PRACTICAL PLANNER NEWSLETTER
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- Seminars: "Income Taxation of Trust: Situs" July 27 Bergen Community College 8-11 am, 3 hours CPE and CFP. Call Annette Schwind
- 201-493-8975 for info.
- "Estate Planning for Chronic Illness" seminars to be presented in Bethlehem PA August 30 8 am, Pittsburgh PA August 31 noon, and Indianapolis September 1 4pm. Call 201-845-8400 for info. See www.rv4thecure.com.

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PLANNING POTPOURRI

Copy Cat Danger: Photocopy machine lease expiring? Be sure that electronic images of the confidential papers recently copied are erased from the copier drives. Have the copier lease company confirm their policies for handling the drives in writing and have your IT consultant confirm that it is adequate. Better – buy the drives from the company. The cost is likely nominal. Then have your IT consultant destroy or erase them so you have control over the process.

What's Up Doc? Lawsuits, the possibility of a million dollar estate tax exemption, your son-in-law, all have you up worrying at night? Do you count defense attorneys leaping over a fence instead of sheep when trying to fall asleep at night? Say you have an interest in the real estate management company worth only $5 million in this market, but you're confident in 10 years it will be at $25 million. If you get hit by a bus Uncle Sam will walk with nearly $12.5 million to pay towards the cash for clunkers debt. Ask your mom to set up a trust for you and that is a grantor trust to you (you pay tax on trust income, not mom, even though she set it up). In tax jargon the trust is a Beneficiary (you) Defective (i.e., grantor) Inheritor's Trust, or a "BDIT." If you get hit by a bus or sued, the entire value is at risk. If you sell the business to the BDIT for a note, no gain will be recognized for income tax purposes. In 10 years the $20 million of appreciation will be outside the gift, estate and GST tax systems and protected from claimants. Since you did not set up the trust, you can be a beneficiary of the trust as well. For physicians worried about malpractice claims, a BDIT can be the ideal approach to protecting interests in real estate housing the practice, an equipment leasing partnership, and other assets ripe for sale to the trust. Thanks to Richard Oshins, Esq., Las Vegas, Nevada.

Revocable Trusts and Personal Property. So you've set up a revocable living trust to manage your assets and provide a structure to protect you as your Parkinson's disease or other health issues progress, or to avoid probate. You should also transfer ownership of personal property (antiques, art, jewelry, etc.) to the trust so that these valuable assets will also be protected. This transfer is often accomplished using a "bill of sale" to transfer personal property to the trustee of the revocable trust.

Practical legal stuff... in plain English

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PRACTICAL PLANNER

Martin M. Shenkman, CPA, MBA, PFS, JD

COOL TOOL: PRIVATE ANNUITIES

Summary: What's better than a Slap Chop (sorry Vince)? Could it be a private annuity? If you expect the estate tax to roar back with a vengeance in 2011, private annuities may warrant another look.

Who, What, Why: Who: In a private annuity transaction you sell an asset, say an interest in a family business, to a grantor trust that will benefit your heirs. If this sounds a little funky and differs from the description of a private annuity deal in your old accounting course books, that because the IRS issued proposed private annuity Regulations, Prop. Reg. Sec. 1.72-6; 1.1001-1 that changed how these deals are typically done. These Regs remain in the "proposed" mode, because, the IRS often uses the Orson Welles Paul Masson commercial paradigm: "We will finalize no regulation before its time." What: The trust will promise to pay you for the business specific, periodic payments for the rest of your life. Yes folks, that's an annuity, and because it is your trust paying for it, it's a "private" annuity in contrast to an annuity an insurance or investment firm sells you. You can even structure the deal as a joint annuity payable over the lives of both you and your spouse. Why: When you die the annuity payments end and there should be nothing left in your estate for Uncle Sam to tax (with a $1 million estate tax exemption on the books for next year, ya better start your tax engines revving).

Buzz: Now, clearly this can't be an exciting tax technique without some confusing jargon (Hey Dr. Ray, you had to call my knee a patella so don't bust my chops). You're called the "annuitant." The trust buying your business is called the "obligor." More buzz to come. Private annuities may be an excellent tool for removing a significant asset from your gross estate for estate tax purposes, while simultaneously providing you with lifetime cash flow.

The Good, The Bad & The Ugly: You didn't know that Clint was an estate planner?

The Good: When you're gone it's gone! Nothing left to tax in your estate if you spend each year's annuity payments. If you sold assets to a trust for a note, the value of the note is still included in your estate (unless you use a note that by its terms cancels on your death, called a "SCIN"). You can keep the asset, like a closely held business, within family control through the use of the family trust as the purchaser. But perhaps for most folks, getting a fixed quarterly or annual payment for their lives is exactly the financial simplification and consistency they want. Mom can sell the family widget business to a trust for the kids and head off to sunny Florida to the carefree golfing lifestyle and just check her mailbox once a quarter. Since the buying trust is a "grantor" trust mom will pay the income tax on the trust earnings, further depleting her taxable estate. The property in the trust will pass to her heirs tax free.

