the Estate PLANNER

September/October 2005

For richer or poorer

Innovative technique lets wealthier spouses retain asset control

ESOPs are no fable

These retirement plans offer estate planning benefits

Form vs. substance

Failure to respect FLP formalities can be costly

Estate planning red flag:
Your estate plan doesn't provide for your pets

OUR ESTATE PLANNING ATTORNEYS

Christopher L. Edgar — ChrisEdgar@lwr.com
John M. Huff — JohnHuff@lwr.com
Steven J. Tjapkes — SteveTjapkes@lwr.com
Stuart F. Cheney — SCheney@lwr.com
Richard J. Puhek — RichPuhek@lwr.com

LAW WEATHERS & RICHARDSON

Professional Corporation
Attorneys and Counselors

800 BRIDGEWATER PLACE • 333 BRIDGE STREET, N.W. • GRAND RAPIDS, MICHIGAN 49504-5320
TELEPHONE (616) 459-1171 • FACSIMILE (616) 732-1740 • www.lwr.com

For richer or poorer

Innovative technique lets wealthier spouses retain asset control

Affluent married couples are usually advised to equalize their estates to minimize federal estate taxes. If one spouse owns a disproportionate share of the couple's assets, the couple may waste some or all of the "poorer" spouse's estate tax exemption.

For many couples, lopsided asset ownership is easily corrected: The richer spouse simply gifts enough of his or her separate property to the poorer spouse to "fund" that spouse's exemption amount. But in some cases — such as second marriages — the richer spouse may be reluctant to give up control over his or her wealth.

Uneven asset ownership can increase a couple's estate tax liability if their combined net worth is substantially higher than the federal estate tax exemption amount, currently $1.5 million.

Last year, the IRS approved an estate planning technique that allows the richer spouse to retain complete control over assets while both spouses are alive, yet still enables the couple to take full advantage of each spouse's estate tax exemption.

Some estates are more equal than others

Uneven asset ownership can increase a couple's estate tax liability if their combined net worth is substantially higher than the federal estate tax exemption amount, currently $1.5 million. It will rise to $2 million next year and to $3.5 million in 2009. In 2010, the estate tax will disappear, only to reappear the following year. Unless Congress passes new estate tax legislation, the exemption amount will drop back to $1 million in 2011.

Here's an example that illustrates the importance of equalizing a couple's estates. Chris and his wife,

Vicky, own assets worth $3 million, all owned by Chris. Vicky dies in 2005 with no assets, so her estate tax exemption is wasted. When Chris dies two years later, his exemption shelters $2 million of his estate, but the remaining $1 million is taxable at a top rate of 45%.

Suppose, instead, that Chris transfers half of his assets to Vicky, so that both of their estates are worth $1.5 million. In this example, when Vicky dies in 2005, her estate plan provides for her assets to go into a credit shelter trust (also known as a bypass trust or family trust). The trust benefits Chris during his life, and the balance goes to the couple's children when Chris dies. The trust's funds are sheltered from estate tax at Vicky's death by her exemption and, because Chris never gains control over the assets, they bypass his estate at his death. In addition, when Chris dies two years later, his exemption shelters his $1.5 million estate. The result: The entire $3 million passes free of federal estate taxes.

No need to relinquish control

Until recently, if a richer spouse wasn't willing to relinquish control over his or her assets, the couple could lose the benefit of the poorer spouse's estate tax exemption, potentially resulting in a hefty tax bite if the poorer spouse died first. But last year, the IRS issued Private Letter Ruling (PLR) 200403094, approving a planning technique that allowed a

husband to retain control over his assets without sacrificing his wife's estate tax exemption.

For example, using the facts from our previous example, Chris places his $3 million in assets in a revocable trust and grants Vicky a general testamentary power of appointment (GPOA). Chris retains complete control over the funds, including the right to revoke the trust or to withdraw income and principal. But if Vicky dies before Chris during the life of the trust, her executor has the right to appoint (in other words, distribute from the trust) an amount up to her unused estate tax exemption. Assuming Vicky dies in 2005, her executor would exercise the GPOA to fund a $1.5 million credit shelter trust for the benefit of Chris and their children.

