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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

Elizabeth Taylor Estate Plan: If the Obama administration enacts portability of the estate tax exclusion the Chapel of Love in Las Vegas may be the biggest beneficiary. Here's the deal. Portability means that if your spouse dies you can use any exclusion (currently $3.5M) he did not use. This is without even needing a bypass trust. This makes planning for married folks simple. An "I love you will" (leaving everything outright to the surviving spouse) will suffice. This, however, will be dangerous because too many people will stop consulting with an estate planner and the myriad of other problems they have will never be addressed (management of assets, liability protection, state estate tax and more). Back to the "Liz Plan." If portability is enacted, depending on how the law is worded, you might be able to marry and accumulate portable exclusions! Here's how it might work. A wealthy Hollywood Starlet marries an elderly terminally ill nursing home resident. The deal in their pre-Nup is that Gramp's kids will get $100,000 from Starlet on his death, and Starlet gets Gramp's exclusion. Do the math. If Starlet is worth $35M she can marry nine "Gramps" and solve her estate tax problem (and she'll beat Liz by 1!). And who said estate planning won't make Entertainment Tonight!

Note Substitution or Replacement: So you sold assets to your kids or a grantor trust years ago. Can you renegotiate the old loan and re-loan new funds at the current low interest rates? Consider the applicable federal rates ("AFRs") to illustrate the change in interest rates. Assume the old loan of $2M was issued in January 1998, when the AFR was 7.13%. Assume that the trust can borrow money from a third party and prepay the loan to you. If a new loan is then made now, the January 2009 AFR was 2.48%, the interest rate savings will be huge. This will result in substantial additional growth outside of your estate over the remaining loan term. This technique, while valuable, is not without gift or income tax risk. For example, the IRS might assert the "step-transaction" doctrine and collapse the repayment and new loan and argue that the reduced interest rate is a gift. Worth exploring, but carefully. PP

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PRACTICAL PLANNER

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

PROPOSED ESTATE TAX LEGISLATION

Summary: Representative Pomeroy introduced estate tax legislation with the snappy title "Certain Estate Tax Relief Act of 2009" (H. R. 436). The Bill proposes a host of changes to the estate tax, including those discussed below. Whether this Bill is enacted, or another one of the proposals, the bottom line is you may need to take action. If your estate is smaller, you need to reassess your planning. A big exclusion doesn't mean you can continue imitating a deer in the headlights. If your estate is larger, get planning while you can (and it may be too late!).

No Repeal. The estate tax is here to stay! (on the count of 3, all the insurance agents can say "yippee!").

Exclusion. The exclusion (the amount you can give junior without any federal estate tax) will stay at this year's $3.5 million level. FYI some studies have estimated that a net worth of about $2.5 - $3.5 million puts you in the wealthiest 1% of families. Basic planning, such as a bypass trust, to preserve the exclusion of two spouses, means $7 million can escape the estate tax. This is far higher than the levels at which President Obama has indicated taxpayers should bear a larger tax burden. So, the risk of a lower exclusion, now or at some future date, remains. For those under the estate tax threshold, planning needs to be reevaluated.

Exclusion Phase Out. The lower graduated tax rates and the $3.5 million exclusion will be phased out by increasing the tax on estates above $10 million.

Tax Rates. The maximum federal estate tax rate will stay fixed at 45%. While this rate is lower than the rates charged historically, for those affected by the estate tax, the rate remains, if this bill is enacted, so high that planning to reduce the tax will remain a priority.

No Carryover Basis. The proposed carryover basis rules won't be enacted. Hey, if you don't know what they are don't worry about it. These rules would have made recordkeeping a real hassle. This is a great change (well, for everyone except your CPA!).

Discounts.

Discounts on Passive Assets to be Repealed. The juice of many estate planning techniques, discounts for lack of control and marketability, will no longer apply to transfers of nonbusiness assets. This change will have a huge impact on planning. The value of any nonbusiness assets held by the entity will be determined as if the transferor had transferred such assets directly to the transferee with no discounts (i.e., rather than having transferred an interest in say an FLP that would be discounted, it will be viewed as if you transferred the building and stocks held by the FLP). If you transfer an interest in an entity, no discount will be allowed as a result of your not having control over the entity if you and your family (as defined in IRC Sec. 2032A(e)(2)) control of the entity. This might mean that if people unrelated to you control the entity, discounts will still be allowed. Does that mean you and two sorority sisters can set up a securities FLP and still get discounts? This also might mean that discounts for

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CHECKLIST: COLLECTIBLES PT 3

Summary: The last two issues reviewed issues affecting art and collectibles. This final part of the series will provide a brief overview of additional planning considerations.

