Lyon & Caron LLP
790 Estate Drive, Suite 180
Deerfield, IL 60015
(847) 945-8810
www.lc-law.com

TAX & TRANSACTIONS BULLETIN

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Federal Estate Tax Credit Rises to $2 Million

- For calendar year 2006, the Federal estate tax credit increases to $2 million
- Every individual may transfer $2 million at death tax-free
- With Proper Planning, a married couple may transfer $4 million at death tax-free
- The Generation Skipping Tax (GST) Credit increases to $2 million
- The Illinois estate tax credit also increases to $2 million

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ESTATE TAX CREDIT RISES TO $2 MILLION

Effective January 1, 2006, the Federal Estate Tax Credit[1] increased to $2 Million. The Estate Credit is great news for the Family. With proper planning, a married couple currently may transfer $4 million to their children tax-free. This tax savings increases Family wealth.

People often desire to keep their wealth within the Family. Typically, a married couple distributes assets for each other during their joint lifetimes, and then distributes assets to younger generations. These distributions are subject to 3 transfer taxes: Gift tax, Estate tax, and Generation Skipping tax (GST). These taxes are interrelated, and apply to all transfers of wealth from one individual to another.

Each tax has its own Credit. The Credit reduces tax on a dollar-for-dollar basis. A Credit thus permits tax-free transfers of Family wealth. The Credits assist a married couple in providing for each other during their joint lifetimes, and then distributing property to their children and grandchildren. Careful planning with Credits can maximize Family tax savings.

The Tax Credits, respectively, are as follows:

Year	Federal Estate Credit	Federal Gift Credit	Federal GST Credit	Illinois Estate Credit
2002 - 2003	$1,000,000	$1,000,000	$1,120,000[2]	$1,000,000
2004 - 2005	$1,500,000	$1,000,000	$1,500,000	$1,500,000
2006 - 2008	$2,000,000	$1,000,000	$2,000,000	$2,000,000
2009	$3,500,000	$1,000,000	$3,500,000	$2,000,000

The increased Estate Credit (and GST Credit) is highly beneficial for the Family. With proper planning, a married couple may, at death,[3] transfer $4 million to their children and grandchildren tax-free. This tax-free transfer permits greater

[1]Every U.S. taxpayer receives an Applicable Exclusion Amount which permits tax-free gifts during life or tax-free bequests upon death. This Applicable Exclusion Amount thus functions as a credit to reduce tax, and is conveniently referred to as the "Tax Credit".

[2]The GST credit was $1,100,000 in 2002, and $1,120,000 in 2003.

[3]Although both the Estate and GST Credits have increased since 2003, the Gift Credit did not increase. Thus, although a person may transfer $2 Million at death tax-free, a person may transfer only $1 Million during life tax-free. This discrepancy reflects the fact that Congress might lower the Estate Credit in the future. Congress does not want an individual to make tax-free lifetime gifts now, which exceed the amount the individual could transmit tax-free at death in the future.

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ESTATE TAX CREDIT RISES TO $2 MILLION (cont'd)

accumulations of Family wealth. (Note that both the Federal Estate tax and GST tax are scheduled to be repealed for individuals dying in 2010. Each tax is then reinstated in 2011. Many practitioners expect Congress to enact legislation prior to 2009, to clarify this situation).

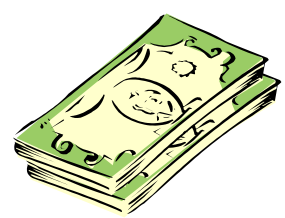
Additional Federal tax laws which became effective January 1, 2006, are:

- The annual exclusion for gifts increases to $12,000.
- The annual exclusion for gifts to a non-citizen spouse increases to $120,000.
- The maximum Gift/Estate tax rate (and flat GST rate) is 46%.
- Note the state death-tax credit was previously eliminated. For decedents dying after 2004, a Federal deduction is allowed for state death taxes paid.[4]
- Note the deduction for a qualified family-owned business interest ("QFOBI") was previously repealed for estates of decedents dying after December 31, 2003.

[4] Code Section 2058(a).

PREFERRED–COMMON PARTNERSHIPS MAY ACHIEVE FAMILY GOALS

Many U.S. Families have accumulated significant wealth. Family goals and objectives often focus on preserving this wealth. Specifically, Family goals and objectives often include: (a) keep assets within the Family; (b) protect assets from creditors; (c) reduce income and estate tax taxes; and (d) avoid probate and guardianship proceedings.



