

Private Client Services Update

Welcome to the latest issue of the Private Client Services Update from McElroy, Deutsch, Mulvaney & Carpenter, LLP. As you may have heard, recently McElroy, Deutsch & Mulvaney has merged with the law firm of Carpenter, Bennett & Morrissey, one of New Jersey's oldest and most respected law firms, to form what is now the third-largest firm in New Jersey.

As a result of the merger, several highly-experienced attorneys have joined the Private Client Services group to form one of the largest private client services groups in New Jersey. Francis X. O'Brien practices in the areas of probate and trust law, real property, and also counsels various business entities, bringing over 30 years of experience to the group. Mary B. Goldhirsch has an LL.M. in Taxation from New York University and also practices in the areas of probate and trust law, providing her wealth of knowledge to the group and our clients. Warren L. Lewis, who is counsel to the firm, lends decades of experience to our practice.

This issue of the Update focuses on three of the more anticipated cases in estate planning and elder law planning, respectively. The Kimbell and Turner cases provide important guidance on family limited partnerships and the Keri case sets the standard for judging transfers by a guardian on behalf of a decedent. We hope that you will find the Update informative and helpful. We welcome any feedback or suggestions for future issues.

Third Circuit Rules on Family Limited Partnerships

A Transfer without a Business Purpose May Not Effect Favorable Taxation

The Third Circuit recently ruled in Betsy T. Turner, Executrix of the Estate of Theodore Thompson, Deceased v. Commissioner that the value of assets transferred to two family limited partnerships should be included in the decedent's gross estate, because the decedent effectively retained an interest in all of the assets and because there was no business purpose behind the transfers. This apparent requirement that there be a business purpose (in the Third Circuit at least) underscores the need for careful planning and administration of family limited partnerships.

When he was 95 years old, Theodore Thompson transferred a total of approximately \$2.8 million in securities and other assets to two family limited partnerships, the Turner Partnership and the Thompson Partnership. Both the Turner Partnership and the Thompson

Partnership consisted primarily of marketable securities, which Mr. Thompson contributed and which, in the case of the Turner Partnership, remained in Mr. Thomson's brokerage account with little post-transfer trading. Family members also contributed real property and their interests in a real estate partnership. In both instances, the family formed a corporation to serve as the general partner. Mr. Thompson retained only \$153,000 in personal assets.

Following Mr. Thompson's death, his estate applied a forty percent discount to the value of his partnership interests for lack of control and marketability when it filed its federal estate tax return. The IRS determined that the full date of death value of the transferred assets should be included in the gross estate, which resulted in an estate tax deficiency of \$707,054. The Third Circuit agreed with the IRS that there was an "implied agreement" that Mr. Thompson would retain lifetime enjoyment and economic benefit of the assets.

The Court also found a lack of business purpose for the formation of the various entities. The Turner Partnership engaged in several business transactions, but none that produced economic gain for the partnership. For example, the Turner Partnership made loans to family members, but never to non-family members, and failed to enforce repayment. In addition, the amended Turner Partnership Agreement provided for allocation of gains and losses from real estate contributed to the partnership to the individuals who contributed the real property. The Thompson Partnership was also comprised primarily of marketable securities and there was little trading after contribution. The only operating activity of the Thompson Partnership related to a ranch, which one of the family members contributed and then continued to use in exchange for below-market rent.

The Third Circuit found that the family limited partnerships existed to shift assets to other family members for estate tax purposes, while allowing the transferor to retain control of the contributed assets.

The Fifth Circuit was kinder to family limited partnerships. In David A. Kimbell, Sr., Independent Executor Under the Will of Ruth A. Kimbell, Deceased v. U.S., Ruth Kimbell contributed assets, including cash, oil and gas interests, securities and notes to a trust, which in turn exchanged certain of these assets for a 99% limited partnership interest. A 1% general partnership interest was held collectively by Mrs. Kimbell, her son, and the trust. The Fifth Circuit agreed in Kimbell that there was considerable evidence that the partnership was created for substantial business and other non-tax reasons. All formalities had been followed in creating the partnership and Ms. Kimbell retained sufficient assets for her support. In addition, the assets contributed to the partnership included working interests in oil and gas properties that required proper management. Mrs. Kimbell wanted these businesses to continue for future generations and combining them made that more likely to occur. The Court upheld the estate tax discounts.

