JONES DAY

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WEALTH MANAGEMENT PLANNING ALERT

RECENT DEVELOPMENTS IN FAMILY WEALTH TAXATION

ESTATE TAX—REPEAL LIKELY DEAD BUT COMPROMISE STILL POSSIBLE

Current law provides for the repeal of the federal estate tax only for persons dying in 2010. Members of Congress have, for some time, been both negotiating and introducing competing bills with changes ranging from a complete and permanent repeal to increased estate tax exclusions and reduced rates. Late this summer, it appeared that a compromise would be struck and that the estate tax would be retained, although with increased exclusions and reduced rates. The tragedy of Hurricane Katrina, however, had the ancillary impact of at least deferring the prospects for estate tax compromise and, in our opinion, completely derailing the chance for a permanent repeal of the estate tax for some time. Although repeal and reform proponents continue to insist that transfer taxes will be on the 2006 agenda, there are other political and tax items (including AMT and income tax reform proposals) that may otherwise occupy limited Congressional resources.

We expect that if there is any change in the law, it will be a higher exclusion amount (estimated to be between $3 million and $5 million per person) and reduced rates (believed to be as low as 15-20 percent). While many would view any such changes as improvements, there has been some anecdotal evidence that a compromise might be reached in exchange for "trading away" some existing planning techniques. Some have speculated that discounts will be eliminated for family-held (nonoperating) entity interests (such as FLPs, discussed below), that grantor retained annuity trusts ("GRATs") will have a material minimum gift amount (perhaps 10 percent of the contributed assets), and that "dynasty" trusts will not shield lower generations from estate or GST taxes. Although there is no way to predict with certainty what will happen, we continue to recommend that our high-net-worth clients consider implementing planning techniques prior to any sort of Congressional compromise that might be forthcoming.

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UPDATE ON FLPS

A number of recent court decisions have addressed the practical aspects of effective planning with closely held family limited partnerships and limited liability companies (collectively, "FLPs"). In general, these decisions demonstrate that carefully formed and operated FLPs should continue to be blessed by courts and awarded material valuation discounts, but that FLPs with less integrity may be rejected—with potentially draconian consequences. As such, the IRS can be expected to continue its pattern and practice of scrutinizing FLPs and taking a hard line against FLPs that have been inadequately formed or operated.

The continued emphasis on proper FLP formation has manifested itself in a variety of ways. First, courts now look to a taxpayer's motivation for forming a FLP (*e.g., Kimbell, Turner, Bongard*), and underscore that a FLP should be formed for a legitimate and significant non-tax purpose or a substantial non-tax reason, such as investment management of the FLP assets (*e.g., Strangi, Turner, Bongard, Schutt*). Second, courts continue to consider whether the partnership agreement incorporates various nuances that are now central to protective FLP planning, such as the preservation of fiduciary duties. Third, courts continue to look for practical funding pitfalls, such as funding a FLP with personal use assets (*Strangi*), funding a FLP with essentially all of an individual's assets (*Bigelow*), unreasonably delaying the funding of a FLP (*Korby*), and allocating disproportionate interests in return for capital contributions (*Bongard*). Thus, focused attention to key formation considerations will continue to play a critical role in defensive FLP planning.

Recent court decisions have likewise underscored the vital, ongoing need for taxpayers to pay vigilant attention to their FLP's operational details. Consistent with FLP precedent in that regard, several courts recently attacked FLPs in part because of sloppy operational facts, such as poor documentation (and ill-conceived timing) of transfers of FLP interests (*Senda*), the use of FLP property to secure a partner's personal loan (*Bigelow*), a general disregard of the partnership agreement (*Korby*), postmortem accounting manipulations (*Hillgren*), and disproportionate distributions to or for a partner (or his estate) on a personal, as-needed basis (*Strangi*). Courts also now expect to see FLP operations and management endeavors that advance the entity's stated non-tax purpose (*Schutt*). Thus, tight operational management remains essential to the successful implementation of a FLP-based plan.

