PRACTICAL PLANNER NEWSLETTER
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Creative solutions that coordinate all your planning goals:
· Estate · Tax · Business · Personal
·Financial ·Asset Protection

Planning Potpourri

o Physician investment planning: Consider malpractice worries, not just investment returns. The structure (who owns an investment) is important. Significant assets rarely belong in your own name, or in your spouse's name. LLCs and trusts are likely a better option. Be sure the accounts are set up in the name of the entity and that an investment policy statement is signed in the name of the entity by the appropriate person. The income tax ramifications of using a trust or LLC are important and need to be addressed with your accountant. If you are setting up a domestic asset protection trust the investment structure should be reviewed. Will the trustee directly invest assets or should the trust own an LLC that owns the actual assets and someone else addresses investments? State income tax issues may be very different since these trusts are almost always in a state other than the state you reside in. Insurance should be evaluated from a different perspective. Even if term insurance meets your needs, permanent insurance owned in an irrevocable trust to safeguard a cash value may be better. Your spouse could be a beneficiary and have access to the cash value in the policy through trust distributions. Non-deductible IRAs are recommended, for asset protection not tax benefit, because the assets are protected up to $1M under the bankruptcy act.

o Regression Analysis: If you're involved in litigation over the value of a business interest (divorce; business dispute), consider a regression analysis of prior valuations (e.g. for bank financing, proposed sales) against revenues (or another relevant variable) as a means of testing the reasonableness of the value being advocated. Your valuation consultant can even visually plot all the prior data points on a graph and demonstrate how your adversary's current valuation is inconsistent with prior values.

o Beneficiary Designations: Retirement plan beneficiary designations prepared on pre-printed bank forms can treat contingent beneficiaries differently then you intend. You have three children named as beneficiaries. One child dies. You might wish that deceased child's heirs (contingent beneficiaries) receive his share. But some forms mandate that the contingent beneficiaries only receive distributions if all primary beneficiaries die. Exercise caution when completing such forms to make sure they really adhere to your wishes. If not modify them accordingly. PP

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VOLUME 1, ISSUE 7
September 2006

PRACTICAL PLANNER

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Duct Tape Estate Planning

When you head off into the backwoods it's always good to take duct tape (usually wrapped around an old pencil stub). Use it to patch a tent, as a bug catcher, to close a wound, and to fix almost anything. Similar creativity can be brought to your estate planning. Standard techniques can be used in creative ways to better meet whatever issues arise. We're not speaking of new fangled exotica that are soon to be on the IRS hit list, we're speaking of common planning techniques applied creatively (just like duct tape). Here are a few ideas:

o FLP/LLC: *Standard Use:* Family limited partnerships (FLPs) and limited liability companies (LLCs) are often used to secure discounts for gift and estate tax purposes. You transfer real estate, securities, etc. to an LLC and give gifts of small percentages. The value of those gifts is invariably less than a pro rata percentage of the whole (e.g., 10% of an LLC owning $750,000 of real estate is worth less than $75,000) because a non-controlling interest is worth less than a pro rata amount. *Tailored Use*: You invest in private equity and other deals. If you die, or wish to make gifts, the process of changing ownership of those assets is potentially costly and complex. Your private equity deal may require an opinion of counsel, general partner approval and more. Instead, if you make these types of investments using your FLP/LLC, you might avoid these transfer difficulties if you later make gifts, or on death when these interests are transferred to various trusts under your will. You may not need to incur any additional costs or jump any extra hurdles if your LLC, and not the underlying private equity deals, are transferred. Caution: the accredited investor rules differ for a partnership and may have an impact when you invest. Rule 501 requires greater than $5M net worth for a partnership, in contrast to greater than $1M for an individual, to be an accredited investor. *Key*: The FLP/LLC is not only for discounts, it facilitates transfers and succession of passive assets, while minimizing transfer costs.

o FLP/LLC: *Standard Use:* Discounts – see above. *Tailored Use*: The "transfer for value rule" can taint the proceeds of your life insurance policy as being subject to income tax! This would be a devastating tax result. This costly rule can apply if your insurance policy is, for example, sold. There are a limited number of exceptions in the law that have to be carefully followed to avoid this dilemma. If the purchaser of the policy is a partner with the insured (i.e., you) this adverse tax result may be avoided. You could set up an investment FLP/LLC for discount, asset protection and other purposes, and then have your insurance trust (ILIT) invest as a partner in the FLP/LLC. When the sale later occurs to your trust, the exception may apply because the trust is your partner. *Key*: The FLP/LLC is not only discounts, it can help you avoid the transfer for value rules thus preventing life insurance proceeds from being subject to income tax.

