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PRACTICAL PLANNER

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UGLIEST 2012 GIFT PLAN

Summary: "Ugliest 2012 Gift Plan." Just like Ripley's Believe it or Not! where "Truth is stranger than fiction," this plan was real. Fortunately the taxpayer appears to have been saved from disaster, but their "plan" is a great checklist of everything you <u>don't</u> want to do in your 2012 gift plan. Space limitations have forced us to leave off other winning facts! It's best to plan, work with a coordinated team of experienced planners: attorney, CPA, wealth manager, etc. to minimize the likelihood of problems. 2012 planning has complex nuances.

■ <u>Form a New LLC</u>: This client had a limited liability company (LLC) that had been around for years, yet the advisers set up a brand new LLC to use for the gifts. If you don't have an LLC (or other suitable entity) and using an entity makes sense in your transaction, then setting up a new one is the only alternative. Setting up a new entity instead of using an existing entity will only heighten tax and asset protection risks. While the old and cold entity might have an established business purpose, will the newly formed entity? Elsie J. Church v. US. Gifts of non-controlling interests in LLCs can qualify for valuation discounts (i.e., the value of a 20% interest in the LLC is less than 20% of the value of the underlying assets).)While 20% of an LLC is worth something less than 20% of say the securities portfolio the LLC owns, securities are worth their actual value. The LLC interest may be discounted because a 20% owner cannot control the vote, distributions, etc. Using a long existing LLC, in the view of some advisers, may be more secure. If you have an asset like an operating business or rental property you certainly want it held in its own LLC to protect your other assets from a potential lawsuit that the business or rental property might create. But if you have an existing investment LLC, setting up a duplicative new one will only increase the costs, tax risks, and complexity.

■ <u>Transfer assets into the LLC 2 Days before Making Gifts</u>: Say you want to put assets into an LLC and then gift non-controlling LLC interests to trusts. Those non-controlling interests should be valued at a discount from the underlying asset value (see above). However, if you plop assets into the LLC just prior to the gift, the IRS will say that the gift was really of the underlying assets and that the LLC "envelope" holding those gifts should be disregarded. Shepherd v. Comr. Poof! Your hoped for discount disappears. Just like a fine wine, assets must be appropriately aged to develop the discount bouquet. Two days barely makes vinegar.

■ <u>Have Documents Notarized in Different States</u>: You sign documents in State A, but your lawyer has a notary in State B notarize key transfer documents. Hmmm, absent a little "Beam me up, Scotty" transporter action, that just isn't possible. The IRS or a creditor might challenge the validity of the document and the entire transaction. Estate of Senda.

■ <u>Put Personal Use Assets in the LLC</u>: If an LLC is supposed to be respected as a legitimate business and investment entity, it should not own personal use assets. Putting your house into an LLC and continuing to live there without paying rent will sink the plan faster than you can say "Supercalifragilisticexpialido cious." Reichardt v. Commr. Well, a residence used by your family member free of rent might differ from the facts in the Reichardt case since it's not you, but free family use of personal property will torpedo the LLC too.

■ <u>Have Lots of Back and Forth Unsubstantiated Loans</u>: Undocumented loans between the LLC and its members and other family entities might be

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CHECKLIST: HOW MUCH GIFT?

Summary: Everyone is talking about the importance of making big gifts in 2012, but the critical question for many, is how much can you realistically afford to gift without jeopardizing your own financial security? What some advisers are proposing as "conservative" may preclude planning. Many clients are being misadvised in the name of an illusory "conservative" approach.

√ What are all of your personal goals? You cannot make a reasonable decision without laying all the cards on the table. Is assuring maximum resources for what hopefully will be many remaining years of retirement key? What are your ages and health status? What is the potential for a long joint life expectancy? What is really necessary to assure financial resources until the second of you dies (if you are married or have a partner)? The prerequisite for those wealthy enough to plan, but not so wealthy that what remains will assuredly cover all future costs, are projections.

√ Some planners might suggest that you "run the numbers" assuming very low growth rates to be "conservative." But is that really the right answer? Using a consistent low investment return may even understate your performance if there is a market drop in early years of

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...Ugliest 2012 Gift Plan

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recharacterized as equity, compensation, gift transfers, etc. depending on the circumstances. Miller v. Comr. An excessive amount of undocumented loans might jeopardize the LLC.

■ Leave the Donor Cash Poor: If you're left with inadequate assets after the transfers to the LLC and trust to support yourself, the transfers could be deemed a fraudulent conveyance indicating that the LLC is not valid as you would have to be able to retrieve cash from it to live. In our worst case scenario the taxpayer was left with a mere $3,500 in cash in his name. That fact alone would likely torpedo the gift plan. Estate of Harper; Estate of Reichardt; Estate of Schauerhamer.

