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FEDERAL TAX LAW

Prospects for Change Under a New Administration

In August of this year, President Clinton vetoed the "Death Tax Elimination Bill of 2000" which would have phased out federal gift, estate, and generation-skipping transfer taxes over a ten-year period. Although the bill did have the support of some Democrats, an attempt to override the veto was unsuccessful. The bill would have reduced gift and estate tax rates during the phase-out period and eliminated such taxes entirely for transfers made after 2009. Instead of receiving a new basis for property included in a decedent's estate (generally, under current law the new basis is the fair market value of the property on the decedent's date of death), the decedent's basis in the property would simply carryover to his or her beneficiaries, resulting in capital gains tax on the sale of inherited assets.

Several other bills that would reduce rather than repeal gift and estate taxes have been introduced. In late September of this year, a group of conservative Democrats introduced a proposal for estate tax relief. The "Death Tax Relief Act of 2000" would double the unified credit exemption from $675,000 to $1.3 million per person immediately, and increase that exemption to $2 million by 2009. Under the current law, the exemption is to increase to $1 million per person by 2006. The proposed legislation would also reduce gift and estate tax rates, with the top rate reduced from 55% to 39.6%. According to Rep. John Tanner of Tennessee, the lead sponsor of the bill, the changes would reduce the number of estates currently subject to the estate tax by one-half.

Governor Bush made the elimination of the federal gift and estate tax part of his campaign, so a repeal of the tax similar to the proposal vetoed by President Clinton may be forthcoming. However, in the November elections, Republicans retained a majority in Congress, but only by the narrowest of margins. With bipartisan support for a reduction rather than an elimination of the tax, a compromise proposal may end up being passed. As we said last year, stay tuned!

Statute of Limitations on Gifts

Many taxpayers have been unpleasantly surprised to learn that, in the past, the value of gifts made by a decedent years before could be adjusted during an estate tax audit. Under the Internal Revenue Code, the IRS generally cannot adjust the value of a gift that was reported on a gift tax return after the three-year statute of limitations expires (the three-year period generally begins on the date the gift is disclosed on a federal gift tax return). However, that is only true if a gift was "adequately disclosed" on the return.

Regulations issued in December 1999 set forth the requirements for adequate disclosure. With respect to hard-to-value assets like limited partnership interests, the requirement of adequate disclosure under the Regulations will be met in most cases if a thorough and complete appraisal of the property being transferred is attached to the gift tax return. The regulations highlight the need for clients to obtain high-quality appraisals when making transfers of hard-to-value assets like stock in a closely-held corporation or in a family limited partnership.

In some cases, other transactions that are not intended to be gifts, but that the IRS may characterize as gifts, should be disclosed on a gift tax return to ensure that the IRS has adequate notice of the transaction and cannot come in at a later date and recharacterize it. An example of such a transaction would be a sale of a hard-to-value asset to a child.

TEXAS LAW UPDATE

Although the Texas legislature did not meet this year, there is an update to a legislative change passed last year. The Constitutional amendment allowing spouses to convert separate property into community property was approved by voters, and this law became effective January 1, 2000. A conversion agreement must be in writing and signed by both spouses, and it must specify the property being converted. Merely transferring title to the names of both spouses is not sufficient. In some cases, conversion of separate property to community property may be a useful planning tool, but there are advantages and disadvantages. To ensure that you are aware of the pros and cons of this technique and that your conversion agreement is properly drafted, be sure to obtain good legal advice and assistance.

FAMILY LIMITED PARTNERSHIP UPDATE

Limited partnerships continue to be an important planning tool. Many of our clients have found that the partnership vehicle provides many advantages to the partners, including the management of various family property interests (both real estate and personal property), as well as consolidation and continuity for these properties. The partnership helps to preserve the separate property character of partners' properties, and can reduce the costs associated with a legal disability or probate proceeding. Finally, the partnership entity provides considerable protection against any future creditors of the partners. Under current law, a partner's creditors cannot force a dissolution of the partnership, and have no right to become substitute partners in the partnership. Instead, any creditor who obtains a judgment against a partner would be entitled to only a "charging order" against that partner's interest in the partnership, which would give the creditor the right to receive that partner's distributions from the partnership. At all times that a charging order is in place against a partner's interest in the partnership, the creditor would also incur its share of the income tax liability generated by the partnership assets.

Generally, a partner's interests in a limited partnership have a fair market value substantially below that partner's pro rata share of the assets owned by the partnership. Because these interests have no readily ascertainable market value, when they are transferred by gift or by death, the value must be determined by a qualified appraiser. Although a number of tax returns filed for estates of decedent's who owned interests in family limited partnerships are audited, many are not. Many of the cases that are audited are settled on terms favorable to the taxpayer. However, the IRS has selected several "test cases" which it refused to settle at the audit level, presumably in the hope that the Tax Court will rule against the taxpayer in question and set a precedent against the allowance of valuation discounts in connection with family limited partnerships. Several of these test cases were decided within the past year. The IRS has not prevailed on any argument that would, as a matter of law, allow it to disregard all family limited partnerships for transfer tax purposes.

Despite several taxpayer victories, it is clear from the cases that any transaction with “bad facts” is vulnerable. For clients who have spent the considerable amount of time and money required to create a limited partnership, we cannot overemphasize the importance of maintaining the formal integrity of the partnership entity, which is a separate "person" from any of its partners for legal purposes. This includes, among other things, the proper titling of assets contributed to or acquired by the partnership, keeping appropriate books and records for the partnership, filing required tax returns for the partnership, making distributions to partners in accordance with the terms of the partnership agreement, and having regular partnership meetings.

