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PRACTICAL PLANNER[®]

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CASE LAW TREND: FORMALITIES REALLY COUNT

Summary: There have been several recent cases indicating that the formalities of a plan are vital to adhere to if you want the IRS and Courts to respect them. If you want your plan to succeed, scrupulously observe formalities. Yet, most taxpayers don't want to be bothered with the hassles or costs of plan administration by a collaborative team of advisers. Four recent cases certainly suggest that perspective could be detrimental. See the Current Development article on Connelly below.

■ **General Lessons:** The cases discussed below present practical lessons for estate planning. Understanding what was done right/wrong provides guidance on how to better structure and implement estate plans. What about the step transaction doctrine? How should you implement and administer a defined value clause? What steps should be taken in terms of tax reporting, entity records and trust records to support a Wandry clause or other planning step? Consistency, avoiding circularity of transactions, and much more all should be addressed. Related party transactions, which includes most estate plans, are subject to close scrutiny, so greater caution is in order.

■ **Smaldino v. Comr.**, T.C. Memo. 2021-127 (November 10, 2021): Mr. Smaldino ("Mr. S") purportedly transferred about 41% of an LLC's membership interests to his wife on April 14, 2013. Mrs. S purportedly gifted those same interests to the family dynasty trust which benefited Mr. S's children from a prior marriage the very next day. The Tax Court recharacterized the claimed gift Mr. S made to Mrs. S, followed by her gift to the Dynasty Trust, as if Mr. S himself had made the gift directly to the Dynasty Trust. Mrs. S held the interests only for a day, if she held them at all. The transaction was circular in that Mrs. S transferred the same exact interests she received from her husband as a gift to her, as her gift to the Dynasty Trust. The family skipped many steps that should have been followed to corroborate that they respected the transaction. No K-1 was issued to Mrs. S. for the day she supposedly held the interests. She never signed an operating agreement. Assignment documents had an effective date but no date actually signed. No gift tax return was filed reflecting the gift made from Mr. S. Mr. S did not adhere to the formalities of the operating agreement (he ignored an approval process). While in *Holman v. Commissioner*, 130 TC 170 (2008), aff'd, 601 F.3d 763 (8th Cir. 2010) the Court accepted six days as sufficient time between phases of a plan, longer periods and independent economic events (distributions, etc.) should be the goal between phases.

■ **Smaldino Lessons:** Have meaningful time and real economic consequences between steps of the plan. The plan should make sense. Income and gift tax compliance must

reflect the steps of the plan. Respect requirements in governing documents. Have a date documents are actually signed in documents even if there is a different effective date.

■ **Levine Est. v. Comr.**, 158 T.C. No. 2 (February 28, 2022), was a taxpayer victory in an intergenerational family split-dollar estate tax case, but it has lessons for how to do most estate planning better, in particular with a focus on formalities and independence. "Swanson [the estate planning attorney] spent a good deal of time thinking through all the advantages and disadvantages, conditions and qualifiers. He put together a PowerPoint

presentation for the family... Then ... he sent a letter to Larson and the children in which he described the transaction and its legal and tax implications." The planners gave meticulous attention to detail. Too often this degree of care does not happen, primarily in many cases because clients do not wish to incur the additional fees to permit their advisers to operate in this manner. The Levine Court noted: "From the beginning, Larson [the independent trustee of the ILIT] and Levine's children made it clear to Swanson [the estate planning attorney] that Lev-

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CHECKLIST: LTR INSTR.

Summary: A key non-legal document to help inform family and fiduciaries of both your wishes and key information are letters of instruction you can prepare. Whether you prepare one general letter or several letters for different people and serving different objectives will depend on your circumstances and wishes. These non-binding instructions can inform heirs of your wishes, fiduciaries of how you want financial and other matters handled, and each appropriate person of key financial and other information that may help them help better.

√ **ICE – In Case of Emergency:** A key purpose of a letter of instruction is to tell someone (e.g., the agent under your

power of attorney for financial matters and the agent under your health proxy for medical decision making) what your wishes are and some of the key information they may need to take action. Indicate where original legal documents are (e.g., home safe).

√ **Financial Info:** Indicate where key financial data is maintained and how to access it. What bills have to be paid and how can they determine that information? If you use a computer explain what you use, which device it is on, and how they can get help if they are not familiar with it. If you use a manual check register explain where you keep paper

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...LEAD ARTICLE TITLE

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ine wanted enough money to maintain her lifestyle until her death. This meant that any estate planning needed to be done with Levine's excess capital—i.e., assets that she would not likely need during her lifetime." Preserving adequate resources for the taxpayer engaging in planning is important to deflect a challenge of, for example, an implied agreement with the trustee of a trust, etc. Only Larson, the independent insurance trustee had the right to prematurely terminate the life insurance policies. These arrangements gave the other two attorneys-in-fact, who were family members of the decedent, no rights to terminate the policies or the arrangement itself. South Dakota Trust Company was the general trustee of the trust and was an independent institutional trustee. The use of not just an independent trustee but an independent institutional trustee seemed favorable to the Court.

