PROSKAUER ROSE LLP®

Client Alert

A report for clients and friends of the firm

October 2003

Florida Intangibles Tax

For the past few years, we have advised our clients on the impact of the Florida Intangibles Tax and methods that Florida residents can use to reduce or eliminate the impact of this tax. These planning alternatives must be in place by the end of the year to affect the amount of the tax payable for 2004.

Planning to Avoid the Florida Intangibles Tax

1. Introduction.

Florida does not impose a state income tax. However, an annual tax is imposed on all intangible personal property owned by a Florida resident. The most common items of intangible personal property are stocks and bonds.

The tax is imposed on the value of all intangible personal property owned by a taxpayer as of January 1 of each year. A return must be filed and the tax paid by June 30 of each year. Beginning in February, discounts are available for each month in advance of June in which the tax is paid. If the tax is paid in February, the discount is 4%; if in March, 3%; if in April, 2%; and if in May, 1%.

Certain forms of intangible personal property are exempt from the tax. These include cash, non-registered partnership interests, United States obligations, State of Florida obligations, and Individual Retirement Accounts.

2004 Change - Increase in Exemption

As of July 1, 2003, the Florida Legislature increased the exemption for individuals for tax years 2004 and beyond from $20,000 to $250,000, and for married couples from $40,000 to $500,000. These exemptions apply to the value of assets subject to the tax and not to the amount of the tax due.
The current rate of the intangibles tax is .1%. This translates to a tax of $1,000 on every $1,000,000 of taxable intangible personal property in excess of the applicable exemption amount. Between 1998 and 2000, the rate of the intangibles tax was reduced from .2% to .1%, and it had been widely speculated that the Florida legislature would continue this trend by further reducing the tax. However, in light of the weak economy and corresponding revenue shortfalls, no further adjustments have been made. Furthermore, given the current economic outlook and expected revenue shortfalls, it is not known what changes, if any, will occur for 2005 and beyond. We will update you regarding any changes in the law as soon as such information, if any, becomes available.

2. Current Planning Alternatives.

Two distinct planning alternatives are available to reduce or eliminate the impact of the Florida intangibles tax. Each has been approved by the Florida Department of Revenue by way of private rulings. Although such rulings are limited in effect to the requesting taxpayer and may not be relied on as law by others, it is likely that if the facts of a specific ruling in this area are followed, the tax savings will be achieved.

The two planning approaches involve the use of a "short-term" trust or the use of multiple business entities. In 1998, new Regulations in this area were issued as a way to provide guidelines on permissible ways to create and maintain both planning alternatives.

a. Short-Term Trusts.

Of the two planning alternatives, the creation of a "short-term" irrevocable trust is by far the simpler. The most common is a "13-Month Trust" that is created in December of one year and lasts until the January after the trust's first anniversary, thereby creating a trust that will span at least one year and two or three days, but will encompass 13 calendar months and two years for intangible tax purposes.

The planning key to the "13-Month Trust" is that it will be in existence on January 1 of two distinct tax years.

In order to avoid imposition of the intangibles tax, a "13-Month Trust" must follow certain rules:

- the beneficiary may not receive *mandatory* distributions of income or principal, but the Trustee may make such payments to the beneficiary on a *discretionary* basis;
- the beneficiary or the trust creator may not: (a) retain the right to revoke the trust; (b) possess a general power of appointment over any portion of the trust; (c) retain the right to appoint successor beneficiaries; or (d) retain the right to withdraw assets from the trust.

Prior to 2001, the general rule for intangible assets held in an irrevocable trust was that if the Trustee of the trust was a Florida resident, the trust would be subject to the intangibles tax. However, as discussed in prior Client Alerts, the Florida legislature eliminated the "Florida resident" requirement, so now Florida residents are permitted to serve as a Trustee of such trusts. According to a recent Department of Revenue ruling, the Trustee of the trust can even be the taxpayer's spouse. As a result, intangible assets held in trust will be subject to the intangibles tax only if the beneficiary of the trust is a Florida resident who retains a "beneficial interest" in the trust, regardless of where the Trustee resides. If a "beneficial interest" is retained, the Florida resident is responsible for filing a return and paying a tax on his or her equitable share of the trust. A "beneficial interest" is defined as at least a current right to trust income and either the power to revoke the trust or the power to appoint any portion of the trust to himself or herself or to his or her estate.

In December, when a "13-Month Trust" is created, the taxpayer transfers to the Trustee as much of his or her intangible holdings as he or she wishes to insulate from the intangibles tax. On January 1, the date of assessment of the intangibles tax, the following will occur:

- *The Trustee is not required to file an intangibles tax return on behalf of the trust.*
- Since the taxpayer no longer has possession of the intangible assets (as they are now held in the trust), *the taxpayer is not required to report the assets on his or her personal intangibles tax return*.
- Because the taxpayer has not retained a "beneficial interest" in the trust, *no portion of his or her interest in the trust must be reported on his or her intangibles tax return*.

A "13-Month Trust" is commonly used to avoid the intangibles tax for two consecutive years. Taxpayers who do not wish to relinquish control over their intangible assets for that long may opt for a shorter term. At least one Department of Revenue ruling approved the use of a "4-Month Trust," commencing in October and ending the following February. The term actually can begin at any time before the end of December so long as the trust term is at least four months.