A Family Limited Partnership ("FLP") or Family Limited Liability Company ("FLLC") permits family members to retain control over their assets and thus ensure their own financial security. The FLP provides unified administration of real estate, marketable securities, and business assets, and ensures continuity of investment and management of the Family's Assets for the long term. The FLP promotes family unity, and bonding of family members.

There are two (2) types of Family Limited Partnerships. The first type is a "straight FLP." In a straight FLP each family member participates proportionately in the growth of assets. There is no explicit federal tax law endorsing or approving a straight FLP. Thus, straight FLPs may be attacked by IRS.

The second type is a "preferred-common FLP" ("Preferred FLP"). The Preferred FLP freezes the value of assets held by the Senior Generation. In a Preferred FLP, Mom and Dad do not participate proportionately in the growth of assets. Thus, Mom and Dad reduce their estate tax by limiting the value of their assets. Preferred FLPs are explicitly authorized by Federal statute.[1] The Preferred FLP therefore rests within a legal safe harbor.[2] The Preferred FLP may offer less audit risk to Mom and Dad, and may be a conservative method to reduce family taxes.

[1] Code Section 2701.
[2] Code Section 2701; IRS Regulations 25.2701 et seq.

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PREFERRED–COMMON PARTNERSHIPS MAY ACHIEVE FAMILY GOALS (cont'd)

The Preferred FLP has at least two classes of equity: (1) Preferred Equity; and (2) Common Equity. The Preferred Equity is entitled to an annual cash flow payment,[3] but does not otherwise participate in the growth of underlying assets. The Common Equity is not entitled to any annual payments, but does participate in the growth of underlying assets. Mom and Dad typically desire to own Preferred Equity, since the Preferred Equity (a) pays a guaranteed annual cash stream similar to a bond, and (b) may reduce Mom and Dad's estate tax liability.

There are several key Operational Rules for Preferred FLPs. First, the Preferred Equity must have a value equal to the assets contributed for it.[4] Second, the total value of all Equity less the value of the Preferred Equity equals the value of the Common Equity.[5] Third, the value of the Common Equity may be reduced by discounts for Minority Interest and Lack of Marketability.[6] There are various additional Operational Rules.[7]

Example – Preferred Family Limited Liability Company ("PLLC"): *Parent contributes $1,000,000 in a diversified portfolio of marketable securities to the PLLC for a Preferred Equity Interest with a $1,000,000 dissolution preference and a 7.5% net-cash-flow preference. Child contributes $1,000,000 in a diversified portfolio of marketable securities for all Nonpreferred/Common Equity Interests. If the value of the PLP's assets doubles to $4,000,000 after one year, Parent's Preferred Interest would have a right to ultimate dissolution proceeds of $1,000,000 and to a $75,000 net-cash-flow preference. At most, then, Parent would have a right, either on a current or deferred basis, to $1,075,000 of the PLLC's $4,000,000 of assets. All other economic rights and appreciation inure to the benefit of Child. On a liquidation basis, Child would have a right to $2,925,000 of the $4,000,000 of PLLC assets, or almost three times Child's initial investment, although the present value of Child's Common Equity Interests would be much less than that (assuming that Child, acting alone, does not have the right to dissolve the PLLC.*

In contrast, if the value of the PLLC assets declines by 50% to $1,000,000 during the first year, Parent, as the holder of the Preferred Interests, will have a current or deferred claim to all $1,000,000 of the PLLC's assets. The $1,000,000 decline in value will be borne almost entirely by Child's Common Equity Interests, although Parent's net-cash-flow preference also will be at risk. On a liquidation basis, Child's interest is worth zero ($0.00).

[3]The Preferred Equity's annual cash flow payment is also referred to as the "Priority Return."
[4]Regulation 25.2701-1(a)(2); 25.2701-3.
[5]Regulation 25.2701-3(a).
[6]Regulation 25.2701-(3)(b)(4)(ii).
[7]For instance, the discounted value of the Common Equity must be greater than or equal to 10% of the value of all Preferred Equity plus the total debt owed by the partnership to family members. Regulation 25.2701-3(c). Also, the Preferred Partnership Agreement should specify that the Preferred Priority Return may be paid either in cash or in-kind assets.

Edited by William B. Fox, B.A., J.D., LL.M. Tax