√ Estate Tax Art Audit
The IRS Art Advisory Panel of the IRS reviews the fair market value of all works of art reported on gift and estate tax returns, or for charitable contribution deductions when the combined value of the items or art exceeds $20,000. The Valuation division of the IRS also reviews artworks. Once reviewed a report is issued by either the Art Advisory Panel or the Valuation division. by taking advantage of the procedure set forth in IRC section 2204. It merely requires that the executor ask the IRS to set the estate tax. The IRS has nine months to do so. As soon as the executor pays the tax he's free of any further liability. If your executor cannot reach an agreement on fair market value of art, your executor can request the matter to be reviewed by the IRS Appeals Division. If the value cannot be resolved at Appeals, your executor will have to petition the Tax Court.

√ Charitable Donations
For claimed contributions of

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...PROPOSED ESTATE TAX LEGISLATION

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other purposes, such as for absorption of a large parcel of land, will still be permitted? *Jane Z. Astleford*, 95 TCM 1497.

<u>What assets are Not Discountable</u>: "Nonbusiness asset" means any asset which is not used in the active conduct of a trade or business. "Passive assets" will not be treated as used in the active conduct of a trade or business. Exceptions are made for active real estate and working capital.

<u>Real Estate Isn't Treated as Passive</u>: Real property used in the active conduct of a real property trade or business is not treated as passive. IRC Sec. 469(c)(7)(C)). This means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business in which the transferor materially participates. This means that the taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates. IRC Sec. 469(h). A taxpayer shall be treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a basis which is regular, continuous, and substantial.

<u>Working Capital Isn't Treated as Passive</u>: Any asset (including a passive asset) which is held as a part of the reasonably required working capital needs of a trade or business will be treated as used in the active conduct of a trade or business (i.e., it will qualify for discounts). But how will the IRS distinguish between passive assets held in the business to try to circumvent this rule, and cash and securities held as working capital to meet the needs of the business? How will "reasonably required" working capital be defined? While it is not clear how this will be defined if enacted, prior law (e.g. such as that governing the accumulated earnings tax), may be used for guidance (or perhaps they'll develop a new set of standards to keep more tax attorneys employed). The accumulated earnings tax under Code Section 533 contains a substantial body of law for how to determine whether earnings held in a business are for the "reasonable needs" of the business. Similar concepts could be applied in the discount context. For example, the *Bardahl* Court evaluated the need for working capital and may provide a test applicable to determining the amount of passive assets that may qualify for discounts as working capital in the active business. *Bardahl Manufacturing Corp.*, TC Memo 1965-200. . The Regulations state that investments in, or loans to suppliers or customers, are reasonable business needs if they are necessary to maintain the business of the corporation. Regs. Sec. 1.537-2(b)(5). It is not clear how any of these concepts will be applied, if at all. But if the determination will be based on facts and circumstances, you may benefit by taking steps to corroborate that the passive assets are necessary for the working capital needs of the business in minutes, financial projections, etc. The complexity that these types of analysis create might just push Congress to consider harsher, but administratively simpler, measures.

Practical Free Webinar:
"Maintaining and Administering Your Estate Plan" 2/17/09 12:30pm.
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<u>Defining "Passive Assets"</u>: The term 'passive asset' means: (1) Cash or cash equivalents; (2) Stock in a corporation or any other equity, profits, or capital interest in any entity, except as provided in future regulations (that means you have to wait for the sequel); (3) Debt, option, forward or futures contract, notional principal contract, or derivatives; (4) Foreign currency, REITs, REITs; and (5) Precious metal, unless used or held in the active conduct of a trade or business; (6) Annuities; (7) Certain royalties (other than a patent, trademark, or copyright); (8) Commodities; (9) Collectibles; etc.