According to the PLR, on Vicky's death exercising the GPOA creates a completed gift from Chris to Vicky that qualifies for the federal gift tax marital deduction. The amount transferred from Chris' revocable trust is removed from his estate for federal estate tax purposes and is sheltered from tax in Vicky's estate by her federal estate tax exemption. The end result: Chris retains control over his wealth, but the couple still takes full advantage of both their exemptions.

If the richer spouse dies first, more traditional estate planning techniques can be used. In the PLR, for example, the husband's estate plan provided that, if he died first, the trust would be split into a marital trust and a credit shelter trust for the benefit of his wife and children.

A few caveats

The technique described above is not without its risks. For one thing, PLRs have no precedential value; they apply only to the parties to whom they're issued. Although PLR 200403094 represents the IRS's interpretation of the law as it applied to the facts of the specific taxpayer who asked for the PLR, there's no guarantee the IRS won't rethink its interpretation if the issue arises again.

Also, the unlimited marital deduction is available only for transfers to U.S. citizens. If the poorer spouse is a noncitizen, additional planning is required. And the credit shelter trust technique may not be possible if a large portion of the richer spouse's wealth is held in qualified retirement plans or IRAs. Finally, the PLR doesn't say what would happen if the poorer spouse fails to exercise the GPOA.

Have your cake and eat it, too

Allowing the richer spouse to retain control over his or her wealth, without giving up the poorer spouse's estate tax exemption, is a classic example of having your cake and eating it, too. And despite the risk that the IRS will change its mind, this technique could play an effective role in your estate plan. ▮

ESOPs are no fable

These retirement plans offer estate planning benefits

Employee stock ownership plans (ESOPs) offer many remarkable benefits for closely held businesses, their owners and their employees. One particular (and often overlooked) benefit is an ESOP's usefulness in estate planning for family businesses.

It's not unusual for a family to tie up most of its wealth in a family business. But this creates two significant estate planning challenges.

First, with few sources of liquid funds, it may be difficult for the family to pay estate taxes and other expenses without selling the business. And second, if some children are active in the business while others are not, designing an estate plan that treats all of them fairly can be problematic. An ESOP may provide a solution to both of these problems.

Chapter 1: ESOP ABCs

An ESOP is a qualified retirement plan that invests in the sponsoring company's stock. The employer makes tax-deductible contributions of stock or cash to the plan for the benefit of its employees (subject to contribution limits).

Cash contributions are typically used to acquire the stock. But the ESOP can borrow money and use the funds to purchase the shares. The company can then make tax-deductible contributions to the plan to cover both the interest and principal payments, making this type of "leveraged ESOP" a tax-efficient vehicle for raising capital.

Like other qualified plans, an ESOP generates tax-exempt earnings, and participants don't recognize any taxable income until they withdraw their benefits from the plan. Also like other qualified plans, ESOPs are subject to rules, restrictions and a variety of administrative expenses. For instance, a qualified, independent appraiser must value the company's stock when the ESOP is established and then once a year thereafter.

After employees retire, die, become disabled or leave the company, they or their families receive benefits from the plan in the form of stock or cash. In a closely held company, employees who receive stock have the right to require the business to repurchase their shares for fair market value.

The resulting "repurchase liability" can be significant — especially if the company's stock substantially appreciates in value. An employer can prepare for this by forecasting its repurchase obligations and setting aside reserves to buy back shares.

Chapter 2: Estate planning benefits

Although ESOPs are *employee* benefit plans, they also provide advantages for business owners. Owners can sell their shares of the business to the ESOP, creating a market for their stock that might not otherwise exist. And if the ESOP owns at least 30% of the company's outstanding common stock immediately after the sale, and certain other requirements are met, the selling shareholders can defer any capital gains taxes on the sale.

