LEGAL UPDATE

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Federal Guidance on Estate Taxation of Family Limited Partnerships and Limited Liability Companies

In July, the U.S. Circuit Court of Appeals for the Fifth Circuit decided Strangi v. Commissioner, and provided long-awaited guidance regarding the estate tax treatment of family limited partnerships (FLPs) and limited liability companies (LLCs). Although the court didn't question the use of an FLP or LLC as an estate planning technique, it ruled that if the entity is not properly administered, it won't be respected for estate tax purposes, and the entity's creator won't have the benefit of estate tax valuation discounts.

In Strangi, the taxpayer established an FLP and transferred nearly all of his assets to it. However, he also continued to use the FLP's assets as his own, and his estate used FLP assets to pay his debts after his death. The court found that there was an "implicit understanding" that Mr. Strangi would continue to use his assets even after they were transferred to the FLP and that the partnership didn't have a "substantial" purpose besides saving taxes. Consequently, the court held that the FLP's assets—rather than the taxpayer's discounted ownership interest in the FLP itself—were includible in his estate and subject to estate tax.

Clients incorporate FLPs and LLCs into their estate plans for many reasons, including protecting their assets from creditors, centralizing the ownership and management of their assets, and facilitating the transfer of their assets to their children during life and after death. FLPs and LLCs also may provide an opportunity for clients to transfer their assets to their heirs at a reduced value for estate and gift tax purposes.

To avoid such a result, clients who establish FLPs and LLCs should do so for valid, non-tax purposes, such as managing a family business or limiting liability. Clients shouldn't put all of their assets into an FLP or LLC, or employ the entity's assets for their personal use. It helps if someone other than the client—such as the client's children or a family trust—also purchases some of the entity's equity interests. FLPs and LLCs must be administered carefully as separate entities according to the terms of their governing instruments.

Even with the ruling, some uncertainty remains about how FLPs and LLCs should be set up and operated to avoid estate tax problems. In particular, the Fifth Circuit didn't rule on some issues involving how FLPs and LLCs should be managed. Until further guidance is issued, some clients might consider ceding management control to others (i.e., the children). Those who maintain control over distributions from their FLPs or LLCs as general partners or managers should ensure that their control is subject to real fiduciary standards (i.e., that the general partner or manager manages the entity's affairs, assets and income in a manner that protects the rights of the partners or members). ❖

Uniform Trust Code Revisions

New Hampshire's Uniform Trust Code (the "UTC") went into effect in 2004. Amendments to the UTC will be effective in September and will modify a trustee's duty to inform and give reports to the beneficiaries of an irrevocable trust. Under the new rules, a client (the "grantor") who creates an irrevocable trust may waive the trustee's obligation to inform the beneficiaries of the trust's existence and assets. Before this change, the grantor could not waive the trustee's duty to notify the beneficiaries of the details of the trust—including information about the value of its assets—immediately after the trust was formed. The grantor therefore could not keep the creation of a trust secret from its beneficiaries, even if the trust was fully discretionary and the beneficiaries had no vested rights in the trust property during the grantor's lifetime. ❖

Now, a grantor can preserve the confidentiality of information concerning an irrevocable trust by making the trustee accountable only to the grantor—rather than the beneficiaries—during the grantor's lifetime.

Status of ESTATE TAX REFORM

Congress failed to act on federal estate tax reform before its summer recess. Publicly, President Bush remains "committed to full repeal", and the House of Representatives voted for full repeal earlier this year. However, proponents of repeal may not have enough votes in the Senate to achieve this goal. Republicans and Democrats spent much of the summer trying to compromise on the issue, but were unable to do so.

Under current law, the estate tax exemption is $1.5 million per person, and the exemption is scheduled to rise to $2 million in 2006. Reform, if any, probably will result in a higher exemption amount and a lower top tax rate—maybe as soon as next year.

