PRACTICAL PLANNER
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MARTIN M. SHENKMAN, PC
PO Box 1300, Tenafly, NJ 07670
Phone: 201 837-1400
Email: newsletter@shenkmanlaw.com
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Planning Potpourri

Oy Veigh:
The lawyer who represented Timothy McVeigh in the Oklahoma City bombing case donated materials from his case file to charity and then tried claiming a charitable contribution tax deduction. The Tax Court denied the deduction. *Jones v. Comm'r*, 129 TC No. 16 (Nov. 1, 2007).

Passive Losses in Your Estate:
The passive loss rules limit the tax losses you can deduct from an activity in which you don't materially participate. IRC Sec. 469. Losses you cannot deduct are held in abeyance (suspended) until they can be deducted in the future. What happens if you die before that future date comes to deduct those suspended losses? The answer is some good news and some bad news, and of course more tax complexity. Good News: Death is treated as a complete disposition of the passive activity freeing all the losses for deduction on your final personal tax return Form 1040. IRC Sec. 469 (g) (2). Bad News: These formerly suspended passive losses have to be reduced by the step-up in income tax basis of the passive activity asset. IRC Sec. 1014. So if you hold a partnership interest that is worth $250,000, but your basis is only $100,000, you'd get a step up of $150,000 (to the fair value at death). Your suspended losses from that partnership interest would be deductible on your final return after reducing them by $150,000. Complexity: The basis rules are complicated. Your executor will have to contend with alternate valuation date values, and after 2009 the $1.3 and $3 million step ups when basis increases are otherwise eliminated. Whew.

Double IDITs:
Remember the gum commercial with twins extolling you to double your fun? Well if you sell assets to a grantor trust for a note (affectionately an "IDIT" or "IDIGIT") and at a later date want to engage in another sale transaction, don't use the same IDIT. Set up a second trust for the new transaction. If the first transaction washes out (e.g. the real estate assets underlying the sale declined dramatically in value) why taint the second transaction with that risk? If the first transaction was a homerun and the next is a disaster, the value of the first will be used to cover the second. Example: You sold 40% of a shopping center LLC to the trust. The center has doubled in value. If you later sell an apartment LLC, use a new trust. Set up a new IDIT and protect your planning gains. PP

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Martin M. Shenkman, CPA, MBA, JD

Family Loan Transactions

Dad loans son money to start a business. Brother loans sister the down payment for her new home. Family loan transactions are common. But to often their frequency makes families complacent about the numerous and potential costly tax implications of these "simple" transactions. This article will highlight many of the important issues involved.

Family Loans Introduction:
Family loan transactions are often sizable transfers. A tad more than envisioned in the 1931 classic song "Brother, Can You Spare a Dime". A threshold issue is what is the transfer? Is it a loan or a gift? Big issue. If the transfer of funds is a gift, to the extent it exceeds the annual $12,000/donee gift tax annual exclusion it will erode your $1 million lifetime gift tax exemption, and beyond that amount will trigger current gift tax. Ouch! If the transfer is a loan you'll avoid current gift tax issues, but have to contend with a confusing web of income tax rules.

Gift or Loan:
The tax laws view a "gift" differently then the typical person would. No boxes and bows required. If you make a transfer for less than full and adequate consideration, you've made a gift. Intent is generally irrelevant. In the context of a family loan it is presumed that a transfer of money to a family member is a gift, not a loan. *Harwood v. Comr.*, 82 TC 239 (1984). You can rebut that presumption if you can demonstrate that you had a real expectation of repayment.

Steps to Assure a Loan:
To assure that the transfer is treated as a loan and not taxed as a gift you should do each of the following:
• Have a written loan document (e.g., a signed promissory note).
• The borrower should be solvent when you make the loan (get a copy of Junior's balance sheet).
• Charge interest (more on this below).
• Junior should make payments as required under the loan documents. Save copies of the cancelled checks.
◦ Your tax return, as well as Junior's, should report the transaction consistent with the position that a loan was made. The transfer is not reported as a gift; you report interest income; Junior reports interest expense, if deductible.
• If Junior misses a payment date, or does not repay on maturity, then you must demand repayment. You really want to treat it no differently than a loan to a stranger.
• Include a fixed repayment schedule. While a demand loan should be respected, a fixed repayment schedule may prove easier to defend.
• Don't plan in advance to forgive any of the loan. A letter to Junior that he'll never have to pay and you'll forgive $12,000 of the loan each year using the annual gift exclusion, may torpedo your loan. Although some courts have respected forgiving portions of a loan as qualifying for the annual gift exclusion, the practice might contradict the position that the original note was ever intended to be repaid. Rev. Rul. 83-180, 1983-2 C.B. 169.