<u>Entities Owning Entities</u>: These are also called "look through rules". If a nonbusiness asset of an entity, say your family LLC, consists of a 10% interest in any other entity, treat your LLC as directly owning its ratable share of the assets of that other entity.

<u>Effective Date</u>. These new rules will

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Review: Andrew Wolfe, CPA, JH Cohn LLP, Roseland, NJ.

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...CHECKLIST: ART & COLLECTIBLES—PART 3

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more than $5,000, in addition to a contemporaneous written acknowledgment, a qualified appraisal generally is required. A qualified appraisal is defined in IRC Sec. 170(f)(11)(E)(i). Either Section A or Section B of Form 8283 (depending on the type of property contributed) must be completed and filed with the tax return on which you claim the deduction.

Is the collectible you donate used for the charity's exempt purpose?

Example: You donate furniture to a shelter for abused women. You paid $10,000 for the antique furniture, but it is now worth $15,000. Since the furniture is used for the charity's exempt purpose, your deduction is the full $15,000.

Example: You donated a statue to the shelter that is valued at $16,000, that has a tax basis of $8,000. The charity sold the statue and used the proceeds for the charity's exempt purpose. Since the statue was not used for the charity's exempt purpose, your charitable deduction is limited to $8,000. You must still attach an appraisal to your tax return.

Example: Assume the same facts as the preceding example, except your tax basis in the statute was only $4,800. Your deduction is limited to $4,800, but since this amount is less then $5,000, you don't require a qualified appraisal to substantiate your deduction.

The appraisal must be completed not more than 60 days before your contribution of the art, and no later than the extended due date for the tax return on which you claim the deduction. If the deduction is claimed on an amended return, the appraisal must be received by the day the return is filed.

√ <u>Insurance</u>

Determine what coverage is available. Obtain a replacement value appraisal for insurance purposes. Replacement value could be substantially more than "fair market value" used for gift and estate tax purposes. The definitions of value are quite different. If you inherit art, don't assume that the value on the estate tax return suffices for insurance.

√ <u>Consignment</u>

Restoration and conservation: How much discretion will you be giving an auction house? What parameters can you set? Should your consent be required before any work occurs? Can the auction house remove matting, framing, etc. without your consent as consignor? Your desire for control should be tempered by the auction house's judgment to take steps (e.g., re-framing) that could increase auction prices.

Promotion: What will the auction house do to market your art? Who should decide which items in the collection to show? Can the auction house divide your collection into lots? What if errors occur in catalogue descriptions? While the auction house might wish to avoid any liability, is that acceptable? Who can decide when, and in which auctions to show your art? Do you want to specify, for example, that your contemporary art should be auctioned with other contemporary art? Should you establish some parameters as to the time and locations within which the auction house can exer-

RECENT DEVELOPMENTS

<u>Real Estate Moguls and Divorce</u>.

Every estate planner is pushing developers to gift real estate now while values and interest rates are low using GRATs, IDIT and other fancy acronyms. But low property values and other economic issues befalling some real estate investors and developers won't necessarily support a sufficient change in circumstances to modify alimony or child support obligations, according to a recent New Jersey case. If you file an application for a downward modification of support, the court's analysis will focus on your ability to pay. *Miller*, 160 N.J. 408 (1999). In conducting this analysis, the court may consider your income as well as your assets. N.J.S.A. 2A:34-23(a)(3). In *Ferraro v. Ferraro*, Docket No. A-1963-07T21963-07T2 the impetus for the husband's motion was the slow-down in the real estate market, which consequently impeded his ability to develop the parcels he owned and thus, thwarted his ability to generate sufficient income to meet his support obligations. He cited the change in the economy, the large tax debts he owed the IRS and the State of New Jersey, increased expenses resulting from rising mortgage interest rates, property taxes and utility costs, and decreased cash flow because income producing assets were liquidated. The Court held that Husband bears the burden of showing: (1) The financial changes he experienced; (2) That those changes are permanent; and (3) His inability to pay the level of ordered support. *Lepis v. Lepis*, 83 N.J. 139 (1980). The Court found that Husband's certification did not elucidate the details of his employment efforts and current business enterprises, or attach documentation to support his inability to further liquidate assets. Further, the Court noted that the identified shortfalls were only after consideration of "paper deductions," such as depreciation. PP