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PRACTICAL PLANNER

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PLANNING POTPOURRI

Springing Powers: What if you're uncomfortable handing over all rights to a child now under a power of attorney while you are still capable of managing your own affairs. Is a springing power of attorney the answer? A springing power is a power of attorney that only becomes effective if you (the grantor or person signing the power) become disabled. This approach addresses the exact concern raised. You don't provide powers to your kid as agent until you really need the help, i.e. when you cannot handle matters on your own. While this sounds seductively good and simple, as the saying goes, the devil is in the details. If you cannot trust your kid while you're alive and well, why and how can you trust the kid to do right when you're disabled? The entire concept of a springing power is often questionable. How do you define disabled such that the power of attorney "springs" into ef-

fect? Not such a simple definition. If you have a temporary illness is that sufficient? What is? What if you recover? How do you get the financial reins back from junior? All these issues can be dealt with but they add complexity. Don't forget HIPAA. This law imposes strict limitations on the disclosure of medical information. To prove disability you need to address these requirements. Once you get through all that your kid will have to convince the bank or other person to accept the power, not always so simple. So a springing power can address a common parental worry, but it creates a host of issues. A power effective immediately might mitigate some of the concerns. A funded revocable living trust can provide an even more comprehensive alternative. The bottom line is, even a power of attorney, which too many people dismiss as "simple" and "standard" is fraught with issues that you can only ignore at

your own peril.

FLP/LLC Funding: Some courts have looked askance at FLPs and LLCs that delay funding after formation, or whose partners/members leave time lags between each making contributions. These delays happen regularly in the non-family world in deals with real independent parties. Consider including in the partnership or operating agreement a clause giving the GP or manager the right to make any equitable adjustment to address the problem. **PP**

Contents: Tax Moment of Truth p. 1 Competency p. 2 529 Plans; S corporations p. 3



Practical legal stuff...
in plain English

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THE MOMENT OF TRUTH (TAX EPISODE)

Summary: Fox has a great new show that could be the paradigm for future IRS audits. Forget IRS agents and field audits, when your number's up...onto the show you go. You'll be strapped to a lie detector and asked a series of questions by an IRS polygraph expert. You want your refund, you have to pass through the gauntlet of piercing questions. To give you a taste of what you'll be facing we've asked a hypothetical client some tough questions on their tax filings. Would you pass muster? What if we strap your favorite CPA into the chair after you? For estates, the IRS will use its Ouija board version. The time has come for you to face your tax moment of truth. For the first \$10,000 of your refund, you have to answer six questions:

Question #1: Do you have anyone working in your home for whom you haven't paid payroll taxes? What about maintaining the proper records? Fess up honey! The fact that so many people ignore these rules doesn't relieve you of the responsibility, Zoe. They must complete U.S. Immigration Services Form I-9 and submit appropriate documents proving eligibility to be employed. You are required to withhold Social Security and Medicare taxes at 7.65%, match those amounts and remit it all to the IRS. Federal unemployment taxes, and perhaps state taxes may be due. Don't overlook worker's compensation insurance.

Question #2: Have you ever used your Lexus SC 08 convertible business car for non-business travel? Your business purchased the car for you to use as an employee of the business. You're required to substantiate the business versus personal use of an employer-provided car with adequate written or computer records. IRC Sec. 274(d). Car use not substantiated by adequate records is considered personal use. Temp. Reg. 1.274-5T(e). Your records must substantiate the amount, date, and time of use. An exception exists if your business adopts a policy that prohibits anything more than *de minimis* personal use. Temp. Reg. 1.274-6T. Of course every trip to the golf course was to play with business contacts only.

Question #3: Are all those medical expenses you reported really qualified tax deductions? Have you snuck in a few things that are really not legit? Not every "medical" type expense is deductible. The costs of elective cosmetic sur-

gery are not deductible. Teeth whitening and marriage counseling costs are not deductible. A weight loss program is deductible only if to relieve a disease (did you get your doctor's note?). Rev. Rul. 2002-19. Stop smoking programs are deductible, but patches and gum are not. Rev. Rul. 99-28. You can't deduct the rent on your Boca apartment just because Dr. Feelgood told you to winter in Florida. Payments for home help are only deductible to the extent that they are nursing costs. Improvements made to

your home for medical reasons are only deductible to the extent that they did not add to the home's value.

