

## PRACTICAL PLANNER NEWSLETTER

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- Seminars: ■ "Heckerling Institute of Estate Planning - A Review", at Marriott Glenpoint 2/3/09, registration/breakfast 7:30, presentation 8:00-11:00 am. 3 CPE/CFP credits. Sponsored by Steven Fishman and Norwood Financial. No charge. Call 201-845-8400.
- ■ Free Webinar "Maintaining your Estate Plan." Practical "how to" seminar for clients and professionals. Listen from your home/office. 1 hour review of steps to keep your plan current and operating properly. Practical ideas. 2/17/09 12-1 pm. Call 201-845-8400 or email shenkan@shenkmanlaw.com to register.

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## PLANNING POTPOURRI

**What's Scariest than the Crypt Keeper?** Not encrypting your laptop! 10,000 laptops are stolen from airports every week. If you have valuable data on your laptop (or perhaps your accountant or estate planner has your data on their laptop), encrypt it. Don't stop there. Here's another Tale from the Crypt -- About 40,000 PDAs a year are left in Chicago area taxis! No, avoiding Chicago isn't the solution. What about all those confidential emails you send to your attorney? Password protect your Blackberry (and be sure your lawyer does too).

**Unintended GST Allocations:** So you have an old insurance trust that owns policies on your life. You're one of three people in the country that heeded their estate planner's advice and withdrawal notices religiously prepared Crummey powers for each gift

to the trust (to make sure the gifts qualify for the annual gift tax exclusion, \$13,000 in 2009). Other than that, you have the Alfred E. Neuman attitude of "What, Me Worry?" So start worrying. Has your CPA addressed GST allocation to the trust? The rules the IRS enacted to "simplify" (you know what happens when anyone simplifies the tax laws!) the allocation of GST exemption to trusts, may have a nasty surprise for you. These rules were enacted in 2001 as part of the Economic Growth and Tax Relief Reconciliation Act (sorry, Barack, this catchy name is already taken). These automatic GST allocation rules (Code Section 2632) can allocate (waste) your valuable GST exemption by automatically allocating it to your insurance trust when that is really not your intent, or what is optimal for your plan. If your old insurance trust meets the requirements to be classified as a

"GST trust" your exemption has been automatically allocated every year you've made gifts to your trust unless your CPA filed a gift tax return electing not to have the allocation made. What to do? Well, meet with your CPA now and make the election on your 2008 return to avoid further waste of GST exemption. Next, consult with your estate planner about seeking a private letter ruling from the IRS fixing the issue. Before heading down that path, be sure the legal fees will be worth the GST exemption that was wasted (assuming you are in fact successful). **PP**

**Contents:** ■ Insurance Trusts



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

# PRACTICAL PLANNER

## LIFE INSURANCE TRUSTS: NOT SO SIMPLE

**Summary:** Irrevocable life insurance trusts ("ILITs") are a common estate planning tool. Having a trust own your insurance can keep the proceeds outside your taxable estate and protect the proceeds from an heir's divorce or lawsuit. Physicians and others worried about malpractice claims use ILITs to hold permanent insurance to build value in the trust's protective envelope. Many assume ILITs are simple boilerplate. Wrong!

### Start Simple: Who Should be Trustee.

The simplest step for an ILIT is to name your buddy the trustee, right? The reality is that administering an ILIT isn't the cake walk most people think. Insurance must be properly purchased, monitored and reviewed. Gifts must be accepted and Crummey notices issued (see below). Financing and other arrangements may have to be monitored. There are a myriad of technical issues that could affect an ILIT. Uncle Joe might be a nice guy, but it's always safer naming a professional trustee, such as a trust company, or a long time family CPA, to be certain your ILIT is handled properly. The fees will pale compared to the problems Uncle Joe frequently creates. You can always have Uncle Joe replace the professional trustee following your death when the ILIT collects on your insurance. But, that too, is a mistake. Instead, have Uncle Joe serve as a co-trustee so that the professional management of your trust can continue. Be sure your ILIT specifically addresses compensation for professional trustees since most ILITs have no income, and many have only nominal asset values (e.g., if they only hold term insurance) so that standard methods of calculation compensation will provide inadequate payment.

### State Law.

Depending on which governs your ILIT, there are a host of trust related issues that can be affected. Several states have enacted legislation holding trustees harmless for insurance investment decisions by relieving the trustees from the general standard of care applicable to trustees, such as investing with care and skill, etc. Del. Code Sec. 3302(d). This relieves the trustee of liability for not: determining if an insurance policy is a proper investment, investigating the financial strength of the insurance company, exercising policy options, etc. If a state other than yours has statutory protections you want for your ILIT trustees, then issues of nexus (connection to that state)

must be addressed. The surest way is to name an institutional trustee in that state. Florida law may permit the trustee to delegate insurance management to other persons without the fiduciary duty of care that would otherwise apply. Fla. Statutes Sec. 518.112(2). North Dakota, Pennsylvania, and Wyoming have similar statutes. Another approach may be to include these indemnifications in your ILIT document to minimize the liability your trustees face (especially if compensation is minimal). But do you really want the trustees to avoid these responsibilities?

