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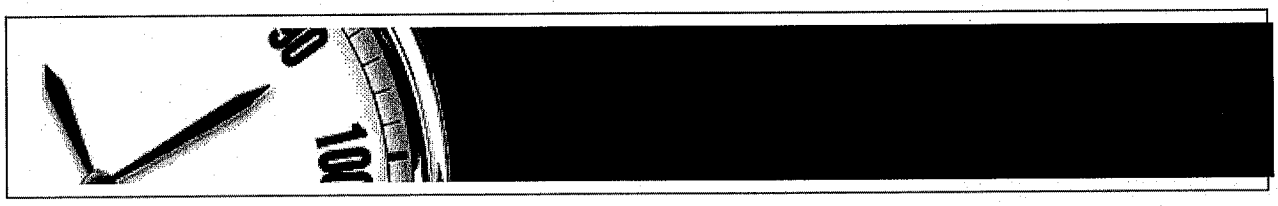
The New Normal for Smaller Estates



How tax planning is changing for these types of clients

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Trusts & Estates

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Certified public accountants tend to be practical folk, and they often view estate planning from a different lens than perhaps attorneys sometimes do. For my last column from Heckerling, "The Beatles and Estate Planning," I spoke with several planners on the trust company/bank side. While there's certainly much common ground, there are some interesting nuances in the different views among CPAs, attorneys and trustees.

There's clearly a growing emphasis on income tax planning for estate-planning clients. A few thoughts on this follow, some from this week's sessions, some from attendees and more.

Dust Off Internal Revenue Code Section 704(e)

Those practitioners old enough to remember the Heckerling sessions in Miami may also remember that once-upon-a-time family limited partnerships (FLPs) were used for more than discounts. For many years, FLPs were used to help shift taxable income to lower bracket family members. The compression of income tax rates has lessened this type of planning, but regardless, for many years the discount elixir eclipsed the income tax planning benefits. Perhaps the FLP pendulum will swing again for moderate wealth clients because of post-American Tax Reform Act changes:

- New higher marginal income tax rates.
- The Medicare surtax.
- The irrelevance of valuation discounts for moderate wealth taxpayers safely under the exemption threshold.
- Increased resistance to the cost and complexity of planning that isn't in the client's mind, justified by potentially significant estate tax savings.

The mechanism is for a parent or other benefactor to make gifts of FLP or limited liability company (LLC) interests to lower income tax bracket family members. For smaller value gifts, moderate wealth clients might forgo what they perceive as the cost and complexity of a trust and just rely on the control features the FLP or LLC can provide. Once the gift is completed, the lower income family member should report his pro-rata share of FLP/LLC earnings at a lower rate.

For gifts of LLC membership interests to be respected, the FLP/LLC will be tested under the provisions of IRC Section 704 (e), the family partnership rules. A failure to meet the test under this section could result in a portion or all of the FLP/LLC income being taxed solely to the donor/parent, rather than to the child/donee of the FLP/LLC interests. The Section 704(e) requirements are directed at determining in whom the actual ownership of the FLP/LLC interests is vested. These requirements are designed to ensure that the allocation of partnership income follows this economic reality.

Capital must be a material income-producing factor in the partnership (Section 704(e)(1); Treasury Regulations Section

1.704-(e)(1)(ii)). This requirement is perhaps most easily met for transactions involving the transfer of real estate properties and other valuable assets to an FLP/LLC, since capital is usually the primary, if not the only, material income-producing factor in a real estate investment. Other transactions can be less certain. The donee members (for example, the transferor's children or other heirs) must be the real owners of the capital interests given to them (Section704(e)(1)). The donee members must have genuine interests in the FLP/LLC. They must be entitled to receive a portion of the assets on withdrawal from the FLP/LLC, and they must be able to transfer their interests in the FLP/LLC without financial detriment. You can interpret these requirements as implying that the donees are the real economic owners of their capital interests in the FLP/LLC. The donees must have dominion and control over their FLP/LLC interests (Treas. Regs. Section 1.704-(1)(e)(2)(i)). If, for example, the operating agreement requires the issuance of membership certificates and the donor/parent retains them in her safe deposit box, this action may violate Section 704(e) requirements and the rules governing a completed gift.

Flip the FLP

And, what might happen if before death, the donor/parent finds a checklist of how to avoid IRC Section 2036 issues for FLPs/LLCs and holds it up to a mirror, so all of the tips on the checklist are backwards? The entirety of the FLP/LLC, including the gifted interests, may be pulled back into the donor/parent's estate, which, even with that additional amount, is under the federal exemption. The FLP/LLC could make an election under IRC Section 754 to step-up the basis in the partnership assets.