The Bad: No, it's not all peaches and cream. Once you're done wincing at the professional fees, there are some real issues to consider. You're getting a fixed annuity for life. What if inflation ramps up to 10%+ a year? Have your CPA generate some projections of future cash flows, inflation assumptions and then stress test the model. Be sure you leave enough off the table that you don't have to ask your son-in-law for grocery money. For the kiddies, if you surprise them and 'dif-tor heh smusma' [for you non-

(Continued on page 2)

CHECKLIST: GLBT PLANNING

Summary: If you're gay, lesbian, bi-sexual and transgender, there are many special planning considerations, only the most obvious being the lack of a marital deduction for federal gift and estate tax purposes. Consider the following:

√ **Act Now**. Doing nothing, which is the un-plan most folks opt for, just won't do. Without your taking specific actions your partner won't have the right to inherit your assets, raise your children, or do other things married couples can count on.

√ **Standard Forms**. These won't address your unique needs. If you cannot get forms that are tailored to your situation they won't work. Yes, tailored forms cost more, but a custom made shirt will fit better than an off the rack one from GAP.

√ **Plan**. You need planning first, forms second. What personal goals do you have? What tax and financial issues do you face? You have to first delineate your unique circumstances and goals before attempting to create documents.

√ **Rules**. Understand the rules, if any, your state has that may govern your relationship. Does your state have a domestic partnership, civil union, or same-sex marriage

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...Cool Tool: Private Annuities

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Trekkies that's Vulcan for live long and prosper] Junior could be pay a lot more for the Widget business than he thought. Remember, if you live to 120 Junior pays the annuity to 120 even though the calculations were based on life expectancy tables. The flip side is that if you die sooner than expected, Junior makes out like a bandit. However, if you die soon after the annuity sale the IRS may argue that the transaction was a set up and the health issues known. What if Junior ruins the business while you're on the links? But this is a risk with any succession plan that transfers a business to an heir.

The Ugly: Code Section 2036 is Freddy Krueger of the tax world. If your annuity payments are tied too closely to the income from the Widget business sold to the trust, the IRS will argue that the transaction should be treated as if you made a gift to a trust in which you retained an interest in the income for life. Under Code Section 2036 that puts the entire Widget empire back in your taxable estate (think 55% rate next year!). If you succeed in removing family business interests from your estate, it sounds like a win, but the IRS has the home team advantage. The benefits from removing the family business interests from your estate with a private annuity means those assets will not be available to qualify for estate tax deferral under Code Sec. 6166 (permits paying the estate tax in installments over 14 years), or the alternate valuation rules (value the assets 6 months after death if the value is lower than the date of death value), the use of a Graegin loan (non-prepayable loan with all interest deducted as an estate administration expense), and other potential estate tax benefits. If the annuitant has a shortened life expectancy, the IRS can argue that the tables normally used to calculate the annuity amount are inappropriate to use. Rev. Rul. 66-307, 1966-2 C.B. 429; Treas. Reg. Sec. 1.7520-3; 20.7520-3(b)(3). This issue can be addressed in appropriate physician letters.

<u>Drafting Considerations</u>

Some practitioners suggest avoiding Freddy by crafting the trust to conform to the requirements of a GRAT by including in the trust the requirements for the private annuity payments to be a "qualified interest" under Chapter 14. Other GRAT terms might include a prohibition of: additional contributions, distributions to anyone other than the Seller during the term of the interest, and commutation. Even with these, there is no assurance that this will work.

The Trust has to be characterized as a grantor trust for income tax purposes to avoid potentially triggering a large tax cost on the sale (with the proposed Regs, there is no other way). The most common approach is for the seller to retain a right to substitute property of an equal value to the Trust assets (i.e., the Widget business you sold to the trust). However, the right to substitute raises an issue in the context of a sale for a private annuity in that it could be viewed by the IRS as a retained interest that could taint the assets sold

New website helping charities serving those living with chronic illness:

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to the trust to be included in your estate. Other mechanisms are used by some practitioners to create grantor trust status (the right to borrow without adequate security; the right to add a charitable beni).

If the typical buyer defaults the seller would reserve the right to reclaim the assets under contractual default provisions. For a private annuity an estate tax risk is that the IRS may assert that you have retained excessive interests in the assets sold to the trust so that they should be included in your estate. So, your planner might suggest excluding this remedy. But limiting what might otherwise be a common remedy makes the transaction look less like a typical sale. This could be problematic from the perspective of "bona fide" requirements.