Although private rulings have only acknowledged four month and thirteen month terms, so long as the trust satisfies the requirements for trusts set forth under the Florida Administrative Code, it appears that the duration could be shorter. However, the shorter the duration, the higher the risk that the Department of Revenue could determine that the substance of the transaction takes precedent over the form, meaning that the trust could be considered to be a sham and ignored for intangibles tax purposes. A conservative approach would be to follow the private rulings and create a trust with either a four month or thirteen month duration.

Other than the length of its term, the provisions of a "4-Month Trust" are identical to those of a "13-Month Trust." The primary advantage of the "13-Month Trust" is that it encompasses two separate years. The "4-Month Trust" requires the creation of a new trust and re-transfer of the assets if the intangibles tax is to be avoided in a later year. The primary advantage of the "4-Month Trust" is that the taxpayer retains control of the intangible assets for 8 months each year, whereas the "13-Month Trust" requires the taxpayer to relinquish control for approximately one full year.

The creation of a "4-Month Trust" requires that the taxpayer execute a new trust every year and the creation of a "13-Month Trust" requires that the taxpayer execute a new trust every two years. Hoping to reduce the amount of legal drafting involved, in recent years many practitioners have created a derivative called a "Perpetual Trust," whereby one trust remains in existence with either no termination date or a termination date many years into the future.

The Perpetual Trust commonly provides that on a specified date in January, all but $100 of trust assets is either distributed to the taxpayer or is subject to an absolute right of withdrawal by the taxpayer. The effect of this provision is that the trust remains in existence for the next year, thereby alleviating the taxpayer of the burden of creating a new trust. Toward the end of the year, the taxpayer simply contributes the assets back to the Perpetual Trust where they remain until after January 1.

The risk in creating a Perpetual Trust is that it is questionable whether it would survive a challenge by the Department of Revenue. In fact, the Perpetual Trust is very similar in substance to a trust described in a published ruling in which the Department of Revenue disregarded the trust for intangibles tax purposes and ruled that the grantor never relinquished control over the assets.

b. Multiple Business Entity Format.

The second planning alternative to reduce or eliminate the impact of the intangibles tax involves the use of "multiple business entities." This alternative involves the creation of a closely-held corporation (or limited liability company) and a family limited partnership.

In the basic format, the taxpayer creates a corporation (or limited liability company) which has a business situs in and is governed by the laws of a state other than Florida. The corporation must have a separate office located outside of Florida and the corporate documents must provide that all business is to be conducted at the corporation's offices outside of Florida. The taxpayer may serve as an officer and director of the corporation, but all corporate activities must be conducted either through a non-Florida officer or director or by an agent retained by the corporation outside of Florida.

The taxpayer will transfer 1% of his or her total intangible holdings to the corporation in exchange for all the corporation's stock. The taxpayer and the corporation (and, perhaps, another individual or entity, who may be a family member, the taxpayer's spouse, or other family trusts) then form a family limited partnership. That, too, is created with a business situs in and is governed by the laws of a state other than Florida.

The corporation will transfer its 1% of the taxpayer's total intangible holdings to the partnership in exchange for a 1% general partnership interest, and the taxpayer (and, if applicable, the other individuals or entities) will transfer the balance of his or her total intangible holdings to the partnership in exchange for a 99% limited partnership interest.

The partnership is not publicly traded and, thus, is not required to be registered with the Securities and Exchange Commission. As with the corporation, it must be provided in the partnership agreement that all business is to be conducted at offices of the partnership located outside of Florida. All mail must be received by the partnership at its office outside of Florida (but copies are permitted to be sent to the taxpayer). The taxpayer must travel to business offices outside of Florida in order to conduct regular meetings and all corporate and partnership business.

If established properly, Department of Revenue rulings have held that the "multiple business entity" format can reduce the impact of most forms of the intangibles tax. Since the business situs of the corporation and of the partnership is located outside of Florida, neither entity is subject to the intangibles tax on its respective holdings. Since the partnership is not publicly traded, the taxpayer is not taxed on his or her limited partnership interests. However, the taxpayer is taxed on his or her shares of the corporation (or on his or her membership interest in the limited liability company), but since it only represents a 1% interest in the partnership, the taxpayer is, in effect, taxed on only 1% of his or her total intangible tax holdings. So long as the entities conform to the laws of the state or states of incorporation or formation, Florida should respect their existence as separate and valid business entities.

The "multiple business entity" alternative is initially more expensive to create than the "short-term" trust and must be maintained on an annual basis. Nevertheless, it may be more useful than the "short-term" trust, because the use of a family limited partnership may have certain other advantages.

c. Coordination with Existing Estate Planning Techniques

If you have undertaken certain estate planning techniques, such as the creation of a family limited liability company or family limited partnership, or wish to create a family limited liability company or family limited partnership, whereby the principal place of business occurs in Florida (which would fall outside the requirements for the use of the "multiple-entity format" discussed above), it still may be possible to reduce or eliminate the impact of the Florida intangibles tax. The nature and scope of such planning can be complex and is beyond the scope of this Client Alert; however, if you would like more information on this topic, please contact us.

3. Conclusion.

By voluntarily relinquishing some control over intangible assets through the use of "short-term" trusts or "multiple business entities," Florida residents can avoid either some or all of the tax burden imposed by the Florida intangibles tax. Prior rulings and regulations give taxpayers a "blueprint" for structuring the techniques discussed above. As January 1 is approaching, we recommend that anyone interested in pursuing one of these techniques call us immediately.

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