o 1 Member LLC: *Standard Use*: A limited liability company (LLC) is used to own a business or rental property so that a lawsuit against either won't reach your personal assets. If you're the only member of the LLC, the entity is ignored (disregarded) for tax purposes. *Tailored Use*: Adding a few creative paragraphs in your LLC operating agreement (the document governing the operation of your LLC) can create an inexpensive and effective disability and succession plan. Name

(Continued on page 2)

Checklist: Family Businesses

If your children have received, or will receive, interests in your family business, what steps can be taken to protect the business?

o Active Involvement: Carefully evaluate if and when to make your heir an officer or director of the family business. Involving an heir may increase loyalty and motivation. However, bestowing officer or director status may also increase the claims the heir's spouse may have in the event of a divorce. Depending on state law, active versus passive involvement can have significant implications to the determination of what the spouse is entitled to in equitable distribution.

o Lifetime Trust: Set up a trust for your child and gift the equity interests into a lifetime trust (sometimes called an inheritor's trust). This can protect the business interests from the child's divorce or malpractice claims. A lifetime trust, if GST exempt, can hold the business interests in trust forever without them ever being subject to estate taxes. Distribution provisions may expressly prohibit distributions of family business stock. Trustees should be carefully chosen to carry out your wishes to preserve the family business. This is one of the

(Continued on page 3)

...Duct Tape Estate Planning

(Continued from page 1)

yourself as manager (the person to operate the LLC, which you were doing as a member/owner, just now its formally addressed). Include provisions governing what a manager can do. Name a successor manager in the event you are disabled or die. These few steps provide a succession plan to protect your investment in the event of your disability or death. *Key*: It's not only asset protection planning, its business succession planning.

O <u>GRAT</u>: *Standard Use*: A grantor retained annuity trust (GRAT) is a tax oriented trust to which you transfer assets, receive an annuity for a set number of years, and at the end of which your heirs (e.g. children) receive the assets. The benefit is a reduction in the value of the assets for gift tax purposes. A typical GRAT scenario might be a short 2-3 year GRAT funded with the most volatile securities in your portfolio, or a private equity deal you hope will balloon in value. The goal is to remove upside appreciation. However, if you're a physician worried about malpractice, perhaps a long 20 year term GRAT designed to give you an annual annuity might be a better bet. With many short term GRATs much of principal is returned to you via the annuity payments, back to the reach of your creditors. In a long term GRAT the principal can be tied up in an irrevocable trust until after you retire. The annual annuity payment are reachable by a claimant, but the principal is in an irrevocable trust. Same technique, same governing legal document, but completely different application. *Key*: It's not only about gift tax minimization, but asset protection as well.

o <u>CLT</u>: *Standard Use*: Charitable lead trusts (CLTs) are a great charitable and gift planning technique. You can gift a large sum to a trust. A charity receives a periodic distribution for some number of years, say 6% of the value, paid annually for 20 years. The result is a dramatic reduction of gift tax cost on a large transfer of assets that will be received by your heirs (e.g. children) in 20 years. Great gift tax play. *Tailored Use*: Spin this by setting up a separate CLT for each child and match the term of each CLT to the number of years until each child reaches retirement age, say 65. *Key*: You still have a gift tax benefit, but now you've effectively given each child a retirement plan. If your heirs blow their inheritances, these funds will be preserved for their later years.

o <u>Pre-Nuptial Agreement</u>: *Standard Use*: Prenups are done to protect your assets if your new marriage doesn't succeed. *Tailored Use*: A prenup can also be used to supplement your asset protection planning. Mandating separate accounts and assets, the preparation of married filing separate tax returns from separate data (so that each of you and your spouse have separate tax data to submit in the event of a suit or claim) even if a joint return is filed; and more. Key: Prenups can do more than protect assets from divorce, they can establish procedures and structure to backstop your asset protection planning.

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o <u>QPRT</u>: *Standard Use*: A Qualified Personal Residence Trust (QPRT) is a special trust used to transfer ownership of your home to your heirs (e.g. children) at a discount from its current value. You gift your house to a QPRT and reserve the right to live in the house for a specified number of years, typically 5-10 years. After that time period the heirs own the right to continue to lease the house after that term at fair value. *Tailored Use*: While QPRTs are typically used by older taxpayers to save estate tax, you might consider using a QPRT even if much younger. You're considering accepting a position on a board of directors and are concerned about the potential liability. You transfer your house to a QPRT for a 25 year term, lasting into your retirement. In the event of a later suit or claim, absent a fraudulent conveyance, the house is owned by an irrevocable trust with remainder beneficiaries having an interest in the trust's property. *Key*: A QPRT can be more than just an estate plan, it can be part of your asset protection plan to protect your house. PP

Publisher Information: Practical Planner is published periodically by Law Made Easy Press, LLC, P.O. Box 1300, Tenafly, New Jersey 07670. For assistance or information email newsletter@shenkmanlaw.com, or call 888-LAW-EASY.