To avoid gain recognition, a selling shareholder must reinvest the proceeds in qualified replacement property (QRP) within a 15-month period beginning three months prior to the sale. QRP essentially

means any stocks or bonds issued by publicly traded domestic operating companies.

Selling shares to an ESOP allows family business owners to diversify their holdings, creating a source of liquid assets that can be used to achieve a variety of estate planning objectives while keeping control of the business in the family. Even if the ESOP owns a majority interest, plan participants have limited power over the company's day-to-day operations.

This liquidity allows the family to pay estate taxes and administrative costs without selling the entire family business. It also makes it easier to provide for children inside and outside the business. Suppose, for example, that Ken owns a small family business that represents most of his net worth. He has three children, Tess, Clay and Tom. Tess works with Ken in the business, but Clay and Tom have pursued other interests.

Ken wants to treat his three children equally in his estate plan. He could give each child a one-third interest in the business, but he feels that it would be unfair to give a noncontrolling interest to Tess, the one child who's active in the business. Ken's solution is to sell two-thirds of his stock to an ESOP. He reinvests the proceeds in QRP, deferring capital gains taxes and creating a liquid source of nonbusiness assets to provide for Clay and Tom. Ken's remaining stock will go to Tess, giving her control over the business.

Chapter 3: A happy ending

Establishing and managing an ESOP can be a complex and expensive undertaking. But under the right circumstances, an ESOP can provide valuable benefits for owners and employees alike while providing solutions to some of the most difficult estate planning challenges family businesses face.

Capital strategies for ESOPs

A key benefit of an employee stock ownership plan (ESOP) is that the selling shareholder can defer capital gains on the sale by reinvesting the proceeds in qualified replacement property (QRP). It's even possible to eliminate capital gains taxes altogether. There are several planning options for dealing with QRP, including:

Holding the assets. The simplest strategy is to hold the QRP for the rest of your life. When you die, your heirs receive a stepped-up basis in the assets and the capital gains disappear. The problem with this approach is that, while it eliminates capital gains taxes, it may not be the most efficient way to minimize estate and gift taxes. Plus, this essentially passive investment strategy may not be in your best interests.

Paying the capital gains taxes. If you're more interested in flexibility than tax deferral, consider selling QRP or investing ESOP sale proceeds in non-QRP, such as a family limited partnership, and paying the capital gains taxes while rates are low. (The top long-term capital gains tax rate is 15%, but it's scheduled to rise to 20% in 2009.)

Giving it away. Selling QRP triggers capital gains taxes, but giving it away does not. For example, you could donate the assets to a charitable remainder trust (CRT), which provides you with a current income tax deduction and an income stream for life (or for the joint lives of you and your spouse), with the remainder going to charity. The CRT can sell the QRP and reinvest the proceeds without triggering a current income tax liability.

Investing in long-term bonds. An interesting, and potentially effective, strategy is to invest ESOP sale proceeds in qualifying floating-rate long-term bonds. You can then borrow against these bonds and invest the loan proceeds in a diversified, actively managed portfolio or other assets. You'll have to pay interest on the loan, but it should be offset, at least partially, by the interest earned on the bonds.

Form vs. substance

Failure to respect FLP formalities can be costly

The family limited partnership (FLP) continues to be a powerful business and estate planning tool. But families must plan, structure and document FLPs carefully and observe all partnership formalities diligently to enjoy this arrangement's benefits.

In a recent Tax Court case, *Senda v. Commissioner,* one family learned this lesson the hard way. Their sloppy documentation of FLP transactions and failure to respect legal formalities cost them almost half a million dollars in gift taxes.

FLPs help families

A properly structured FLP allows you to transfer wealth to family members at deeply discounted gift and estate tax values. By placing securities, real estate, business interests or other assets in an FLP, and then transferring limited partnership interests to family members, you can take advantage of valuation discounts for transfer tax purposes.

Because limited partnership interests are relatively unmarketable and provide you with little control over partnership affairs, taxpayers have discounted their value by 30% to 50% from the value of the underlying assets.