**Reciprocal Trust Doctrine.** If you set up an ILIT with a \$1 million 20 year term policy on your life naming your wife as beneficiary and co-trustee, and your wife sets up an identical trust naming you as beneficiary and co-trustee, the two parallel (reciprocal) trusts might be unwound by application of the reciprocal trust doctrine. If you and your spouse, or another family member, establish similar ILITs, plan around the reciprocal trust doctrine. See *U.S. v. Grace*, 395 316 (1969); PLR 9643013; PLR 200426008.

*(Continued on page 2)*

## CHECKLIST: COLLECTIBLES-II

**Summary:** Last month's checklist addressed record keeping and income tax considerations for art and collectibles. This month's column addresses additional issues.

**Appraisals.** Art and collectible appraisal is an important component of planning. "Value" has many definitions depending on the context. You have to clarify the correct definition of "value" to obtain the appropriate result.

✓ An appraisal, to be certain your art is appropriately insured, should be aimed at identifying the "replacement value" of the property. This is the highest price that would be

required to replace the property with another of similar age, quality, origin, appearance, provenance and condition. The replacement purchase is assumed to be completed in a reasonable time period, and in the appropriate market. Similar items are from comparable artists, craftsmen, or designers, and are made using similar materials. They should be close in size, date, importance, and appearance.

✓ If you're planning a gift of collectibles to your children or a charity, for tax purposes your appraiser should determine the "fair market value,"

*(Continued on page 3)*

## ...LIFE INSURANCE TRUSTS: NOT SO SIMPLE

(Continued from page 1)

Create differences between the two trusts. While substantive economic differences are preferred, if not essential, creating administrative differences may still support the independence of the two trusts. The following listing does not weigh the strength of the various factors listed: The parties, e.g. husband and wife, should not be in the same economic position following the establishment of the two trusts. Give one spouse a “5 and 5” power under one trust, but don’t include a “5 and 5” power under the second trust. Include an inter-vivos special power of appointment (“SPA”) under one trust, but not another. Endeavor to make the power meaningful, not just a reallocation of assets between the same group of grandchildren. Include a testamentary special power of appointment under one trust, but not the other. Include a marital

savings clause in one trust, but not in the other. Each trust should have different distribution scheme, e.g., one trust could mandate distributions at specified ages and the other trust could be a perpetual dynasty trust. Use different distribution standards in each trust, e.g., one trust could distribute based on an ascertainable standard, and the other using a broad discretionary standard. Add an additional beneficiary, like aunt Jane, to one of the trusts, but not the other. Use different trustees for each trust. If neither spouse is a trustee or co-trustee and you have different trustees for each trust, this could be a significant factor. Have the trusts signed at different dates. Each trust can hold different assets, e.g., husband’s trust holds universal life, and wife’s term insurance). Vary the amount of insurance coverage and other assets in each trust. For example the wife’s term policy could be for \$5 million while the husband’s trust only holds \$2 million of coverage. Give one trust a significant initial gift and the second trust a nominal gift.

### GST Exempt or Not.

Should the trust be generation skipping transfer (“GST”) tax exempt or not? Since only about 2% of term insurance policies ever pay-off, evaluate whether your GST exemption may be wasted on an ILIT holding only term coverage. Also, even if your ILIT holds permanent insurance that is almost assuredly going to be maintained in force for the duration, you may have more important uses of your GST exemption. Plan accordingly. So even if making the ILIT GST exempt is reasonable, if you have better uses of your exemption, design the trust in a manner that avoids GST issues. For example, the ILIT could be drafted in a manner that causes it to be included in your children’s estates to avoid GST

tax. If your intent is to allocate GST exemption on your gift tax return, be sure to allocate sufficient GST tax exemption to the trust to keep it free of GST tax (i.e., to create a zero inclusion ratio). See “Potpourri”.

### Who is Your Spouse

Free Webinar “Maintaining Your Estate Plan” 2/17/09  
12:30-1:30pm  
Email  
shenkman@shenkmanlaw.com.  
To register.

No, this is not about the ABC show *Wifeswap*. But if you set up an irrevocable (can’t be changed) insurance trust, you need to plan for lots’ of “what-ifs.” At some future point you may no longer be insurable and you might be divorced, perhaps remarried, perhaps several times. Who should benefit from your ILIT? Should “spouse” be defined as a particular person, or as the person married to you at a specific time (a “floating spouse” clause)?