Finally, a number of 2005 Tax Court decisions pointedly illustrate that properly formed and operated FLPs should continue to receive material discounts for lack of control and lack of marketability. For example, the *Kelley* case involved a cash (and cash equivalent) FLP that reportedly enjoyed sound formation and operational facts, and the Tax Court awarded the taxpayer a combined 32 percent FLP discount. In the *Schutt* case, the IRS and the taxpayer stipulated to a combined 32.5 percent discount in the event the court determined, in effect, that the FLP had solid formation and operational facts that precluded includability. The IRS and the taxpayer in *Bongard* similarly stipulated to 28.2 percent and 31.8 percent combined discounts on voting and nonvoting interests, respectively.

In sum, recent FLP decisions underscore that questionable formation and operational facts will continue to pose a real danger to FLPs, whereas solid facts will provide a firm defense against IRS attacks and support material valuation discounts.

HURRICANE KATRINA – END-OF-YEAR CHARITABLE CONTRIBUTION OPPORTUNITY

The Katrina Emergency Tax Relief Act of 2005 ("KETRA"), which was signed into law in September, provides a brief window of opportunity for additional charitable contributions before year-end. Generally, income tax charitable contributions for an individual's contribution of cash to a public

charity are limited to 50 percent of a taxpayer's adjusted gross income ("AGI"), with a five-year carryforward for excess contributions. Under KETRA, that 50 percent AGI limitation is suspended for cash contributions made to a public charity between August 28, 2005, and December 31, 2005. Therefore, until the end of 2005, such contributions are deductible up to 100 percent of a taxpayer's AGI (still with a five-year carry-forward for excess contributions). In addition, the income tax charitable deduction for these qualified gifts will not be subject to the tax reduction rule that reduces itemized deductions by 3 percent for taxpayers with AGI over $145,950. A similar provision of the Act suspends the 10 percent of income limitation for charitable contributions by corporations; however such corporate contributions must be for Katrina disaster relief, while qualifying gifts by individuals may be made to any public charity.

You should note that only gifts of cash qualify; gifts of stock or other property do not. In addition, contributions to a donor-advised fund, private foundation, or supporting organization will not qualify for this additional benefit.

Many advisers are recommending that taxpayers take advantage of this unique opportunity, including by withdrawing IRA proceeds and contributing them to a public charity. While contributions of cash generated from withdrawals from an IRA (or the sale of an appreciated asset) can also qualify for this increased charitable deduction opportunity, there are other complicated tax implications to consider, including possible early-withdrawal penalties. For instance, many state and local income tax calculations are based on a taxpayer's federal AGI; therefore, the sale of an asset or withdrawal from an IRA can generate income that would still be taxed for state and local income tax purposes with no offsetting deduction. In addition, an increase in a taxpayer's AGI may reduce the deductibility of noncharitable itemized deductions under the tax reduction rule noted above. If passed, the CARE Act (discussed below) would offer a more effective solution than that provided by KETRA for individuals wishing to make lifetime contributions of IRA proceeds to charity.

REINTRODUCTION OF THE CARE ACT

New versions of the CARE (Charity Aid, Recovery, and Empowerment) Act that passed both the House and Senate in 2003, but failed to clear a conference agreement, have been reintroduced in the House and Senate. As with the earlier versions of this Act, the CARE Act of 2005 would permit tax-free rollovers to charity from IRAs, including to fund charitable remainder trusts and charitable gift annuities, and would allow non-itemizers to deduct a portion of their charitable contributions. Bipartisan supporters of this legislation are urging passage, particularly in light of the increased charitable needs due to Hurricane Katrina and other natural disasters.

INCREASED EXCLUSIONS AND EXEMPTIONS FOR 2006

There are several important increases in federal transfer tax exclusions and exemptions that are effective as of January 1, 2006:

- The federal **gift tax annual exclusion** (the amount that you can give each year to each donee free from gift tax) rises from $11,000 to **$12,000**.
- The federal **estate tax exclusion amount** (the amount that can pass free from estate tax) rises from $1.5 million to **$2 million** (the federal gift tax exclusion remains at $1 million).
- The maximum federal **estate tax rate** drops from 47 percent to **46 percent**.
- The federal **GST tax exemption** (the amount that can be transferred to or for grandchildren free from the GST tax) rises from $1.5 million to **$2 million**.
- The amount that a taxpayer can give to a **non-U.S. citizen spouse** free from gift taxes rises from $117,000 to **$120,000**.

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