

Wealth Preservation Advisor

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Congress May Close Estate Planning Loopholes

As we move to larger quarters at the Chrysler Building, we continue to keep you informed of developments in the Private Client Service Group.

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The Joint Committee on Taxation recently issued a report to Congress entitled "Options to Improve Compliance and Reform Tax Expenditures" in which the Committee made several proposals that, if adopted, would have a significant impact on estate, gift and generation-skipping transfer tax planning. While it is of course impossible to say whether these proposals will be adopted in their current form, we are compelled to bring them to your attention because of the possibility that planning opportunities that are currently available to you may shortly be foreclosed.

I: Dynasty Trusts

Dynasty Trusts (referred to also as Generation Skipping Trusts) are a mechanism for leveraging the transfer of wealth to future generations by avoiding the impact of transfer taxes at the passing of each generation. This is accomplished by retaining property in perpetual trust. By giving the trustee broad discretion over distributions, the beneficiaries can benefit from their inheritance notwithstanding the fact that it is held in trust. Moreover, the beneficiary can even be appointed as a protector, with the power to remove and replace intransigent trustees.

The Committee has proposed to substantially curtail such planning by limiting the application of generation-skipping transfer tax exemption to a single generation of trust beneficiaries. This proposal, if adopted, would have the effect of subjecting assets held in a dynasty trust to a generation-skipping transfer tax, (imposed at the highest estate tax rate), when the primary benefit of the trust passes from the grantor's grandchildren to the grantor's great-grandchildren, and then again when

future generations of descendants become the primary beneficiaries of the trust.

Planning Opportunity: Create a dynasty trust, or make additional transfers to an existing dynasty trust, before such legislation is introduced in Congress.

II: Discounts on Transfers of Minority Interests

Valuation discounts permit wealth to be transferred to the next generation at a reduced transfer tax cost. The use of valuation discounts is predicated on the fact that the fair market value of a non-controlling business interest is worth something less than a pro rata share of the entity's underlying assets.

To date, valuation discounts have been applied to the transfer of a business without regard to whether the transferee already owns an interest in the business. The practical effect has been that individuals have been able to transfer interests at a discounted value irrespective of the fact that when the transferred interest is aggregated with any interest already owned by the transferee, the interest is a controlling, rather than a minority, interest.

The Committee has proposed to adopt a "transferee aggregation rule" aggregating the transferor's interest with that of the transferee and effectively eliminating or substantially reducing the application of valuation discounts in such circumstances.

Planning Opportunity: Where transfers of closely held business interests may otherwise be subject to the transferee aggregation rule, gifts of such interests should be made before such legislation is introduced in Congress.

III: Crummey Withdrawal Powers

Crummey withdrawal powers have long been used, particularly with respect to life insurance trusts, to enable individuals to make annual exclusion gifts to trusts. Normally gifts to trusts do not qualify for the \$11,000 annual exclusion from gift tax because the recipient must have a present right to benefit from the gift and trust beneficiaries do not have such a present right. So called "Crummey" powers (named after the leading case in this area) permit a beneficiary to withdraw some portion or all of each gift to a trust thereby converting what would otherwise be a non-qualifying gift into a qualifying gift by giving the beneficiary the present right to benefit from the gift.

The Committee has made three suggestions in order to curb perceived abuses with respect to these withdrawal rights. One proposal is to limit potential Crummey beneficiaries to those persons with a direct, non-contingent interest in the trust (i.e., disallow a grandchild as a Crummey beneficiary if he or she can only benefit from the trust following his or her parent's death).

Another proposal is to consider powers as being effective only if they do not lapse during a beneficiary's lifetime. In almost all such trusts, these powers are structured to lapse for both tax and non-tax reasons.

The third proposal would be to restrict the effectiveness of Crummey powers to situations where it could be proven

that there was no arrangement or understanding not to exercise the powers and where a meaningful possibility existed that such powers would be exercised, thereby putting a seemingly impossible burden of proof on the taxpayer.

The enactment of any one or more these proposals would serve to substantially limit the use and availability of the Crummey powers and could result in clients having to use a portion of their \$1,000,000 lifetime gift tax exemption to effectuate certain transfers.

Planning Opportunity: Clients with existing life insurance trusts which are still paying premiums should take full advantage of the existing Crummey powers to pre-fund their trusts to the greatest extent possible.

How the Decoupling of the Federal and State Death Tax Affects You

Under the federal tax law enacted in 2001, the value of an individual's estate that can pass free of federal estate tax (referred to as the "federal exemption amount") has risen from \$1 million to \$1.5 million (for individuals dying in 2005) and is scheduled to rise to \$2 million for those dying in 2006, 2007 and 2008, and \$3.5 million for those dying in 2009. Under the law as it currently stands, the federal estate tax is then scheduled to be repealed entirely for individuals dying in 2010, only to return for individuals dying in 2011 and beyond with a reduced federal exemption amount of \$1 million.

