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MARTIN M. SHENKMAN, PC
PO Box 1300, Tenafly, NJ 07670
Phone: 201 845-8400
Email: newsletter@shenkmanlaw.com
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Planning Potpourri

Charitable Powers. Powers of Attorney and Living Trusts could include the right of the agent/trustee to prepay a charitable bequest. Consider a mechanism in the document that allows the donation to be accompanied by a letter stating that it is a prepayment of the bequest. With the uncertainty of the estate tax this is a clever and simple technique. If there is no estate tax try to prepay the charitable bequest before death and get an income tax bennie. If the estate tax is reinstated the fiduciaries can pay it as a bequest for an estate tax benefit without your changing your will back again. Thanks to Steve B. Gorin, Esq. of Thompson Coburn.

Elective Share Lotto or While that Cat's Away the Caretaker Mice Will Play. Daughter was dad's primary caretaker. Dad, Howard, had dementia. While daughter was on vacation the caretaker, Nidia, married dad and later asserted a spousal right of election against his estate. During that same week Nidia changed title on a $150,000 bank account to joint with her, and had herself named as sole beneficiary of Howard's retirement plan. Busy week! Based on the law the caretaker had the legal right to elect against the estate, but the court refused because of the equitable principle that no one should profit from a wrong they commit. Campbell v. Thomas, 08-02246, App. Div. 2nd Dept., March 16, 2010. This was an appeal from Campbell v. Thomas, 36 AD3d 576! Think what this cost the family in terms of both dollars and aggravation!

The court's opinion begins by acknowledging that the abuse and financial exploitation of the elderly is a well hidden problem, and that the perpetrator is often a member of the victims own family! So your wonderful son the lawyer wants to be the sole agent and trustee for your 2nd husband if you're not able to serve! Just say no!

How can you protect yourself or a loved one? Annual meetings and coordination of all advisers is a great first step. Use an institutional co-trustee and a fully funded revocable trust (the bank won't marry dad and that bank account would not have been changed to joint!). Have periodic visits by an independent social worker/geriatric consultant to interview the subject in their home setting. If the safety net is weak (e.g., when daughter is on vacation) up the fre-

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PRACTICAL PLANNER

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

Guarantees in Family Transactions

Summary: In the real world guarantees are used to entice a lender to lend. How much attention was paid to the details and formalities of commercial guarantees? A recent legal newspaper stated: "...guarantees were often glossed over by borrowers entering into commercial real estate loan agreements..." The use of guarantees in estate planning related transactions has grown in recent years and the IRS isn't a fan of glossing over....

Why Use Guarantees?

When you sell interests in a family business to a trust, myth has it that the trust should be capitalized at 10%+ of value of the property sold. (Compare the folks selling home mortgages during the halcyon days of yore who made deals with less money down than it costs to buy a Starbucks!) As this myth has grown in stature, those structuring these deals are forced to contend with the $1 million gift exemption. The size of the sale transaction, if you subscribe to the 10% myth, is strictly limited by how much gift exemption you have left. The sale of a $50 million slice of your business would require a $5 million taxable gift to the purchasing trust, and a resulting gift tax of almost $2 million. Ouch! The magic elixir of guarantees to the rescue! Make a $1 million gift to the trust (this is called a "seed gift") and have the beneficiaries of the trust guarantee the first $4 million tranche of the note the trust issues to buy the $50 million of the business. Cool. While some practitioners view seed gifts and guarantees as being of biblical origin, others view them as superfluous. Suppose you subscribe to the Doctrine of Guarantees—what does it mean to the plan?

Why Do You Care?

Apart from being hot locker room chat, selling a family business to a trust remains one of the top estate planning techniques. When you factor in the possibility of discounting a non-controlling slice of the family company, the current depressed values, historically low interest rates that can be charged on the loan, now may be the ideal window of opportunity to sell business interests and freeze the value included in your estate.

The Real McCoy

The 10% myth perhaps began with Private Letter Ruling 9535026 in which the IRS suggested a 10% benchmark. However, the applicability of the PLR's concepts to current note sale transactions is not really clear. The real issue is whether the trust (or any entity) which is going to consummate a purchase has to have some minimal level of net worth in order for the transactions to be respected. Are some seed gifts and/guarantees necessary so that the sale to the trust will be respected by the IRS? Will the note the trust gives you be a bona fide installment obligation? If not, the transaction might be recast by the IRS as a gift to the trust of the asset transferred, which could mean a huge current gift tax bill. The IRS may argue that the business interest sold to the trust is included in your estate because you retained a prohibited interest .