...Checklist: Family Business Heirs

(Continued from page 1)

most important safeguards.

o Revocable Living Trust: While these trusts can avoid probate they can do more, especially in the context of a family business interest. If you're married and you've inherited assets or received gifts, setting up a revocable trust designed expressly to only hold inherited/gift assets can be a powerful tool to protect those assets from becoming tainted as marital assets subject to distribution if you divorce. Name the trust to highlight its limited purpose, limit trustees to your family members (not your spouse), transfer only inherited/gift assets to the trust (never marital assets), and operate it so as to avoid commingling trust and marital assets (don't pay income tax on trust income with marital funds). Living trusts are not only for avoiding probate, but they can supplement your pre-nuptial agreement, or provide protection when you've failed to obtain a prenuptial agreement.

o Prudent Investor Act: This law, enacted in various forms in most states, mandates that estate and trust assets be diversified and invested in accordance with an investment policy. Be certain that your will and any trusts you establish (including insurance trusts) modify these rules to permit your executor and trustees to hold family business interests.

o Shareholders' Agreement: Be certain to have a comprehensive shareholders' (or other) agreement governing the operation of the family business and severely restricting the right of any owner to transfer business interests. When you gift shares to an heir (or preferably a trust for that heir) the heir, or trustee, must obviously sign the agreement acknowledging that they are bound by the restrictions. But you should also have the heir's spouse sign acknowledging that he/she has read and understood the agreement.

o Pre-Nuptial Agreement: If your heir balks at a full blow prenuptial agreement as being contrary to his/her professed love, at least a limited prenuptial agreement addressing family business interests should be signed. Do it right. The new spouse should have his/her own counsel, it should be done with full disclosure (attach a business financial statement, tax return, and shareholders' agreement as exhibits), consummate it well in advance of the divorce (not on the Church steps!), and make reasonable provisions for the new spouse (e.g., life insurance, etc.).

o Voting vs. Non-Voting: At certain points in time it may be advisable to only transfer non-voting equity interests to maintain consistency in the control of the family business. Caution: This might raise estate tax issues under Chapter 14 of the Internal Revenue Code, so review this with your estate planner, not only your corporate attorney. You might even consider mandating that if stock is distributed from certain trusts, that distribution will trigger a conversion to non-voting status. In some instances a voting trust arrangement might be helpful. In such an arrangement the heirs could continue to own the beneficial interest in the stock but a named voting trustee may be given the right to vote. Caution: Have your estate planner review Code Section 2036 issues in this regard. PP

Recent Developments

o <u>Reasonable Compensation</u>: If your business remains organized as a C corporation paying salaries is critical to avoiding the double corporate tax (corporation tax, plus tax you pay on dividends distributed). If you hire family in your business and want to shift economic value to them, paying them salaries can be an excellent means of accomplishing this goal. It can save gift tax (on transferring value) and income tax (if the family member is in a lower income tax bracket). However, for these payments to withstand IRS challenge they must be reasonable. The appropriateness of the salary amounts will be based on the payee's actual contributions to the operation and management of the business, earnings and profits of the business, roles and responsibilities, etc. In Wechsler Co. Inc., v. Commr., TC Memo 2006-173 the court disallowed any payments to the taxpayer's brother since no proof was presented that he actually provided services, and payments to the taxpayer's wife were reduced by ½ since they were unreasonable in light of the services provided. Tip: Have your CPA provide a compensation study to corroborate the reasonableness of the salaries used.

o <u>New York LLCs – "Publish or Perish"</u>: If you have a New York limited liability company (LLC) you have to publish specified information in at least two local newspapers, once per week for six weeks. Thereafter you have to file a certification of the publication with the NY Department of State. There had been much controversy over this requirement and many people opted not to publish. The controversy is resolved. If you formed an LLC prior to 6/1/06 and published under the old rules, you are deemed in compliance with the new law. If not, you must comply with the new law by 6/1/07 or your LLC will be suspended. If your LLC was formed prior to 1/1/99 you don't have to publish (but may wish to do so). If you formed an LLC after 6/1/06 you must publish within 120 days. http://public.leginfo.state.ny.us/menugetf.cgi. PP