Notwithstanding these changes the amount that can pass free of New York estate tax remains fixed at \$1 million. The amount that can pass free of New Jersey estate tax is fixed at

\$675,000. The law of other states may differ.

For a married couple, this "decoupling" of the federal and state death tax exemption amounts presents a question as to whether the optimal estate planning result will be achieved by utilizing, at the cost of some state level estate tax, the full federal exemption amount upon the first spouse to die.

Assume for purposes of the following discussion that a husband, who has assets in excess of \$1,500,000, dies a resident of New York State in 2005. If the husband's Will utilizes his full \$1,500,000 federal exemption amount by bequeathing that amount to an "Exempt Trust," a New York State death tax of \$64,400 will be imposed on his estate. However, on the wife's subsequent death, the entire \$1,500,000

that was bequeathed to the Exempt Trust, plus any appreciation, will pass free of all death taxes. On the other hand, if the husband's Will bequeathed only \$1 million to the Exempt Trust, and the remaining \$500,000 passed to the surviving spouse in a tax-qualified manner, no New York State estate taxes would have been imposed on his death (because, as mentioned above, New York does not impose a death tax on taxable estates of \$1 million or less), but this would increase the wife's estate by \$500,000, plus appreciation, thereby likely resulting in additional federal and New York estate tax on her subsequent death.

This effect of decoupling is of even greater significance as the federal estate tax exemption rises. For example, for individuals dying in 2006 through 2008 the federal exemption amount will be \$2,000,000. Fully funding the Exempt

Trust with that amount would result in a New York state estate tax of \$99,600. In 2009, when the federal exemption amount rises to \$3,500,000, fully funding the Exempt Trust will result in a New York estate tax of \$229,200.

A number of factors play into the decision as to whether the Exempt

Trust should be fully funded with the federal exemption amount. In addition, since New York and New Jersey do not impose gift tax on lifetime gifts, deathbed gifting may provide additional tax savings. As each client's situation is necessarily unique, there cannot be a one-size-fits-all solution, so each client's particular

situation should be separately assessed. We encourage you to call our office to schedule a mutually convenient time to review your Will and to consider whether any changes should be made in light of decoupling.

Update on Family Partnerships

The “family” limited partnership (or “FLP”) has long been a valuable estate planning tool for transferring wealth to one's family at a reduced transfer tax cost. A limited partnership consists of one or more general partners who have exclusive control over the operation of the partnership 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 day to day operation of the partnership.

A limited partner's inability to control the operation of the partnership constitutes a basis for a discounted valuation of the limited partner's partnership interest for gift and estate tax purposes. In addition, the fact that a limited partnership interest does not have a readily available public market results in a further valuation discount. Properly structured partnerships have routinely achieved aggregate discounts in excess of thirty percent of the value of the partnership's underlying assets, resulting in significant gift and estate tax savings.

Although the Internal Revenue Service has conceded the legitimacy of these discounts it has, over the last several years, been aggressive in challenging family limited partnership

arrangements in the context of the estate tax. The Internal Revenue Service has primarily focused on partnerships involving taxpayers who either (i) failed to properly maintain and administer their partnerships, or (ii) retained too much control over the partnership.

With respect to administration and maintenance, partnerships have repeatedly been challenged because taxpayers failed to open separate partnership bank accounts, commingled partnership property with personal property, made non pro-rata distributions to the partners and used partnership funds to pay personal expenses. (Many of these cases had other “bad facts” including that the taxpayer was elderly, transferred a majority of his or her assets to the family limited partnership, and died shortly after the partnership's creation). In general, these types of attacks can be avoided if proper care is taken to ensure that the partnership form is respected.

The Internal Revenue Service has also been successful of late in attacking partnerships in which the taxpayer retained too much control over the partnership. In particular, the Internal Revenue Service has challenged

taxpayers who, at death, had direct or indirect powers to participate in decisions regarding partnership distributions and/or liquidations.

A successful challenge by the Internal Revenue Service could result in the entire value of the underlying partnership assets being includible in the estate of a decedent and the nullification of any discounts on the partnership assets. As a result, we recommend that clients with existing partnerships consider revisiting their structures with us in order to ensure that their partnerships are being properly administered and that their documents are not in need of any updating in light of the attacks by the Internal Revenue Service. Moreover, for those who have not yet considered the possibility of incorporating a family limited partnership structure into their overall estate plan, when non-tax motivated reasons exist, family limited partnerships may still offer significant opportunities for tax savings.