Thin is not In

This isn't Curves. If the buying trust is too thin (thinly capitalized) adverse consequences can result. The IRS' favorite toy in the estate tax game is Code Section 2036. This provision does not apply to retained interests from life-

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Checklist: CGAs

Summary: Charitable Gift Annuities, or CGAs, are a popular investment/charitable giving technique. CGAs can be a great tool in certain circumstances, but too often they are used, nor avoided, for the wrong reasons. The following checklist will provide some guidance in understanding and evaluating this popular tool.

√ A CGA is a contract between you and a charity (tax-exempt organization) pursuant to which you make a gift to the charity in exchange for a guaranteed cash flow stream for your life, or the joint lives of you and your spouse (or another named beneficiary).

√ Benefits of a CGA can include: a monthly or quarterly cash flow stream for the rest of your life; payments that are generally fixed regardless of market performance; generally, no worries about asset allocation, monitoring a stock portfolio, market ups or downs.

√ Negatives of using CGAs include no flexibility. You cannot get at the principal you've given away. Your cash flow is higher, but there is an ill-liquidity. Your annuity is a fixed payment which may not keep pace with inflation. Solution -- limit the portion of your investment assets you use to purchase gift annuities.

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...Guarantees in Family Transactions

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time transfers for "adequate and full consideration in money or money's worth." Thus the validity of the note becomes integral to supporting the "adequate consideration" to avert an IRC Sec. 2036 issue. Inadequate capitalization of the trust with sufficient seed money could also raise the specter of Chapter 14 valuation issues. IRC Sec. 2702 applies to a transfer to a trust for the benefit of a member of the transferor's family if the transferor retains an interest in the trust. Unless an exception applies, the retained interest is valued at zero and the entire asset is deemed a gift. If the note is a valid indebtedness, then the transferor will not be deemed to have retained an interest in the assets sold to the trust. However, if the note is not respected the "interest" payments could be argued by the IRS as constituting a retained interest triggering IRC Sec. 2702 valuation rules.

Review: Andrew Wolfe, CPA, Esq.

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<u>Bottom Line</u>

The pertinent issue to the use of seed gifts and guarantees is whether there was reasonable security and a reasonable expectation of repayment. No magic 10% formula alone wins the day. Just like Sgt. Joe Friday, "Just the facts, Ma'am." Many tax experts advocate that guarantees be used in lieu of, or in addition to, seed gifts to enhance the economics of a note sale transaction, and the likelihood that the note will be respected.

<u>Evolution of the Myth</u>

If Joseph Campbell examined the tax cultures he would have found some interesting developments in the evolution of guarantees. *<u>1st</u>* no guarantees. *<u>2nd</u>* guarantees with no fees charged. *<u>3rd</u>* guarantees with fees. *<u>4th</u>* guarantees with fees ascertained by appraisers. This is the "conservative" approach suggests Dick Oshins, Esq. Some practitioners differentiate a beneficiary of the trust providing the guarantee since a beneficiary will benefit from the trust and thus has an economic incentive to provide the guarantee that a third party doesn't. So, a beneficiary may not need to be paid a fee. Bradford, 34 TC 1059 (1960), CCH Dec. 24,353 addresses a beneficiary protecting his interests in the trust, so that a guarantee fee isn't necessary. If the trust has assets to repay the loan, then what fee is really appropriate? If there is no value to the contingent debt for estate tax purposes how much compensation should be paid? In Cafaro Est. v. Comr., T.C. Memo 1989-348, no deduction was permitted because the loans were not in default.

<u>Its the weight of love, highs and lows, it's alright</u>

Some practitioners have advocated using the fees a bank would charge for a letter of credit to establish the fee to be paid for a guarantee. It's not clear that this is appropriate.

Kalman Barson, CPA suggests evaluating the following in determining how to value a guarantee: The amount of the obligation, how much is being guaranteed. Repayment timeframe Anticipated cash flow from the business. Credit worthiness of the business. Remedy and rights in case of default. The value of the guarantee could be a percent of the obligation – perhaps around 2% as a base point to be adjusted for the factors noted above. The percentage may be regional, depending for instance on what is typical for banks in the area. The fee may change from time to time. This concept is similar to the build up approach used in determining discount rates for future cash flows. Start with a base rate and adjust upward or downward for other relevant factors. With transactions so unique how "solid" can the figures be for base rates or adjustments? Appraiser Daniel Jordan suggests a different approach that appears more akin to a decision tree with weighted present values. Estimate the probabilities of different outcomes, e.g. a 20% chance of the guarantee being called, etc. Discount the expected values of each branch of the decision tree to a single net present value. The rate may depend on the type of investment. Another appraiser, suggested that the cost of stand-by letters of credit be used as a proxy for guaranteeing the debt (a service fee) and that these range from 0.2% to 0.5%. Another appraiser estimates fees

...Checklist: Charitable Gift Annuities

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The younger you are the lower the gift annuity payment rates. Under age 55 it probably doesn't pay to buy one. At ages 55-60 it might make sense. Over 60 it makes more sense. From 65-70 on, a gift annuity can be a good deal.