■ **Lessons from Levine:** Take the time and make the effort as the taxpayer to understand the plan. You may not

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need to dive deep into the weeds, but be certain to be comfortable with the big picture. Pay your advisers to prepare memos and schematics explaining the plan. Have meetings with all advisers to discuss the plan so you understand the implications from each lens. The Levine Court praised the taxpayers and their advisers for doing just this. Yet many feel they are saving a few bucks by not paying their advisers for these steps. Bad move. Strive for deliberate careful planning. In too many plans, clients do not have advisers prepare forecasts corroborating their financial position after proposed transfers are made. The financial adviser should be integrally involved in the planning process and prepare forecasts demonstrating that the taxpayer has sufficient assets to reasonably meet lifestyle expenses. If financial gaps are identified in the plan, tweak the plan to make it more viable, and when appropriate, have an insurance consultant offer insurance options that may address certain risks (e.g., premature death of a spouse in a SLAT type plan). You might feel warm and fuzzy having your brother or cousin serve as trustee, but don't. Name an independent, ideally professional, trustee. While not relevant to the case, the trust in Levine was in South Dakota, a trust friendly jurisdiction. Why not use trust friendly jurisdictions if the values are sufficient to warrant the modest additional costs involved?

■ **Sorensen v. Commissioner, Tax Ct. Dkt. Nos. 24797-18, 24798-18, 20284-19, 20285-19 (decision entered Aug. 22, 2022)** highlighted the importance of proper documentation and implementation of planning. Is that starting to sound like a common tune? The taxpayers tried to give a gift of a fixed dollar value of shares, \$5M worth, to a trust. That is patterned after a successful case, Wandry, in which the taxpayer did just that. But in Sorensen, the taxpayers did not respect the formalities of the plan that they purported to do. The Court found that the donors relinquished control of all the shares, so that the gift was of the full amount of shares, not the \$5M worth of shares contemplated under the Wandry fixed dol-

lar transfer. The reporting by the entity didn't comport with the defined value transfer. The company reported that each trust owned 9,385 shares on its stock ledgers and on income tax returns. The stock ledger and tax returns should have included a reference explaining the actual transfer was \$5M worth of shares

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which was estimated at 9,385 shares. The trusts received pro rata distributions based on the ownership of 9,385 shares. Those amounts should have been subject to adjustment based on finally determined gift tax values. The transferors and their trusts should have obligated themselves to make adjustments between themselves if the shares were changed on audit. The trusts should have countersigned the stock powers to acknowledge the conditions under which they were receiving the stock.

■ **Lessons from Sorensen:** Be certain every record of the transaction consistent reports in a manner consistent with the actual valuation adjustment mechanism used. If stock is transferred pursuant to a defined value clause, the stock ledger, stock certificate, shareholder's agreement, transferee trust records, and tax filings, all reflect the proper formulation of shares transferred. Adhering to formalities in all transactions is vital to success. A preferable approach might be to not have the equity interests pass to the donee trusts, but rather to instead be held in escrow with an independent escrow agent pending resolution of the contingency of the gift tax value as finally determined. Incorporate into the transfer documents an economic adjustment mechanism to assure the economics of the transaction are properly adjusted as between the parties. PP

...CHECKLIST: LETTERS OF INSTRUCTION

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checks and the check register. Even if you don't disclose all financial information set forth the practical information necessary to get bills paid.

✓**Health Care Info:** Provide key health information, indicate where health records are maintained (e.g., on a laptop, in a file or loose-leaf binder in your home, etc.). Contact information for key medical professionals should be listed, e.g., your internist or primary care physician, specialists, if you have a particular health challenge. List health insurance info. Where can your health care agent find your health insurance and drug cards or at least the information on them? What types of health care decisions do you want made? Are their religious considerations? What end of life decisions do you want?

✓**Key Family, Advisers and Others:** List of positions, names and contact info that may be helpful for everyone to see so that they know if certain actions they might have to take may in fact be in the purview of someone else. The listing should be by categories that make sense for you. Some of the positions/relationships you might list: ■Professional Advisers: estate planning attorney, CPA, life/disability insurance consultant, property casualty and liability insurance consultant, banker, trust officer, business/corporate attorney, etc.

■Family: parents, siblings, spouse/partner, children, others.

■Fiduciaries: trustees of trusts, executor (Personal representative under your will), financial agent under your power of attorney, agents under your health care proxy, funeral agent, ■Representative for receipt of social security benefits. ■Who has access to your safety deposit box.

■Long term care insurance lapse designee. ■Successor "owner" under 529 accounts.

✓**Passwords:** Account info, passwords, and other critical data for credit cards, bank and other financial accounts, utility companies, vendors, etc.

✓**Key Financial Info:** ■Credit card info; ■Bank and Financial Accounts: Type of account, name of institution, name of broker/banker, contact info,

account number, password, and other pertinent information. ■Budget.

■Balance Sheet/Cash Flow or Income Statement. ■Debts/Loans: Name of lender, account number, how payments are made, when due. Include home mortgages, credit card balances, etc.