■ Don't Get an Appraisal: Four months after the purported transaction was completed the lawyer wrote the clients suggesting they obtain an appraisal of the LLC interests given. Consummating a $5 million gift without a formal appraisal of the LLC interests is certainly inadvisable. While in the recent Wandry case the appraisal was completed after the gift the transfer documents clearly limited the dollar amount specified and there was a commitment to obtain a qualified appraisal. Winging it just isn't sensible and gives no protection in the event of an audit.

■ Don't Sign Appropriate Post Gift Documentation: If you gift away 80% of an LLC, there should be a post-gift operating agreement signed by all the owners and confirming the ownership percentages. In this worst case scenario nothing was done for more than a year after the assignments were executed. No current operating agreement.

■ Be Sure the Donor Didn't Understand the Transaction: The IRS has taken a liking to asking taxpayers to explain the transactions they were involved in. If the taxpayer had no clue as to what deal was done, how or why, you may as well just start praying that the taxpayer is not questioned by the IRS, or the plan will assuredly flop.

■ Use Effective Dates and No Real Execution Date: Proper execution of documents to assure their effectiveness is important. Proper dating of documents to assure that the sequence of events occurred as appropriate, and that there was sufficient time between different steps of the transactions (whatever those time frames might be) is vital. If your attorney prepares key documents signed listing an effective date, but not a date of your actual signing, you can't demonstrate what time frames existed between steps, or the order in which steps actually occurred.

■ Pay Personal Expenses from the LLC: Paying personal expenses from a family entity is contrary to respecting the entity for tax and legal purposes. If past practices were lax, clean them up before any transfers.

■ Don't Open an LLC Bank Account: Without the fundamental business formality of a bank account how can the LLC pay its own bills? How can it possibly look real?

■ Don't Use a Defined Value Clause: In the wake of the Wandry case, some advisers are suggesting a more frequent use of a defined value clause that establishes a gift of an intended dollar value of LLC interests rather than a percentage of LLC interests. When gifts are made of hard to value assets, like LLC interests that may be discounted, especially when the LLC owns minority interests in other entities that hold hard to value real estate assets, and when you're pushing up to the line of your $5.12 million gift exemption, some type of safety valve, like a Wandry defined value clause should at a minimum be considered.

■ Show LLC Assets on the Donor's Balance Sheet: If you want to convince the IRS that the LLC is, in the words of Dr. Phil, the "real deal" you really should consider separate LLC financial statements, but you absolutely don't want to show your pro-rata share of underlying LLC assets on your balance sheet. That is tantamount to corroborating to the IRS that there should be no discounts because the gift was of underlying assets, not discountable LLC membership interests.

■ No Documentation of Capacity: 50% of those over 85 have some cognitive impairment. If you're a donor in her late 80s counsel should at least corroborate that you have adequate capacity to sign the gift documents. PP

2012 Estate Planning: Tax Planning Steps to Take Now, new 200 page book by Shenkman, Blattmachr and Keebler available as an e-book on www.amazon.com for $39.95.

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...Checklist: How Much Can You Gift?

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your projections. It might also so understate the anticipated return that it will preclude you from really achieving your gift and other goals. More sophisticated simulation models may better help you gain a level of comfort, and delineate a more robust gift plan.

√ Whatever projections are done, life expectancy has been increasing, future inflation rates are difficult to predict, and possible health issues and the state of government and insurance programs to offset health care costs are a significant uncertainty. And since you've lived through the Great Recession investment risk must be a worry. But using worst case scenario projections won't protect you any better than going on a diet and using "very low" calorie estimates for the food you eat. It would be a fun diet but not very productive.

√ Some planners suggest running illustrations out to age 100 years; others suggest that if there is longevity in your family, run it out to 120. One well known planner suggests: "…run to some age that you think is well beyond the point you will actually live to, and show a high inflation rate and a low rate of return." That may eliminate any incentive to make gifts when you can and should. Importantly it ignores the tremendous flexibility that trust drafting can provide. You might make a gift to a self settled trust of which you, your spouse, and all descendants are beneficiaries. This way you can receive distributions if needed. Your spouse or partner might fund another non-reciprocal trust that names you and descendants as beneficiaries. One of the assets you might gift to the trust might be a close business from which you will continue to draw a salary.