Question #4: Did all your trust beneficiaries sign their Crummey notices? Signing them 10 years later when you finally show up for the annual meeting your estate planner told you was essential doesn't count. Many types of trusts are intended to receive cash gifts each year that are meant, to qualify for the annual gift

(Continued on page 2)

CHECKLIST: COMPETENCY

Summary: To sign a will you must have testamentary capacity. You must know the nature of your assets and the objects of your bounty. To sign a trust and many complex estate planning documents, you need contractual capacity. If not, the documents will be invalid. Plan early when competency is not an issue. However, the reality in many situations is that the luxury of time is just not available. When planning for an elderly or infirm family member (we'll call her Mom), demonstrating competency may be vital to assuring success.

✓ **Circumstances:** Competency

is not defined in a formulistic manner. What constitutes competency will vary depending on the facts and circumstances involved. If a particular legal document is extraordinarily complex, it may be feasible to add simpler explanatory sentences that Mom can understand. Just as importantly, if it comes to it, a jury might better believe Mom understood it.

✓ **Different Definitions:** The degrees or definitions of what constitutes "competent" can vary considerably depending on the matter involved. The degree of competency re-

(Continued on page 3)

...TAX MOMENT OF TRUTH

(Continued from page 1)

tax exclusion. To do so beneficiaries need the right to withdraw the property being gifted to the trust. The beneficiaries should sign a written acknowledgment sent to them by the trustee. These are called annual demand or Crummey power notices, after a court case that sanctioned them). And while you're still hooked up to the polygraph, please confirm that there was never an understanding between you and your kids that they would never exercise their Crummey powers.

Question #5: Have you deducted interest on your home mortgage when it really didn't qualify? It has to be your debt. Helping out Ma by paying the mortgage on her homestead is not deductible by you. Interest only qualifies for deduction if it's on your principal residence or one vacation home. Interest is only deductible on up to a \$1 mil-

lion home mortgage used to acquire, construct or improve the residence. If you refi'd and paid off the \$450,000 balance on the \$1 million mortgage used to purchase your house with a new \$1 million loan, only interest on \$450,000 of that new loan qualifies, unless you've used the new funds to improve your house. You can also deduct interest on up to \$100,000 of a home equity line, regardless of use. If you have a \$400,000 equity line outstanding that you used to pay for a new boat, you can only deduct 1/4th of the interest.

Question #6: Has your business claimed deductions for entertainment expenses that weren't real and properly documented? We'll assume everyone you've ever spoken to is a potential customer for your commercial floor solvents. The expense has to be "directly related" to the active conduct of your business. Alternatively, the expense can be "associated" with your business if it precedes or follows a substantial bona fide business discussion. This would include your meaningful conversation about floor solvents following Giants David Tyree's amazing SB XLII catch. In a recent case the taxpayers claimed business deductions for meal and entertainment expenses pertaining to a real estate finder/consultant business. The only corroboration the taxpayer had was a few receipts, credit card statements, and self-prepared non-contemporaneous spreadsheets none of which met the tax requirements for substantiation and adequate records. *Alemasov v. Comr.*, (2007) TC Memo 2007-130. Have you done the paperwork right?

Are you the only taxpayer that would have made it past Level 1?

Question #7: Have you made gifts of more than \$12,000 in any year to any person (other than a spouse) and not reported it to the IRS? Every taxpayer

knows you can make annual gifts of \$12,000 per person, per year. Qualified payments for tuition and medical expenses aren't counted. But every other gift is. You used \$12,000 annual gifts as stocking stuffers (sure beats a pair of Dr. Scholls Massaging Gel Insoles). But did you also add up the

*Terms in red defined in the
glossary at
www.laweasy.com.
For e-newsletter sign up at
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new car, birthday present, and graduation gift? It's not a \$12,000 check on top of the gifts, it's the value of the whole package.

Question #8: So you formed a family limited partnership (FLP) and transferred significant wealth to it. You've claimed substantial discounts on the value of the FLP interests given to your kids, and expect them to claim large discounts on the remaining FLP interests in your estate. So confirm that you do not have an implied agreement with your children/partners, that you can have access to the assets in the FLP whenever you wish. In *Estate of Lillie Rosen, et al. v. Comr.*, TC Memo 2006-115, the Court held that the FLP was to be included in the estate because there was an implied agreement between the partners that the decedent (mom) had access to partnership assets whenever she needed them. IRC Sec. 2036(a)(1). "Decedent will have retained an interest in the transferred assets to the extent that the assets were transferred with an understanding or agreement, express or implied, that the possession or enjoyment of, or the right to the income from, the assets would be for decedent's pecuni-

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...CHECKLIST: COMPETENCY

(Continued from page 1)

quired to sign a will, called "testamentary capacity" is less than the degree of competency required to sign a contract (e.g. a trust, such as a GRAT, a wealth managers investment policy statement), called "contractual capacity". Consider that when Mom is being asked to sign a living trust instead of a will. A document such as a power of attorney is considered adequate under some state laws if the grantor had testamentary capacity, while other states may require contractual capacity.