No third party should have the ability to render the annuity obligation worthless. See Rev. Rul. 76-491, 1976-2, C.B. 301. If FLP or LLC interests are sold to the trust exercise care in the entity governing docs.

Traditionally private annuities were expressly structured without any security. But since the proposed Regs private annuity sales are made to grantor trusts, so the analysis of security interests has changed. PP

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Review: Andrew Wolfe, CPA, Esq.

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...Checklist: GLBT Planning

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statute? What does it provide? Do the benefits of moving to a state that has more favorable law outweigh the negative impacts (job loss, costs of move, etc.)? Regardless of state law the federal Defense of Marriage Act will prevent you from obtaining federal tax treatment comparable to a married couple.

√ <u>Get Real</u>. You need to honestly assess your situation, not a hypothetical or idealized situation and communicate it clearly to the professionals you are working with. How does your family and others deal with your lifestyle choice? What type of safety net and support do you have in the event of illness? Is your family really going to cooperate with your partner if you are ill or die? Remember difficult times bring out tough emotions so what might be OK now may not be if a traumatic event occurs.

√ <u>Contract</u>. Use a living together or other contractual agreement to bolster and corroborate the decisions set forth in your will in case family or others seek to challenge your plans. A well crafted living together agreement can also minimize the difficulties if your relationship with a significant other terminates. You will not have the benefits of state law that govern the dissolution of marriage, so a contractual arrangement is important to fill in those and other gaps.

√ <u>Hostile Family</u>. Take appropriate steps to fend off a potential future challenge by hostile family members. Revise documents periodically to create a history confirming your wishes. Consider making lifetime gifts to those you name as heirs to establish a pattern.

√ <u>Trustee</u>. Consider the benefits of using an institutional trustee in your documents. They are not subject to the emotional whims or issues that a family member or friend may be. They can provide the objective and professionalism you may need.

√ <u>Agent</u>. Carefully evaluate who you would give the power to handle your financial matters if you are ill. Carefully review any proposed power of attorney. You may not really want or need a broad general power that gives your agent every conceivable power over your assets. A more restrictive durable power of attorney may be preferable. The best approach for many is a living trust with an independent or institutional trustee as the primary tool for disposing of your assets in the event of a problem.

√ <u>Health</u>. Be sure to clearly indicate your wishes in your living will and health care proxy. Address religious considerations specifically (what you do and what you don't want). If you have a partner specifically mention that your partner is your agent and that you want your partner to have all the same rights and privileges afforded to a spouse. For example, if you want your partner to be afforded the same visitation rights as a spouse if you are hospitalized, state that clearly in the documents. If you have any particular health issue, address clearly what it means in your documents. Standard form language can miss what is really important to you.

√ <u>Tax</u>. With the federal estate tax potentially returning with a $1 million exemption next year, plan to minimize estate taxes on transfers to your partner. This is challenging without the benefit of an unlimited marital deduction. Use lifetime gifts, GRITs, life insurance planning, and other techniques. Thanks Marianne

Recent Developments

<u>Surrogate Costs Not Deductible</u>. In addition to estate tax challenges, GLBT couples face income tax challenges as well. A recent case held that the costs of hiring a surrogate to bear a child is not deductible as a medical expense. Magdalin v. Commr., 96 TCM (CCH) 491 (2008) , aff'd without published opinion (1st Cir. 2010).

<u>Who Pays the Estate Tax</u>. Reality is that much estate planning is done by bank clerks. If you set up the ownership (title) to a bank or brokerage account as "Pay on Death" (POD) to your named heir, who pays the estate tax? If your will doesn't expressly make the POD beneficiary pay his or her fair share of tax, and your state law apportionment statute doesn't address it, they may be off the tax hook and the beneficiaries under your will may bear the cost. If we get a 55% federal estate tax rate next year, that's a whopper. Estate of Sheppard v. Schleis, 2010 WI 32 (Wis. May 4, 2010).

<u>Be Reasonable to have "Reasonable Cause"</u>. The taxpayer relied on his CPA to handle payroll tax payments and filings but the CPA didn't do either. If a taxpayer can demonstrate that there was "reasonable cause" and not the taxpayer's willful neglect penalties may be avoided. Penalties were imposed and the taxpayer argued that it had reasonable cause not to pay because it relied on its CPA. IRC Sec. 6651(a)(1). To qualify the taxpayer must demonstrate that it exercised ordinary business care and prudence. The court noted that a failure to file a timely return is not excused by reliance on an agent. Penalty assessments were upheld. McNair Eye Center v. Comr., TC Memo. 2010-81.

<u>S Corporations and Payroll Tax</u>. We've been warning you for a while that this is getting hotter! This is another case that is a sign of things to come. The IRS challenged an S corporation that paid its executive $24,000/year in salary and treated all other distributions as dividends not subject to payroll taxes. No research was done to corroborate what a fair wage would be. If you've been tax-naughty