√ Excessively conservative financial projections will be damaging to making gifts. Perhaps a more sophisticated approach can achieve more objectives: facilitate maximizing gifts, deflecting any fraudulent conveyance claims by creditors (e.g., you gave away so much as to render yourself insolvent), rebutting an IRS challenge that you had to have an understanding with the donee's to give your money back since you failed to retain sufficient assets, all while assuring your financial security. What approach may achieve all these goals? Perhaps model a result that gives you an 80% probability of achieving your financial goals. Then gift sufficient funds into a self settled trust (domestic asset protection trust or DAPT) to assure a much higher probability of achieving your financial goals. The excess over that can be given to a dynastic trust that you are not a beneficiary of. Making unreasonably "conservative" projections ignoring the nature of the donee trusts is not conservative but dangerous!

√ The core of the above decision must be a budget and financial plan that assures that both of you retain resources you need for your future, from whatever sources. Intelligent financial planning must lead the estate plan. You cannot gift completely away assets that the financial plan shows are essential for your financial needs. You can gift away assets to your children or trusts for them that the financial plan demonstrates you will never need. Some amount of wealth, perhaps unlikely to be needed by you, but which might be needed by you, could be gifted in a manner that permits you access to it "just in case" you should need it. PP

Recent Developments

■ <u>Hug Your Appraiser</u>: The Court denied a real estate developer's charitable contribution deduction for $18.5M of real estate donated to a charitable remainder unitrust (CRUT) because he did his own appraisals and failed to satisfy the substantiation requirements. Mohamed, TC Memo 2012-152. Lot's of folks making donations or gifts get cheap on the appraisals. This case is a painful lesson that a good appraisal may well prove money well spent.

■ <u>Madoff</u>: Losing money to Madoff was devastating, but having an estate tax assessed on assets that really didn't exist is beyond reason. A recent NJ taxpayer victory, by David Edelblum, Esq., protected taxpayer's rights to avoid this painful result. The decision validates that tax laws, to be given efficacy, must reflect common sense and be equitable. The court recognized that the estate tax can only be imposed if there is wealth transferred based on economic reality, and not based on fictitious brokerage statements that perpetuated the underlying Ponzi scheme. Most importantly, the court looked to Federal tax principles and stated that events that come to light after date of death but that impact on the true value at death must be taken into account. Thanks to David Edelblum, Esq. Feingold & Edelblum, LLC, Hackensack, NJ.

■ <u>Reimburse Taxes</u>: Grantor trusts are popular especially for 2012 gifts. But if a grantor trust sells an asset at a large gain, you have to bear the tax. That actually is the whole point, because that reduces your estate for estate tax purposes and creditor protection. The trustee can have the discretion to reimburse you for the taxes, and that discretion won't cause the trust to be taxed in your estate if state law doesn't result in that discretion making trust assets reachable by your creditors. Revenue Ruling 2004-64. NJ might be amending its law to permit reimbursement. Before running to create a trust in NJ, remember that Alaska, Delaware, Nevada and South Dakota lead the way in trust friendly jurisdictions and there are better options to tax reimbursement. Instead have the trust loan you funds to cover taxes. See NY EPTL 7-3.1(d). PP

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Planning Potpourri

Pet Planning: Take affirmative steps to protect your pet. Draft a letter of instruction for whoever will step in to help in an emergency. Save key pet records electronically and inform them where they are (vet records, licenses, vaccination records, etc.). Create a checklist of care that is appropriate, a listing of likes and dislikes. Save this letter in the same electronic folder and give a hard copy to those who will be responsible for your pets. Introduce the potential care takers to your pets in advance and show them some of the important nuances of care. Include in your durable power of attorney (pets are treated as property under the law) authority and direction to care for pets. In your will you could bequeath your pets to a particular caregiver. Name successors. Decide if you wish to leave money to the caretakers to defray the costs of caring for your pets, and whether you want to do more and leave them money as an incentive to provide good care. Do you want to have the money and pet held in a trust so that someone has a fiduciary obligation for the care of the pets? State laws differ and this may not be legal in your state, and your state may put caps on how much you can give to such a trust. If you set money aside for care and it is not used, in the trust you can mandate that it be given to an appropriate pet oriented charity. Make a non-legally binding request—excess funds be given to charity.

■ **18th Birthday**: If your kid recently turned 18 there are steps to take. Consider transferring the car title to her, but be sure there is adequate auto and excess liability coverage. She should sign a durable power of attorney and health proxy for emergencies. Even if she has negligible wealth a power of attorney can be important to help out. If there are any trusts for her you should review them and see if they have an age based payout that is triggered. For example, many old style trusts have a mandate to pay income beginning at age 18. UGMA accounts might end. If she has a job encourage her to start an IRA and get a credit card to build her own credit record. Teach her how to get free credit reports and monitor her status.

■ **Don't Get Scammed**: If you get an email fraud alert don't call the number in the email. Instead call the main number for your bank, or the credit card number on the back of the card and let them connect you to their fraud unit. If the email itself is a scam this will prevent you from getting a fake "fraud department" number. PP

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