FLPs also provide many nontax benefits, including the ability to give valuable assets to your children without relinquishing control, protection against creditors' claims, consolidation of assets and facilitation of succession planning.

Indirect gifts may hurt

In *Senda,* the parents formed two limited partnerships, one in 1998 and one in 1999. They transferred publicly traded stock to the partnerships and, on the same day, transferred limited partnership interests to trusts for their children. The parents later filed gift tax returns that treated the transactions as gifts of limited partnership interests to their children, claiming substantial valuation discounts from the underlying stock's fair market value.

The IRS had a different interpretation. In its view, the parents didn't transfer the stock to the partnerships until *after* the children received their limited partnership interests. This seemingly minor technicality had dramatic tax consequences.

Under the indirect gift rule, when a shareholder transfers property to a corporation for less than full and adequate consideration, the transfer is treated as a gift to the other shareholders in proportion to their interests in the corporation. The gift's value is based on the undiscounted value of the underlying assets. A similar rule applies to partnerships.

When a partner transfers property to a partnership in exchange for partnership interests, it's deemed to be made for full and adequate consideration provided his or her capital account is credited for the property's fair market value.

In *Senda,* the parents argued that their capital accounts were credited for the stock's value, and they'd transferred limited partnership interests to their children *after* they'd contributed the stock to the partnership.

Unfortunately, the parents' informal treatment of the FLP made this difficult to prove. They didn't maintain any books or records for the FLP other than brokerage account statements and partnership tax returns. In addition, certificates of ownership purporting to reflect certain partnership transactions weren't prepared or signed until weeks, or sometimes years, after the transfers took place.

The court found that it was "unclear whether petitioners' contributions of stock were ever reflected in their capital accounts" and that there was "no reliable evidence" that the partnerships were funded before the children received their partnership interests. "At best, the transactions were integrated … and, in effect, simultaneous," the court said.

In addition, one parent's "evasive" testimony led the court to believe that both parents "were more concerned with ensuring that the beneficial ownership of the stock was transferred to the children in tax-advantaged form than they were with the formalities of the FLPs."

In *Senda,* application of the indirect gift rule resulted in additional gift tax liability of almost $500,000.

Form must follow function

You can avoid an outcome like the one in *Senda* by observing partnership formalities and carefully documenting all partnership transactions. This means maintaining partnership books, properly crediting contributions to the appropriate capital account before transferring interests and documenting transfers of partnership interests at the time of the transfer.

Estate planning red flag

Your estate plan doesn't provide for your pets

The bonds between people and their pets are often as strong as those with family members and friends. Yet many people overlook their pets when planning their estates, perhaps because they've made informal arrangements with relatives or because they assume that they'll outlive their animal friends. But without more formal arrangements, you risk leaving your pets uncared for when you die or if you become incapacitated.

To ensure that your pets continue to live in the style to which they're accustomed, your estate plan should include a will, trust or other document that provides for the custody and care of your pets as well as the money needed to care for them. About half the states have passed laws authorizing pet trusts, and even states without specific legislation may recognize these trusts.

Trusts are usually preferable to will provisions because they can provide for your pets not only when you die, but also if you become ill or incapacitated. They also can be designed to avoid probate and carry out your wishes immediately — even if final settlement of your will is delayed. When setting up a pet trust:

Name a caretaker for your pets as well as a trustee to oversee the funds. This can be the same person. You should also designate a beneficiary, such as an animal charity, to receive any funds left in the trust when the pets die.

Be reasonable. An increasing number of people — especially those with many pets — are actually placing real estate in pet trusts so their pets can continue to live together in the family home. Look into your state's rules against overfunding trusts, however, before attempting this technique.

Another option to consider is one of the many "pet retirement homes" that have been springing up around the country. Also known as "pet sanctuaries," these facilities can be an attractive option if you can't find a family member or friend to take care of your pets. They range from high-end "retirement centers" with private rooms and other luxuries to more modest "mom and pop" operations. For more information, contact the Association of Sanctuaries at www.taosanctuaries.org.