Turner and Kimbell teach us that it is important to plan and administer these partnerships carefully. You should only transfer to partnerships assets that you would

otherwise be willing to give away for estate tax and family planning purposes. You should not put all or the majority of your assets into the partnership. In no circumstances should you contribute your residence or other personal use assets. Many continue to believe that a partnership funded only with marketable securities is still valid and can be discounted for estate and gift tax purposes. Nonetheless, if you can add other assets to the mix, such as real estate or interests in a business, a challenge by the IRS may be less likely. The formalities of the partnership must be followed. There should be separate bank and other accounts for partnership assets. Distributions should be made on a pro rata basis. For example, if you own only 1% of the partnership (a common arrangement) you should only receive 1% of any distribution. Ideally, the general partner and the limited partners should meet on a regular basis to review the partnership's assets, goals and investment performance. In short, the "business purpose" test in Turner may or may not actually be a binding rule, but the partnership should be managed in a businesslike way. If you follow these guidelines, family limited partnerships should continue to be a viable estate planning tool.

Landmark New Jersey State Supreme Court Case On Medicaid Planning

Standard Set For Judging Applications By Guardians To Make Transfers

In an important case, the New Jersey State Supreme Court has held that, if certain criteria are met, a guardian may make transfers on behalf of an incapacitated person to make that person eligible for Medicaid benefits. In the past, there was no set standard for determining whether a guardian may transfer assets from an incapacitated person to family members. The success of each application seemed to depend on the location of the court in which the application was heard. That is no longer true.

Now, a guardian may transfer assets of an incapacitated person to family members if a court specifically finds that:

- (1) the possibility of restoration of the incapacitated person to competence is virtually nonexistent,
- (2) the assets remaining after the proposed transfer are sufficient to maintain the style and comfort the incapacitated person enjoyed prior to the court application,
- (3) the recipients of the proposed transfers are the naturally anticipated heirs of the incapacitated person,
- (4) the proposed transfer will reduce the estate taxes of the incapacitated person, and
- (5) there is no substantial evidence that the incapacitated person would have done anything different with respect to the transfers if competent.

In the Matter of Mildred A. Keri, a Mentally Incompetent Person involved a 90-year old woman who had lived alone. Because of irreversible dementia, she depended exclusively on the care of her two sons. The woman's residence comprised the bulk of her estate. She received a monthly income from her pension and social security benefits. Although she had given one of the sons power of attorney that authorized that son to apply for Medicaid benefits, the power of attorney did not explicitly authorize the son to make transfers on her behalf for any reason.

As a result, the son applied to the court to be appointed as guardian and for approval of a proposed plan to, among other things, sell the house and transfer the proceeds of the sale to the two sons. The trial court denied the so-called "spend-down" plan and the appellate court affirmed the trial court's decision in part and reversed in part. The New Jersey State Supreme Court reversed the appellate court's ruling and remanded the case for further proceedings, holding that a guardian may make transfers on behalf of an incapacitated person if certain criteria are met.

The Court noted that under New Jersey statutes a guardian is specifically empowered to apply to a court for authority to make a transfer "as the [incapacitated person] might have been expected to make." This is known as the substituted judgment rule. Previously, however, courts have been reluctant at times to apply the substituted judgment rule. In the Keri case, though, the New Jersey State Supreme Court found that it was obligated to apply the substituted judgment rule unless there was substantial evidence that the incapacitated person would not approve the "spend-down" plan. The Court found that it would be unfair to prohibit an incapacitated person the right to do that which a competent person could do.

Although the Court held that a guardian may make certain transfers on behalf of an incapacitated individual if the above noted criteria are met, certain related matters have not yet been addressed by a court. For example, how would a court rule where the incapacitated person is moving from that individual's personal residence to a nursing home? As noted above, one of the criteria in Keri case was that the lifestyle of the incapacitated person must be maintained in the same manner as it existed before application to the court for approval of the "spend-down" plan. Whether home care would compare with nursing home care is an issue that will be left for another day, but right now the courts in New Jersey have a set standard for judging whether a guardian may transfer assets of an incapacitated person in order to make that person eligible for Medicaid benefits.