✓**Real Estate and Private Equity:** If you own interests in real estate rental properties, private businesses, etc. provide key information here.

✓**Key Personal Info:** ■Driver's license. ■Passport. ■Social Security Number. ■Birth certificate.

■Key Insurance Information.

✓**Planning Goals:** This is an important part of many letters of instruction, and the first and most common matter many people think about. This is personal instructions to those you love, or to fiduciaries (e.g., those serving as trustee of

trusts) as to what your wishes are. Explain your wishes for how your wealth should be used to care for you in the event of your aging, illness or incapacity. If you create trusts for heirs, especially minors, you might indicate your wishes as to their care and upbringing, how money should be spent for their lifestyle and needs, and other personal wishes. Should private education be paid for? Summary travel, camps or other programs? For older children, should they receive help buying a house? Any parameters to that assistance? One client referred to this as the "two tissue box letter." It may be painful and sorrowful to imagine how children or other loved ones should be cared for if you become incapacitated or die, it can be very important to protect your wishes and help those you love. **PP**

RECENT DEVELOPMENTS

■ **Connelly:** It is common to have a closely held business own life insurance on the owners (e.g., shareholders if it is a corporation). When an owner dies the business uses the life insurance proceeds on the owner's life to buy the equity interests the owner held at death. Since the corporation, not the other shareholders, are purchasing the deceased shareholder's stock it is called a "redemption." This is a simple way to keep the stock or other equity interests in the hands of the remaining active shareholders. But the Court held that the value of insurance used for the buyout had to be included in the valuation of the business (and hence in the shareholder's estate), and the value of the buyout obligation could not reduce the value of the business. The result was that insurance funded redemption agreements may create a "phantom" value in the shareholder's estate increasing estate tax costs. *Connelly v. IRS*, No. 21-3683 (8th Cir. 2023). Some suggest expressly stating in the buyout contract that the insurance won't be included in the business value, but it is not at all clear that will suffice to avoid estate inclusion. The only safe bet may be to use a cross-purchase agreement in which each shareholder buys life insurance on each other owner and contractually obligates them to buy those shares. Also consider an insurance LLC structure. That could be more costly and complex especially as the number of shareholders increases (3 shareholders would require 6 policies in contrast to only 3 in a redemption arrangement).

■ **Connelly Another Lesson:** Connelly is also another case stressing the importance of taxpayers adhering to the formalities of the deals they structure. In that way, Connelly echoes the same message as the cases discussed in the lead article. The stock-purchase agreement provided two mechanisms for determining the price at which Crown would redeem the shares. The principal mechanism required the brothers to execute a new Certificate of Agreed Value at the end of every tax year, which set the price per share by "mutual agreement." If they failed to do so, the brothers were supposed to obtain two or more appraisals of fair market value. The brothers never executed a Certificate of Agreed Value or obtained appraisals as required by the stock-purchase agreement. **PP**

PRACTICAL PLANNER® NEWSLETTER

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PLANNING POTPOURRI

■ **Is Financial Disaster Lurking:** A recent study noted that pre-retirees expect to spend just 58% of their current household income in retirement. Yet 1/3rd of actual retirees who participated in the study are spending at least 75% of their pre-retirement income in retirement. In another study participants felt they needed to earn \$233,000/year to be financially secure and \$483,000/year to feel rich. Yet, median earnings for a full-time, year-round worker in 2021 was \$56,473. What's the common theme? People's financial perceptions are dangerous to planning and financial well-being. Too many underestimate what they'll need in retirement. Too many set their financial wishes far higher than what they will ever achieve, thereby setting themselves up for disappointment. While these studies did not focus on the wealthiest Americans, the misconceptions may differ but the mistakes may be similar. Having a realistic budget and financial model, and doing one of the hardest things

that can be done, reducing your lifestyle, may be what many people really need to do to get on track. Folks making this mistake may well spend down their estates leaving little for heirs so that their estate plans may be wishful thinking at best. Is your financial adviser really giving you the tough news you really need to hear? Or is she sugar-coating the bad news? Have you given your advisers the permission to tell you the tough truth?

■ **Email Mistake:** Don't use your business email for your financial and estate planning communications. You probably shouldn't have that personal info on an office computer accessible to partners, reach in litigation by a plaintiff's counsel, or viewable by business employees or business IT consultants. Set up a personal email address and get the same cybersecurity protections you would like for your business.

■ **Cohabitation:** Many people cohabit without being married. Getting a written agreement governing your rela-

tionship could be important to protecting both of you and avoiding legal conflict if the relationship ends, or one of you dies. Hire family counsel to get it right and discuss whether a cohabitation agreement might avoid issues. That might require full financial disclosure and some degree of fairness in terms. Creative uses of trusts might protect you and can help avoid gift tax issues on transfers you make to a non-spouse. Gifts in excess of the annual exclusion (\$17,000/year in 2023) have to be reported on a gift tax return and will use some of your lifetime exemption (if you have any left). Caution: state laws are quite different. PP



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