Certainly, taking the income tax planning position that the children own the gifted interests would appear to be inconsistent with the Section 2036 inclusion position at death.

New Gift Paradigm for the Moderate Wealth Client

For some moderate wealth clients subject to estate tax in a decoupled state with a low state exemption, like New York or New Jersey, gift and estate planning might take on a new paradigm. In the past, a client with a moderate estate would have almost assuredly had a bypass trust in his will and may have undertook other planning. That strategy may now change. The cost and complexity of more sophisticated planning may not be viewed as worthwhile for the potential state estate tax savings. Some of these clients might opt for making simple annual gifts of family entity or real estate interests directly to heirs. The gift of entity interests or minority interests in real estate will provide low cost and some simple control, as compared to the use of a trust. If these assets were highly appreciated, the gifts may just be deferred until after the death of the first spouse, to obtain a basis adjustment to the higher fair market value.

"Many moderate wealth clients with family businesses may do simple recaps and then just make one-time lifetime transfer gifts using non-voting interests, eliminating the need for sophisticated GRAT [grantor retained annuity trust] or sale to defective grantor trusts or requiring multiple valuations of interests when using annual exclusion gifting," suggests Hal Terr, CPA and partner at WithumSmith+Brown in Princeton, N.J.

While practitioners can readily point out the flaws with such planning, some clients at moderate wealth levels may simply not be willing to accept the cost and complexity they might have accepted just last year.

For moderate wealth clients safely below the federal exemption amounts, but desirous of minimizing state estate tax in a decoupled state with a low exemption, spousal lifetime access trusts (SLATs) may be preferable to bypass trusts. The control and asset protection features in SLATs will be achieved earlier on when the need is greater; the surviving spouse won't have to deal with the complexity of funding a bypass trust after the first spouse's death; and most importantly, the SLAT can be funded (other than in Connecticut) with far more than the bypass trust can on the first death of a spouse. So, if state estate tax minimization is the goal, the permanent high federal gift tax exemption will provide a simple solution for those who don't have highly appreciated assets.

Gift Tax Annual Exclusion

Do the FLP/LLC gifts qualify for the gift tax annual exclusion? Does anyone care?

Some of the above planning scenarios suggested gifts of entity interests. A significant concern for clients was whether entity gifts qualify for the gift tax annual exclusion. Do they meet the present interest requirement to qualify for the gift tax annual exclusion? *Hackl v. Commissioner*, 118. T.C. 279 (2002), *aff'd*, 335 F.3d 664 (7th Cir. 2003) had presented challenges for qualifying gifts of entity interests for the annual exclusion. But *Estate of George H. Wimmer, et al. v. Comm'r*, T.C. Memo. 2012-157 (June 4, 2012), a case discussed in one of this week's Heckerling sessions, presented a three-part test and a taxpayer friendly result.

In *Wimmer*, for the gifts to qualify for the gift tax annual exclusion, there must have been an unrestricted right to take immediate use and possession of the property or to realize enjoyment or income of the property. The *Wimmer* court found that there was a right to receive income from the property, and individual partners did, in fact, receive income. The court used a three-part test:

- Was income generated?
- Did some income flow through?
- Was the portion readily ascertainable?

The gifts in this case met the three-part test.

"Kiddie Tax" Impact on Planning

When addressing the higher income tax rates and 3.8 percent Medicaid tax that will kick in at low income levels, what should be done with trust investments and distributions, given the compressed trust income tax rates? CPAs worry about the difficulties they will encounter towards the end of 2013, when they will have to complete projections for trusts to plan 2013 distributions to minimize income taxes. The kiddie tax will pose an issue for some clients, in that income over a few thousand dollars will be taxed on the parent's marginal tax rate. That may eliminate some of the benefits of pushing distributions out of a trust. Not all beneficiaries will necessarily be subject to the kiddie tax. "But most of those subject to the kiddie tax will still have income below the threshold at which the 3.8 percent Medicare tax on passive income will kick in. So, there could still be some savings for the planning effort," notes Don Scheier, EA, partner at WithumSmith+Brown in New York, New York.

Similarly, if clients are able to use gifts of FLPs and LLCs to shift income to lower bracket family members, the kiddie tax implications will have to be considered as well.
