest techniques to implement effective plans for business succession and tax minimization to the greatest extent possible.

The firm is also recognized as a leader in wealth preservation strategies to protect client assets from future creditors and potential litigation exposure.

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*This Advisor is intended as a general comment on certain recent developments in the law. It does not contain a complete legal analysis or constitute an opinion of Moses & Singer LLP or any member of the Firm on the legal issues herein described. This newsletter contains timely information that may eventually be modified or rendered incorrect by future legislative or judicial developments. It is recommended that readers not rely on this general guide in structuring or analyzing individual transactions but that professional advice be sought in connection with any such transaction.*

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