While not all factors have to be present for the IRS to respect the transaction as a loan, the more the merrier.

Interest Rate on the Loan:
While you may be tempted to give Junior a break on the interest he has to pay you on the loan, charging less then

(Continued on page 2)

Checklist: Instruction Ltr

A personal note detailing your wishes, hopes, messages to fiduciaries and heirs, is a key part of every estate plan. It doesn't require legal, tax or other professional involvement, but it can play a vital role that even the most comprehensive planning documents can't address.

Letters of instruction are to often not done. They don't save taxes, and they don't substitute for properly written, current (yes *current* for all of you whose wills are still written on parchment) planning documents. Even the best drafted will or trust won't address key personal issues. They also change over time. Everyone should write a letter of instruction to their fiduciaries and revise it periodically. Nothing can fill in the "blanks" better than a detailed heart felt letter. Rarely does a trust or will give this detail, but after you're gone your fiduciaries will want to carry out your wishes. They need to know more than what a sterile legal document contains. And that is exactly why you should write a last letter of instruction. It's tough to do. One client referred to it as the "two tissue box letter". Here's a checklist of ideas:

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...Family Loan Transactions

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current IRS rates has a tax consequence. IRC Sec. 7872. The determination of the minimum required interest rate, called the Applicable Federal Rate (AFR) is made under Code Section 1274(d) which provides for different interest rates depending on the term of the loan. These rates are updated monthly and are based on the average yield of Treasury securities. Special rules are provided for demand loans (loans without a set maturity, but rather which are due when the parent/lender demands repayment). If you charge less than the mandated interest rate the undercharge is deemed a gift from you to Junior which could trigger a gift tax cost if in excess of the annual gift tax exclusion amount. The computation is actually based on determining the present value of all interest and principal payments using the AFR as the discount rate. The interest undercharge you gifted to Junior is then treated as if Junior paid it to you as interest and you have to report the amount as interest income. Junior might qualify for an interest deduction. IRC Sec. 163.

Review: Andrew Wolfe, CPA, JH Cohn LLP, Roseland, NJ.

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<u>Exceptions to Interest Imputation</u>: There are a number of exceptions when the above imputed interest rules don't apply. If the money you loan is not invested by Junior and is not more than $10,000, interest does not have to be imputed. If the loan is not more than $100,000 and Junior's net investment income is note more than $1,000, the rules won't apply for income tax purposes. Special rules apply to a sale of land between family members for $500,000 or less and other transactions. IRC Sec. 483.

<u>Types and Uses of Family Loans</u>: Family loans come in many forms, and can be used to accomplish a wide array of purposes. If the transfer of funds to Junior is properly structured as a loan it can provide significant tax and economic advantages to the family.

Divorce Protection: A loan can protect the family funds if Junior divorces. The loan gives you a claim on the principal.

Wealth Transfer: If Junior can earn more on the loan proceeds then the interest he has to pay, the excess earnings are effectively transferred outside the parent/lender's estate. For example, if mom finds an interesting real estate project, rather then her buying she can permit Junior to invest in the deal, and she can loan him the funds to do so. This avoids including the property and all appreciation from the deal in mom's estate. However, the recent expansion of the Kiddie tax can result in Junior paying tax at your bracket even at age 23! While this planning still makes sense to shift value to Junior free of gift tax, the Kiddie tax lessens the benefits.

Home Down payment: A common application of these rules occurs when you help Junior buy his first house. Given the present issues in the mortgage market, you might be able to give Junior a loan more favorable then he could secure from an independent lender, if he can even obtain a loan now. You can charge Junior less than a bank would. The interest you charge may still exceed whatever you might earn investing the funds. While the imputed interest rules may apply they would only lessen the overall family benefits, not eliminate them. Consider the benefits of recording a mortgage on Junior's house to secure your loan in the event Junior's business or marriage goes bust.

Terms in red defined in the glossary at www.laweasy.com. For e-newsletter sign up at www.laweasy.com.

