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Estate Planning & Administration Group

UPDATE

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Temporary Guardianship Forms — Don't Leave Home Without Them

Take care when your children are under someone else's temporary care.

Going on vacation and leaving your minor children under the care of others? If so, be sure to leave the necessary legal documents so that a trusted family member or friend can take care of any emergency situations that may arise while you are gone.

Easy to do — here is how it is done:

Many states' laws permit parents to name a temporary guardian — called a "short-term guardian." The appointment can last for up to 60 days, but most people set a duration limited for the period they intend to be away, plus an extra day or so in case of a delayed return. A separate form must be signed for each child. The form names the individual who will have legal authority to make health care and other decisions for the child in your absence. The standard form is designed to name just one person as temporary guardian. It must be signed by both parents (if applicable), by the temporary guardian, and by two witnesses. If you are in need of such a form, or would like our assistance in preparing one, please let us know.

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Courts Flip-Flop Over FLPs

Increased confusion over the transfer tax savings from family limited partnerships.

After a string of victories for taxpayers, the Tax Court recently has issued several unfavorable opinions regarding family limited partnerships (“FLPs”). The gist of those opinions was that FLPs may not work to reduce transfer taxes. Now, two recent appellate cases, reversing 2003 Tax Court opinions, have come down on different sides of the issue.

Background — why taxpayers flip for FLPs.

For years, taxpayers have created FLPs for a variety of tax and non-tax reasons. The tax reason relates to the ability to take discounts in valuing the partnership interests for gift and estate tax purposes. For example, assume an individual had \$1,000 of marketable securities. If the taxpayer gave those securities to her daughter, there would be a gift of \$1,000. However, if the securities were first transferred to a FLP and then the limited partnership units were given away, the value of the gift might only be \$700 (or less). This decrease in value arises because the limited partnership units are not marketable. Unlike the underlying securities, there is no ready market in which they can be sold and turned into cash, and limited partners typically have no say in how the partnership is operated.

Bad news for taxpayers — the Tax Court attacks FLPs.

Recent Tax Court cases have held that when a taxpayer dies holding FLP interests, the assets he or she put into the partnership may be brought back into the taxpayer’s estate if he or she continued to have a voice in the management of the partnership. If the Tax Court cases are upheld, FLP discounts will be harder to obtain.

Differing appellate court rulings on family limited partnerships send mixed signals.

The Fifth Circuit Court of Appeals (which hears cases from Texas, Louisiana, and Mississippi) recently overturned the Tax Court in the *Estate of Kimbell*. In a strong, pro-taxpayer opinion, it ruled that, in most cases, the validity of partnerships — and thus the tax valuation discounts — should be respected for federal estate tax purposes. However, before taxpayers could fully digest that victory, the Third Circuit Court of Appeals (which hears cases from Pennsylvania, New Jersey, and Delaware) issued a pro-IRS opinion in the *Estate of Thompson* (also known as the *Turner* case because of the name of the executor), ruling that the partnership in that case should be ignored — meaning no tax valuation discounts. At the moment, these cases do not bind taxpayers outside of those circuits. It remains to be seen how other courts will rule on this issue.

Equal opportunity confusion for LLCs, too.

An important note — these court flip-flops are not limited to FLPs. They apply equally to limited liability companies, too.

Don’t abandon your family limited partnership or LLC — at least not yet.

We believe that, properly drafted and administered, FLPs remain a useful estate planning tool. However, taxpayers must continue to monitor developments to see if corrective action is needed.

Teaching Old Trusts New Tricks

New legislative and regulatory developments create new planning opportunities.

Some of our clients are beneficiaries or trustees of older irrevocable trusts. Recent changes in some states’ laws, as well as tax rule liberalizations, have created options to make these old trusts more flexible and tax efficient. New IRS regulations allow the trustee of a trust to divide the trust into two separate trusts to minimize generation-skipping transfer taxes. Other new regulations permit the trustee of a trust to make annual beneficiary distributions based on a pre-determined percentage of the trust’s assets (generally 3% to 5% each year) in lieu of distributions tied to the actual income of the trust.

Background of the GST.

In 1985, Congress enacted the federal generation-skipping transfer tax (“GST tax”), which levies an additional transfer tax on assets left to grandchildren or through trusts. A separate GST exemption (currently \$1.5 million) is allowed to each individual. If gifts or bequests into trusts exceed that exemption, tax efficiencies can be obtained by creating two trusts — one that holds the GST-exempt amount and the other that holds the balance of the assets. This allows the trustee to make distributions to children using assets from the nonexempt trust (your children are the next generation below you, so a distribution to children does not incur a generation-skipping tax because no generation is being skipped) and to make distributions to grandchildren from the GST-exempt trust, thereby saving a 48% tax on that distribution. It also allows the trustee to invest the trusts differently, for example, putting the higher growth assets in the exempt trust that will not be taxed at the child’s death and the lower growth assets in the nonexempt trust that will be taxed at the child’s death. If all of the assets were held in one trust, these techniques would not be possible.

Putting together a GST solution through trust severance.

In some cases, particularly early in the GST era, single trusts were created that were only partially exempt from GST tax. Prior to the 2001 Tax Act, there was no way to split these trusts into two trusts, so that one could be wholly exempt and the other could be wholly non-exempt. That is no longer the case, and new IRS regulations give clear guidance on how to sever. The trust instrument or state law must permit the severance. (Many states, such as Illinois, have a statute that gives a trustee this authority.) The two trusts that are created from the severance do not have to be identical, but the beneficiaries must, in the aggregate, have basically the same interests they had before the severance. Other technical requirements must also be met, and any severance has

to be reported to the IRS (including ones that were done prior to the issuance of the regulations). If done properly, there will be no adverse tax consequences resulting from the severance. Thus, these new regulations offer the possibility of making an old trust much more flexible and tax-efficient.