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The Bankruptcy Abuse Prevention and Consumer Protection Act

The New Bankruptcy Law

On April 20, 2005, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the “Act”) was signed into law with an effective date generally 180 days following enactment. The Act contains over five hundred pages of amendments to the Bankruptcy Code, but several are of particular significance to our wealth preservation practice. As a service to our clients our analysis of those provisions follows.

Impact on the Homestead Exemption

Several states (i.e., Florida, Iowa, Texas, etc.) provide for an unlimited creditor exemption for an individual's interest in his or her home. Individuals resident in states with less generous homestead exemptions, such as New York, New Jersey and Connecticut, have sometimes found it appropriate to take up residence in a state with an unlimited homestead exemption and to invest otherwise non-exempt assets (i.e., cash) in an expensive home in such a state. Over the years, the unlimited homestead exemption that is available in those states has resulted in a number of notorious abuses. As a result of such abuses, the Act substantially curtails the availability of the unlimited homestead exemption in such states as a creditor protection planning device if the debtor files bankruptcy. More specifically:

- Notwithstanding state law to the contrary, no more than \$125,000 of value in an individual's interest

in a homestead can be claimed as exempt in bankruptcy until the expiration of 1,215 days (i.e., three years and four months) from acquisition of the interest.

- Thereafter, the unlimited homestead exemption can be overturned if it can be shown that the debtor intended to hinder, delay or defraud a creditor within the ten years prior to filing bankruptcy by converting non-exempt assets into a homestead.
- Finally, an individual is permanently limited to a homestead exemption of \$125,000 if he or she is found to have violated state or federal securities laws, is found to have committed fraud, is guilty of a RICO violation, or has caused serious injury or death to another.

We believe that this aspect of the Act has made timely asset protection planning even more important since it removes what has long been a remedy of last resort from the asset protection toolbox.

Impact on Self-Settled Trusts

For more than twenty years, legislation has been available in various jurisdictions, both foreign and domestic, which permits an individual to create a spendthrift trust in which the individual may continue to benefit from the trust fund at the discretion of the trustee. Such trusts have often been created for asset protection planning, in order to preserve some

“nest egg” of assets against the possibility of future creditor claims. Such trusts have also been created for “pure” estate planning purposes, however, in order to minimize future estate taxation without the risk of impoverishment by reason of unknowingly having transferred too much into trust. In recent years self-settled spendthrift trust legislation has been enacted in eight states – Alaska, Delaware, Missouri, Nevada, Oklahoma, Rhode Island, South Dakota and Utah.

Nevertheless, the Act permits a transfer to a self-settled spendthrift trust to be avoided if made within ten years prior to the bankruptcy filing and the transferor had an actual intent to hinder, delay or defraud a present or future creditor.

In effect, the Act has extended to ten years the statute of limitation on an action to avoid transfers to self-settled spendthrift trusts. We believe that this aspect of the Act will actually result in the establishment of more self-settled spendthrift trusts. Specifically, we anticipate that more self settled spendthrift trusts will be established as individuals are compelled to plan well in advance of any potential creditor problems in order to exhaust the ten year statute of limitations period as early as possible. We also expect that the Act will have the effect of increasing the use of offshore self-settled spendthrift trusts relative to domestic self-settled spendthrift trusts. Finally, a “silver lining” to this aspect of the Act is the implicit validation of self-settled spendthrift trusts to protect

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against creditors where there was no actual intent to defraud at the time the trust was established. Due to significant ambiguities with drafting and potentially various interpretations that the courts will apply to the fraudulent transfer provision, there is a need to consider revisions to existing structures to minimize the risks under the Act.

Impact on Retirement Accounts

A significant bright spot in the Act is an enhanced level of protection for individual retirement accounts ("IRA's") and Roth IRA's. Specifically, an individual may now claim as exempt in bankruptcy up to \$1 million in IRA and Roth IRA accounts, in the aggregate. Moreover, to the extent that the IRA was funded via a qualified rollover from a qualified retirement plan, the exemption is unlimited.

Conclusion

Without a doubt, the Act represents a significant revision of our bankruptcy law and will have far reaching effect. At the risk of stating the obvious, however, it should be noted that the Act only affects debtors who are in bankruptcy. To the extent that an individual is not in bankruptcy, the homestead exemption in a state like Florida is unaffected, the unlimited exemption for individual retirement accounts in a state like New York is unaffected, and the statute of limitations for a future creditor to attempt to unwind a transfer to a self-settled trust in a state like Nevada remains only two years. With that being said, however, clients who established self-settled trusts less than ten years ago are advised to speak with us to help determine what changes, if any, might now be recommended in

order to maintain the protection offered by such trusts.

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