Remember that the gift tax exemption is $1 million and is not scheduled to be increased under current law. The gift tax annual exclusion for 2005 is $11,000 per donee. ❖

Status of MEDICAID REFORM

A new state law passed this summer makes significant changes to the Medicaid eligibility rules by increasing the "look back" period for gifts to individuals from 36 to 60 months. (Under current law, gifts to trusts already are subject to a 60 month look back period.) The look back period is the period of time, beginning on the date an individual applies for Medicaid, that the government will review to determine whether the individual made any gifts (either outright to individuals or to a trust). If an individual made gifts during the look back period, eligibility for Medicaid benefits may be delayed. This change to the look back period will not become effective unless the state submits a waiver request to the federal government and the federal government approves it. ❖

McDonald & Kanyuk, PLLC

ESTATE PLANNING AND WEALTH MANAGEMENT WITH A PERSONAL TOUCH

A New Option for Retirement Savings—the Roth 401(k)

Beginning in 2006, employers may offer a new element in their retirement plans—the Roth 401(k). The Roth 401(k) combines the features of a traditional 401(k) plan with a Roth IRA.

An employee who contributes to a Roth 401(k) will not receive an income tax deduction for the contribution, but the account will grow tax-free, and withdrawals taken during retirement will not be taxable. Unlike Roth IRAs, there are no income restrictions for Roth 401(k)s.

In 2006, an employee who has access to both a Roth 401(k) and a traditional 401(k) can contribute a total of $15,000 to the two accounts (people age 50 and over by the end of the year may contribute a total of $20,000). The employee can divide the contribution between the two accounts, or allocate the entire contribution to one of them, so long as the total contributed isn't more than $15,000.

When an employee with a Roth 401(k) leaves his job, he may roll the plan's assets into a Roth IRA. Unlike a traditional IRA, the Roth IRA does not require the employee to make annual withdrawals during retirement. High-income individuals therefore may be able to use a Roth 401(k) (and subsequent Roth IRA rollover) to create an income tax-sheltered legacy for their heirs.

A worker whose employer offers both types of 401(k)s must determine whether the benefit of tax-free withdrawals during retirement is worth the upfront cost of including the contributed funds in income today. In general, people whose tax rate will be lower in retirement than it is now will be better off with a traditional 401(k). Those who expect their tax rate to be higher in retirement may be better off with the Roth 401(k). Although current income tax rates are relatively low, the budget deficit and cost of funding Social Security and Medicare may drive rates up in the future. Be sure to bring your crystal ball with you when you visit your financial advisor to discuss the Roth 401(k). ❖

IRA Federal Bankruptcy Exemption

In April, the U.S. Supreme Court ruled that federal bankruptcy law shields individual retirement accounts (IRAs) from creditors. The decision affords IRAs the same federal bankruptcy protection that already applied to 401(k) plans and company pensions.

For New Hampshire residents, the Supreme Court's decision has only limited importance in light of the new federal bankruptcy laws and existing state asset protection rules. The new bankruptcy rules shield all qualified retirement accounts from creditors, with one significant limitation—the exemption for traditional IRAs (other than simplified employee pensions (SEPs) and SIMPLE retirement accounts) and Roth IRAs is limited to $1 million plus the amount of all rollovers (and earnings attributable to the rollovers). Since 1999, New Hampshire law has provided an unlimited exemption for any "retirement plan or arrangement qualified for tax exemption purposes." When filing for bankruptcy, New Hampshire debtors may choose between New Hampshire and federal bankruptcy exemptions. Under the new bankruptcy rules, however, the federal exemption will shelter all tax-favored retirement plans regardless of whether the debtor uses the state or federal exemptions.

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Consequently, the protection of retirement benefits will no longer be the deciding factor for most debtors in the choice between the federal and state exemptions. ❖

BANKRUPTCY REFORM

The most sweeping overhaul to the bankruptcy laws since 1978 will go into effect this October. The new rules are designed to encourage people to repay their debts instead of try to discharge them in bankruptcy. Before seeking bankruptcy protection, consumers first must participate in credit counseling. Those who still choose to file for personal bankruptcy will face more stringent eligibility criteria for bankruptcy under Chapter 7 of the Bankruptcy Code. (Chapter 7 allows a debtor to eliminate unsecured debts like credit card bills after certain assets are liquidated.) A New Hampshire resident whose income is more than the median level for the state, and who can pay at least $6,000 over five years, can't file under Chapter 7, and instead must seek protection under Chapter 13. Chapter 13 requires debtors to consolidate their debts and make payments to their creditors over a three- to five-year period. ❖

FOR MORE INFORMATION ON ANY OF THESE TOPICS, PLEASE CONTACT JOE MCDONALD, AMY KANYUK OR JOY RIDDELL AT (603) 228-9900, OR VISIT OUR WEBSITE AT WWW.MCKAN.COM.

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