√ You transfer property directly to the charity directly which is used to purchase a CGA. The annuity payments may begin immediately (an immediate annuity) or be deferred until some future date (a deferred annuity).

√ To more easily understand CGAs view your transfer of property to the charity as a charitable contribution and a separate investment in an annuity. The 1st part is the donation. You get a charitable contribution deduction when you donate property for the CGA based on the present value of the annuity you'll get back. Your deduction is the excess of the value of the property you donated over the value of the annuity. The value of the annuity is calculated using the tables prescribed under Code Section 7520 (Table S for a single life; Table B for an annuity for a term certain; Table R(2) for a joint and survivor annuity).

√ The 2nd part is the purchase of an annuity. The tax basis of the property you donate for the CGA must be allocated between the portion donated to charity and the portion exchanged for the annuity. IRC Sec. 1011(b). Part of each payment is treated as a return of your investment and isn't taxable. Part will reflect the interest (income) you've earned on the annuity and be taxable at ordinary income tax rates. Finally, if you donated appreciated capital gain property (e.g., stock held for investment) part may be treated as long-term capital gain and taxed at more favorable rates. The gain is generally reported over your life expectancy (from Table V of Reg. 1.72-9) using an "exclusion ratio" calculated on purchase. Theory was that you'd be getting your charitable deduction while working and subject to higher tax rates, but report the income portion of the CGA in your retirement years when in a lower tax bracket. Well folks, you may face higher rates in retirement as Uncle Sam deals with the growing deficits. CGAs can still be groovy, but don't count on the tax arbitrage.

√ CGA rates are typically set by the American Council on Gift Annuities, and are conservative to increase the likelihood that the charity will realize a meaningful donation when the CGA ends. This is why you should have charitable intent for a CGA to be worthwhile.

√ If you name another person (other than a U.S. citizen spouse) there may be a gift tax implication to the purchase. If the value of the annuity interest exceeds the annual gift exclusion (currently $13,000) you'll have made a taxable gift. There can be estate tax implications too. If you die first, the discounted value of the payments to be received by the survivor annuitant are included in your estate (well, when they reinstate the estate tax). If the surviving annuitant is your spouse that amount may qualify for the estate tax marital deduction and avoid tax. If it is anyone but a spouse it will use up your remaining estate tax exclusion (not applicable this year, $1M next year) and if it exceeds that, tax will be due.

√ CGAs are regulated by each state so for information as to the safety of a particular charity and the requirements it must meet, check with the

Recent Developments

<u>Trust Protectors</u>. Lot's of folks have integrated a raft of new fangled positions into the ever increasingly complex trust instruments that have become more common. There is little law on these positions so that while using snazzy titles can potentially be helpful, caution is in order. In a recent case the trust protector was sued for not monitoring trustees, not preventing theft of trust assets, and breach of loyalty (they argued that the protector was more loyal to trustees then to the beneficiaries). The Court struggled with the issues since state law didn't provide any direction. See UTC Sec. 808. This was a case of first impression. The Court considered the trust document which gave powers and said trust protector was a fiduciary. It gave the protector the power to remove the trustee and appoint a successor, but no standards for these acts were provided. The trust protector had the power to resign and appoint a successor. The Court held that the trust protector had a fiduciary duty but did not define the scope of those duties. The trust exonerated the trust protector for acts taken in good faith. The Court said this implied that the protector would be liable for acts which were not in good faith. What if the Trust Protector doesn't even know he is appointed trust protector? What are the duties? Are they a fiduciary? Is the protector supposed to do the same things that a trustee is required to do? Some states require that the protector submit to jurisdiction in the state of situs. Did the trust protector sign the document accepting the position? If not, how can you hold him liable? So given all the above, how can you protect the trust protector? Can you protect the protector by stating that if they make a mistake they should not be sued. Robert T. McLean Irrevocable Trust v. Patrick Davis, P.C., 283 S.W. 3d 786 (Mo. Ct. App. 2009). Hey folks, you've read it here dozens of times, hold an annual trust meeting with all advisers, fiduciaries and other key people present. You cannot operate a sophisticated trust successfully without doing this. It just won't work! Got it? PP