Increasing income flow from trusts.

When interest rates and dividend yields are low, trustees are confronted with an investment dilemma — how to generate an appropriate level of income for current beneficiaries while also meeting their “prudent investor” responsibilities to build trust assets for future beneficiaries. Many states’ laws, including Illinois, now permit a trustee to solve that dilemma by converting the trust into a unitrust. A unitrust provides that a fixed percentage of trust assets are to be distributed each year as income, regardless of how much current income the trust actually earns.

Unitrusts can do the job when trust investment and distribution provisions don’t work.

Many trusts contain provisions that allow a trustee to distribute principal as well as income. In those instances, a unitrust conversion is ordinarily not necessary because the cash needs of a beneficiary may be addressed through discretionary principal distributions that supplement income on a case-by-case basis. However, if the terms of a trust do not allow for discretionary distributions of principal to income beneficiaries, or if a trustee is caught in a disagreement between the investment preferences of income and principal beneficiaries, converting a trust to a unitrust often allows a trustee to better find a balance that serves the needs of all beneficiaries.

Low Interest Rates Are Good for Things Other Than Refinancing Your Mortgage

Less can be more in terms of transfer tax reductions.

The low interest rates that have prevailed over the last few years continue. From an estate planning standpoint, these rates offer a special opportunity to transfer assets to children with little or no transfer tax. Given the uncertainty whether these rates will be increasing (and many experts predict rates will increase sooner rather than later) this is an excellent time to consider these techniques.

GRATs and CLATs are where it’s at.

Two highly effective techniques that take advantage of low interest rates are grantor retained annuity trusts (“GRATs”) and charitable lead annuity trusts (“CLATs”). In both cases, the creator of the trust (the “grantor”) transfers assets to the trust. With a GRAT, the grantor receives an annual payment (the “annuity”) starting at the inception of the GRAT and continuing for a fixed term of years. With a CLAT, the annuity payments for the fixed period of years instead are made to charities designated by the grantor. With both

a GRAT and a CLAT, at the end of the annuity term, the property remaining in the trust can pass to the grantor’s children or to trusts for their benefit. (The grantor’s spouse can also be a beneficiary of these trusts after the annuity term.) The trusts can be designed so there is no gift tax upon creation of the trust, thus saving about 50 cents on each dollar that remains in the trust at the end of the annuity term.

How the IRS can help you cash in on lower interest rates.

The IRS “assumes” that total return on any investment (income and appreciation) is a fixed annual rate. The assumed rate is tied to interest rates that prevail at the time of the gift. Thus, the lower the interest rates in the real world, the lower the assumed IRS rate. In November 2004, the IRS assumed rate is 4.2% annually.

Gift tax calculations are based on this assumed rate. When the IRS calculates what it expects will remain in a trust after the trust pays an annuity for many years, it assumes the trust will earn the assumed rate every year regardless of actual investment performance. Thus, if the investment of the GRAT or the CLAT can outperform the assumed IRS rate, some assets will pass to the grantor’s children absolutely free of transfer tax at the end of the annuity term. The higher the assumed IRS rate, the harder it is to outperform. With the current historically low interest rates (much lower than the historical total return on equity securities) the IRS assumed rates may be much lower than actual investment results so that much more will pass at the end of the annuity free of transfer taxes. If a GRAT can be funded with closely held business assets, such as S corporation stock or real estate, the results often are especially good.

GRATs offer upside potential with no downside risk.

Theoretically, there is no limit on the amount of property that can pass tax-free at the end of a GRAT. It all depends upon how well the assets perform. Of course, it is possible that the trust investments will not beat the IRS rate. In that case, nothing may pass to the grantor’s children and all the assets will be returned to the grantor. But, if the GRAT was properly designed, the grantor also would not be charged with making a gift, so nothing is lost.

Transform loans and installment sales into transfer tax-free gifts to children.

Loans or installment sales to children are also good techniques while interest rates are low. The required interest rates for these techniques also are based on the assumed IRS rates at the time of the loan or sale. These rates currently are very low. For example, a nine-year loan or installment sale to a child entered into in November 2004 could charge interest as low as 3.55%. Assuming the child can earn more than 3.55% on assets acquired with the loan or installment sale, the parent will have succeeded in transferring assets free of transfer tax to the child.

We can help you sort through the options while rates are still low.

American Jobs Creation Act Will Create Tax and Estate Planning Opportunities

Put it to work for you.

The American Jobs Creation Act of 2004 is a massive piece of legislation that will significantly impact income and estate tax planning. Some of the highlights include new rules with respect to defined compensation benefits, deductibility of sales taxes as an itemized deduction in lieu of state and local income taxes, S corporation reform, charitable gifts of automobiles, small business expensing and depreciation, foreign taxes, agricultural and small manufacturing business incentives, tax avoidance by corporations that move off-shore, and numerous other provisions related to specific industries and products. We can assist you in determining which aspects the American Jobs Creation Act may impact your personal planning.

Does Your Estate Own Your Frequent Flier Miles?

Only heaven and each individual airline actually know.

Can you pass your unused frequent flier miles on to a family member or otherwise bequeath them in your will? The answer is up in the air.

Generally, airline rules state that unused miles are the airline's property, not yours. So you have no absolute right to give them away during your lifetime or at death. Some airlines, however, will allow surviving spouses, family members, or others named in a will to use the miles. Different airlines have differing rules about the transfer of the miles and whether transfer fees will be charged. As a result, if you have a significant number of air miles, you should carefully review the applicable rules to be sure your estate plan deals with them properly.



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