### Divorce.

Under some state’s laws divorce may terminate your ex-spouse’s interests as a beneficiary in insurance on your life. Should your ILIT override this statute? You could have your ILIT automatically terminate your spouse as a beneficiary in the event of divorce. But if you’re required to provide insurance as part of the divorce settlement, and you’re rated because of health issues, it’ll be costly.

### Conclusion.

The above are just a few of the scores of issues that should be addressed in even a “simple” insurance trust and plan. If Capital One did insurance trusts as well as credit cards, their slogan might be “What’s in your

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**Publisher Information:** Practical Planner is published monthly by Law Made Easy Press, LLC, P.O. Box 1300, Tenafly, New Jersey 07670. Information: newsletter@shenkmanlaw.com, or call 888-LAW-EASY.

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## ...CHECKLIST: ART AND COLLECTIBLES—II

(Continued from page 1)

as defined in the tax laws — the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts. Treas. Reg. Sec. 20.2031-1 (b). The appraisal report should identify, compare and contrast recent sales of comparable items in the market where they are commonly traded.

✓ A qualified appraisal must be dated and signed. The appraiser should: hold himself out to the public as an appraiser or performs appraisals regularly; be qualified by background, experience, and education to make appraisals of the type of property being valued; not be the donor, donee, or someone employed by either, or the dealer who sold the art; not charge based on a percentage of the valuation; understand that an intentional overstatement of the value of the property may subject the appraiser to a civil penalty under IRC Sec. 6701; understand that a valuation misstatement may subject the appraiser to the penalty under IRC Sec. 6695A; and is not barred from presenting testimony. Reg. 1.170A-13(c)(5).

### Estate Planning.

There are a myriad of estate planning implications and considerations affecting your collectibles, including: ✓ Code Section 2036(a)(1) is a major landmine in estate planning that can pull assets back into your taxable estate if you retained inappropriate “strings” to the asset involved. Property transferred by you, during your lifetime, is brought back into your gross estate if you retain the right to receive the income from the property, or if you retain the “possession or enjoyment” of the transferred property, for: (1) life, (2) a period ascertainable only with reference to your death (e.g., monthly, except for the month in which you died), or (3) a

period that does not in fact end before your death (e.g., 5 years if you died during this period). So if you give your daughter your Miro, but you retain the right to display the painting in your home for your life, the Miro is taxable in your estate regardless of the “gift”.

✓ The tax allocation clause in your will can allocate the tax burden in proportion to the value of assets given. However, if one heir receives a bequest of \$3 million in securities, and your other heir \$3 million in collections, how will the heir with the collections raise the cash to pay his share of the estate tax? Think through “standard” clauses to make sure the result is what you intend.

✓ Another “will” trap for art and collectibles is to be certain that it is

clear which provision of your will governs the distributions of your art and collectibles. Most wills contain a general clause governing the distribution of tangible property, which generally covers collectibles. If you have important pieces that you want distributed in a specified manner use a specific clause. You might leave your furniture and certain art along with your home that is bequeathed to your new spouse, but wish your collection of Chinese porcelain vases be bequeathed to your daughter. Absent specific language, the general bequest may govern. If you own a business, and the business actually purchased and displayed vases, the bequest of the stock in the business may include the vases owned by the business, unless you take specific action

## RECENT DEVELOPMENTS

**Bankruptcy:** When you make a mortgage payment, part of each payment is interest, and the balance is principal, reducing the amount you owe, and increasing your equity. The Bankruptcy Code provides that: “...a debtor may not exempt any amount of interest that was acquired by the debtor during the 1215-day period preceding the date of the filing of the petition...” A recent case held that your making regular mortgage payments, including principal payments that build equity in your home, won’t be treated as your acquiring an interest in real property under Section 522(p) of the Bankruptcy Code. *In re Burns*, 21 Fla. L.L. Weekly Fed. B487 (U.S. Bankruptcy Court, M.D. Fla. August 8, 2008). Exercise caution extrapolating this to payments in excess of your normal monthly payments. The courts might not view it as favorably.

**S Corporation Tax Basis:** Tax basis is important to your being able to deduct losses, and reducing gain on a sale of stock. Your basis in your S corporation stock is increased by your share of income and reduced by your share of loss, etc. Once your tax basis in your S corporation stock is reduced to zero, additional losses will reduce your tax basis in loans to the corporation. IRC Sec. 1367(b)(2) (A). The taxpayers argued that capital contributions should be treated as income restoring tax basis in their loans. The Tax Court held that capital contributions are not income, and the contributions did not increase the taxpayers basis in his loans. The court noted that capital contributions increase a taxpayer’s basis in his stock. *Nathel*, 131 TC No. 17 (2008).

**Private Annuity Respected:** The Tax Court held that a private annuity transaction should be respected and capital gains deferred. *Katz*, TC Memo 2008-269. While this case is helpful to the use of private annuity transactions, the effective date precedes the proposed Treasury Regulations effective for sales after 10/18/06 requiring the seller of appreciated property for a private annuity to