Timing is Key: In many cases its not an issue as to whether Mom is incompetent, but at what point her competency waned to the degree when it was inappropriate for her to execute specific legal documents. Steps can be taken throughout the planning process to demonstrate competency. If the IRS challenges significant tax transactions, or the wayward son challenges the will that left him less, they often have the hindsight that Mom eventually was incompetent. If a significant transaction is to be undertaken, or an important document signed, take independent steps to demonstrate competency before and after. The attorney handling the will signing can take measures to demonstrate competency at the time of the signing. Perhaps you can document independent social interactions prior to and following the day or week of signing. You might even have an independent evaluation apart from the steps undertaken by Mom's attorney. You might have a mental health expert administer a screening test, such as a Folstein Mini-Mental State Exam, to document Mom's status. This is a series of questions Mom is asked, and actions which Mom is asked to perform, which are scored. The range of scores provides an indication of Mom's capacity as normal, borderline or impaired.

Consistency: If Mom's new will is consistent with prior versions, the actions will more likely be respected. A slight modification of a dispositive scheme which has evolved in relatively consistent steps over many wills and many years is more likely to be respected than a sudden change in heirs from the children to a caretaker in the last months of life. If there is a change, such as reducing one child's inheritance, documenting the reasons and rationale for that change, showing the consistency of Mom's actions in revising and coordinating not just the will but trusts, beneficiary designations and other matters, may all prove helpful. Demonstrating that Mom's actions are reasonable, appropriate and rational should protect those actions

from a competency challenge.

Medical Records: Review medical records (you'll need the appropriate HIPAA authorization). Are the records consistent with the conclusions you and Mom's attorney have reached? Often nursing notes, not just the conclusions of the examining physician, can be telling. Nursing notes may disclose appropriate conduct and conversation, concerns about make-up and appearance and a range of anecdotal evidence indicating competency (or lack of it). If you don't have the medical knowledge to appropriately interpret the notations and comments, hire an appropriate expert ("AO x 3 = alert and oriented in all three spheres),

RECENT DEVELOPMENTS

529 College Savings and Qualified Tuition Plans (QTPs). 529 plans are ubiquitous in the planning world. But don't let the fact that they are so common lull you into thinking there aren't technical pitfalls. You can contribute up to \$12,000 per year, per person to such plans, and even front load five years at one time to accelerate the tax benefits. But to take advantage of this 5-year up front gift you have to meet several requirements. A recent Private Letter Ruling 200743001 provides some insight into these rules. In the ruling Grandma gave substantial funds to eight separate QTP accounts, one for each of her grandchildren. All of the gifts were reported on Grandma's Gift Tax Return, Form 709. Grandma attached a statement to the return indicating her intent to prorate each contribution over the 5-year period. However, Grandma failed to check the box on Line B of Schedule A to make the election under section 529(c)(2)(B) to treat each gift as ratably made over the 5-year period. The IRS concluded that an attachment to Grandma's gift tax return for the year contained sufficient information to constitute substantial compliance with the requirements for making the election for 5-year front loading under Code Section 529(c)(2)(B). The IRS was forgiving because literal compliance with all the nuances of making an election is not always necessary. *Hewlett Packard Co. v. Comr.*, 67 T.C. 736 (1977), acq. in result, 1979-1 C.B. 1. When the election is properly made the gifts to the QTP would be treated as if made ratably over 5 years beginning with the year of the gift. Anything more than 5 x the annual gift amount (\$60,000) is treated as a taxable gift in the year made.

S corporations require an initial election (statement) be filed with the IRS. If you miss the deadline the IRS may forgive the oversight if the taxpayer acted reasonably and in good faith, and the grant of relief will not prejudice the interests of the IRS. Rev. Proc. 2007-62, 2007-41 IRB 786. **PP**