Family Sale Transactions: Another common loan transaction is your sale of FLP, LLC or family business interests to a grantor trust in hopes of removing future appreciation from the estate. Given the dollar size of these loan transactions, additional care and precaution to meet the above loan criteria, as well as other steps are in order. When a loan is used in a sale transaction, such as between a family member and a family trust or partnership, greater care should be taken. The courts don't always look favorably or leniently on intra-family loans. See *Estate of Rosen v. Comr.*, T.C. Memo 2006-115. In these types of loan transactions you might want to add additional steps such as some capitalization of the borrower to support the loan, representation by independent legal counsel for each of the borrower and the lender, etc. PP

...Checklist: Letters of Instruction

(Continued from page 1)

√<u>Education</u>: What type of education do you want for your children? If you prefer that they have a certain type of private school education, or to attend a particular school, indicate it. If you want them educated under the auspices of a particular religion's schools, or that their public school education be supplemented by afternoon or weekend religious classes, explain it in detail.

√<u>Lifestyle</u>: Describe the lifestyle and values you want for your children. Most trusts include vague language like "ascertainable standard", "comfort and welfare", etc. What do you want for your children? Do you want them to keep up with the spending patterns of Mary-Kate and Ashley? Would you prefer a more subdued lifestyle? When a trustee is trying to stand in your shoes 10 years after your death, some stories and discussions of values, lifestyle and so on can provide valuable guidance to the trustee. What do you view as a reasonable vacation? Is first class air travel a must or an extravagance? Is a new car every year or two appropriate? What type of car?

√<u>Life Events</u>: Should key life events be paid for? How and to what extent? Do you want your child's spouse-to-be to share wedding costs? Would you want the trust for Junior to cover all the costs? How lavish a wedding? How much input should the trustee have if any? What about graduations, confirmations, christenings, Bar Mitzvahs? Life events can range from tasteful family affairs, to full blown catered parties, to extravaganzas on a charted yacht.

√<u>Second Marriages</u>: The issue only compounds as the number of marriages increase (think of Elizabeth Taylor – 8 times if you count both marriages to Richard). This is one of the classic balancing acts for fiduciaries. How does the fiduciary allocate trust resources between your new spouse and children from other marriages? How should the trustees spend money? While the legal documents need to set the parameters, they rarely provide the details or personal insights that can really help a trustee make some of the tough calls. Whether the trust is structured so that it must pay income to your new spouse, or a unitrust amount (e.g., 4% of principal), most trusts still provide the trustee with discretion to make principal distributions.

√<u>Investments</u>: Do you have a particular philosophy you want considered? Perhaps you have a wealth manager that you prefer be used but don't want to formally mandate his or her use. A non-binding instruction may be the ideal approach.

√<u>Family Business</u>: Who should run the business? Should the trusts you've formed for insurance or other family members loan the business money? If no heir is in the business should the business be retained for potential future heirs to join? How strongly do you wish your fiduciaries to hold onto the business interests? What if your heirs cannot agree on salaries, titles or other matters? Should the trustee intervene? While all these points should be addressed to varying degrees in the shareholder agreement and other business documents and in a coordinated manner in trust agreements, the flexibility of providing personal anecdotes and thoughts in a side letter can provide

Recent Developments

Deferring Estate Tax: If more than 35% of your estate consists of interests in closely held businesses your estate may qualify to defer the payment of estate taxes. To qualify the businesses must be active trades or businesses. The business interest must also be closely held, which means for a corporation that either 20%+ of the value of the corporation's voting stock is in your estate, or the corporation has 45 or fewer shareholders. If you own interests in two or more closely held businesses, and 20%+ of the total value of each business is included in your estate, these will be aggregated as an interest in a single closely held business for purposes of qualifying for this benefit. This deferral enables your executor to pay estate tax attributable to the business in 10 annual installments beginning 5 years after the regular payment of estate tax would be due. IRC Sec. 6166. This can be a valuable option for estates that largely consist of family businesses or real estate holdings. A special low 2% interest rate may apply to the first $1.25 million of deferred taxes. IRC Sec. 6601(j); Rev. Proc. 2006-53. Interest paid on deferred tax is not deductible. IRC Sec. 2053(c)(1) (D). The IRS had determined that a significant number of estates electing to defer estate tax never paid the tax. Since the tax law permits the IRS to secure the payment of the tax, it does so, rather aggressively. Code Section 6165 provides that if the IRS grants an extension of time within which to pay tax it may require the taxpayer to furnish a bond in such amount conditioned upon the payment of the amount extended in accordance with the terms of such extension. The Tax Court recently held, *Estate of Roski*, (2007) 128 TC 113, that IRS cannot require a bond or lien from every taxpayer that defers tax under 6166. Those liens or bonds could disrupt business practices and deterred some taxpayers from taking advantage of the deferral. The IRS has just announced a change in policy in this regard. Now, the necessity of a bond or lien will be determined on a case-by-case basis. Notice 2007-90, 2007-46 IRB. PP