CONSIDER A “LOW RISK” ESTATE PLANNING TECHNIQUE

One estate planning technique that is specifically authorized by the Internal Revenue Code is the qualified personal residence trust (a “QPRT”). Unlike many techniques, this one is particularly advantageous as interest rates increase.

To utilize this technique, a donor transfers his residence to a trust. The trust agreement provides that the donor has the exclusive right to live in the residence during a set number of years which is the term of the trust. When this term expires, the residence passes to the remainder beneficiaries of the trust, typically the donor’s children. Because the IRS imputes a value to the donor’s retained right to live in the house for a number of years, the gift to the children is reduced by that imputed value. The imputed value is determined by prevailing federal interest rates at the time the trust is created. Therefore, the longer the trust lasts, the “cheaper” the gift to the children. Also, the higher the applicable interest rate is at the time the trust is created, the greater the imputed value of the donor’s retained interest, which also reduces the value of the gift to the children.

For an example of this technique, assume that a single woman, aged 65, has a home that is currently worth $500,000. She transfers the house to a qualified personal residence trust with a ten-year term. At the end of the ten-year term, the property of the trust (the house) will pass to the donor’s children. Assume that at the time of the transfer, the federal interest rate applicable to transfers of this kind is 7% (the applicable rate for December 2000). Based upon these assumptions, the value of the donor’s gift to her children will be $187,230. She will report a $187,230 gift to her children on a gift tax return filed for the year in which she created the trust. Assuming that she lives throughout the term of the trust, her children will receive the house at the end of the trust term, and upon her death, the house will not be included in her estate for estate tax purposes. This is true no matter how much the house appreciates in value over the term of the trust.

There are, of course, disadvantages to this technique. If the donor dies before the term of the trust is completed, it is as if the trust were never created and the full value of the residence is included in the donor’s estate for estate tax purposes. The donor’s estate will, however, receive a credit for any gift taxes paid when the trust was created. This would put the estate in the same position as it would have been in had the trust never been created. Another disadvantage is that, at the end of the trust term, the children really do own the house. If the donor wishes to continue to live in the house, she will have to pay rent at market value. Finally, to achieve the desired results for estate tax purposes, the trust must be irrevocable and unamendable. As noted below with respect to life insurance trusts, if the grantor becomes disenchanted with a trust beneficiary or otherwise wants to change the term of the trust or the identity of who will ultimately receive the house, she cannot do so.

LIFE INSURANCE TRUSTS

Many of our clients have created irrevocable trusts to hold policies of insurance on their lives. One of the primary purposes, and advantages, to creating such a trust is removing the proceeds of the insurance policy from the insured's taxable estate upon his or her death. Generally, if you die owning a policy of insurance on your life, the full amount of the proceeds from that policy will be included in your estate for estate tax purposes when the policy matures upon your death. If, however, you do not possess what the IRS refers to as "incidents of ownership" over the policy at your death, the proceeds of the insurance policy will not be included in your estate and will pass on to your beneficiaries estate tax free and income tax free. "Incidents of Ownership" include certain powers over the insurance policy, including the right to assign ownership of the policy, the right to change the beneficiary of the policy, and the right to pledge the policy or borrow against its value. With a life insurance trust, you give up these rights in favor of the trustee of the trust.

For an example of how an insurance trust works, assume that a single man with three adult children would like to purchase a $1million insurance policy on his life, and would like to avoid having the proceeds of that policy included in his estate at his death. He can accomplish these goals by using an irrevocable life insurance trust, or "ILIT". He would first, as grantor, create an irrevocable trust, with his oldest child as trustee. The grantor cannot be trustee of the trust or he would be deemed to have powers over the insurance that would be deemed "incidents of ownership". The trustee of the trust would apply for and acquire the $1million policy of insurance on grantor's life. The trustee would be both the owner and the beneficiary of the policy. Each year prior to the time that insurance premiums are due, the grantor can make gifts to the trust to enable the trustee to pay those premiums. The trust agreement would state that, upon the grantor's death, all of the properties of the trust are payable to his three children. When the grantor dies, the trustee files a claim for the insurance proceeds, and the proceeds are paid to the trustee, to be distributed to the beneficiaries in accordance with the terms of the trust agreement. The grantor's estate tax return would not reflect the insurance because the grantor retained no "incidents of ownership" that would cause it to be taxable in his estate.

The above example is a simple case, but many variations exist. For instance, you can create an insurance trust that will benefit both your surviving spouse and children. Generation-skipping planning can also be incorporated. You can transfer existing policies to a trust to achieve the same results, although the estate tax benefits will generally be lost if you die within three years of transferring a policy that you currently own.

The obvious benefit of this technique is removing the insurance proceeds from the grantor's taxable estate. There are also disadvantages. The biggest disadvantage is that, for the technique to be effective, the trust must be irrevocable and unamendable. If a grantor becomes disenchanted with a trust beneficiary or otherwise wants to change the distribution of the insurance, he cannot do so. We note, however, that he can always stop making gift to the trust to cover the premiums, and if he is still insurable, create a new trust. The other primary disadvantage is the administrative steps that must be followed in establishing and maintaining the trust to ensure that the desired results are achieved. If you are interested in learning more about this technique and whether it is right for you, we would be happy to discuss it with you.