This publication is distributed with the understanding that the author, publisher and distributor are not rendering legal, accounting or other professional advice or opinions on specific facts or matters, and accordingly assume no liability whatsoever in connection with its use. ©2005 ESTso05

LAW WEATHERS & RICHARDSON

Estate Planning Group

THE FIRM. The members of Law, Weathers & Richardson, P.C. are committed to our clients, dedicated to our profession, and devoted to our community and families. Working with these values, the firm has provided counsel and legal advice to individuals, businesses, and municipalities throughout Michigan since 1868. Large enough to offer expertise in virtually every area of the law, yet small enough to ensure personal attention and easy access, we strive to anticipate our clients' needs and help them avoid legal problems before they arise. Prompt and reliable service is our overriding priority. Our Estate Planning and Probate Practice Group attorneys are available at (616) 459-1171. The firm fax number is (616) 732-1740.

Christopher L. Edgar, chairperson of the Estate Planning Practice Group, concentrates his practice in estate planning, where he advises on business succession planning and uses advanced techniques such as family limited partnerships and limited liability companies, split interest trusts, irrevocable life insurance trusts and educational trusts, as well as incorporating life insurance and charitable giving in estate planning. He is experienced at handling probate-related litigation and has an extensive practice as an arbitrator for the American Arbitration Association. Chris is a member of the American Bar Association Real Property and Probate, Taxation and Business Law Sections and the State Bar of Michigan Probate and Estate Planning Council. He is also a Fellow of the American College Trusts and Estates Counsel and a past president of the West Michigan Estate Planning Council.

John M. Huff works with the firm's clients on the entire breadth of estate planning issues, including living trusts, charitable trusts, life insurance trusts, qualified personal residence trusts, and family limited liability companies and partnerships. He is a member of the Real Property, Probate and Trust Law Section of the American Bar Association, the Probate and Estate Planning Section of the State Bar of Michigan, and the West Michigan Estate Planning Council, as well as being an accredited Estate Planner for the National Association of Estate Planners and Councils. A frequent lecturer on estate planning and probate issues, John is a member of the East Grand Rapids Community Action Council and the Planned Giving Advisory Council for Albion College.

Steven J. Tjapkes focuses on business succession planning, estate planning, and probate. He works with business owners and executives to effectively transfer businesses and other assets to succeeding generations. Previously a veterinarian in private practice in mid-Michigan, Steve received his Bachelor of Arts degree in history from Calvin College, a Doctor of Veterinary Medicine degree from Michigan State University, and his law degree cum laude from the University of Michigan Law School. Steve is a member of the Grand Rapids Bar Association and the Probate and Business Law sections of the State Bar of Michigan.

Stuart F. Cheney engages in a tax based practice concentrated in corporate, securities and business law together with estate tax planning for the principal corporate owner. He received his law degree from the University of Michigan, where he also received a Masters of Business Administration degree and a Bachelor of Science degree in Mechanical Engineering. Stuart has acted as a guest lecturer for Chartered Life Underwriters estate planning courses and adjunct professor of estate tax planning at Grand Valley State University.

Richard J. Puhek brings his extensive experience in estate and gift taxation, estate planning and income taxation to the firm after many years at BDO Seidman, LLP, the former Old Kent Bank and Trust Company and Manufacturers National Bank. He received his B.B.A. from the University of Michigan and his Juris Doctor from the University of Detroit Law School. Rich holds Master of Business Administration and Master of Laws in Taxation degrees from Wayne State University, as well as Series 7 and Series 66 securities licenses.

Barbara L. Gracki, a legal assistant with the firm since 1983, assists the practice group and their clients with the administration of probate estates, consults with them regarding post mortem tax planning; and prepares federal estate tax and gift tax returns. She received a Master of Science degree from Brown University and a Masters of Business Administration from Grand Valley State University. Barbara serves as Board Chairperson of the Visiting Nurse Foundation and previously served as chair of the AIDS Resource Center board and on the Grand Valley State Legal Studies advisory board.