Insight on Estate Planning

Year End 2015

Defined-value gifts: A formula for estate planning success?

Paying for LTC insurance using a tax-free exchange

The family vacation home

Relax — but don't relax the rules

Estate Planning Pitfall

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Defined-value gifts: A formula for estate planning success?

Affluent families who wish to make large lifetime gifts should consider using defined-value clauses or other formula clauses to minimize or eliminate gift taxes. These clauses are especially effective when transferring assets that are difficult to value, such as closely held business interests or real estate.

By defining the gift according to the amount of value you wish to transfer — rather than a percentage interest or specified number of ownership units — you can protect yourself and your family in the event the IRS or state tax authorities challenge your valuation.

Revaluation risk

When you transfer difficult-to-value assets to your children or other family members, there's a risk that the IRS, in connection with an audit of your gift tax return, will revalue those assets, triggering additional gift taxes.

A properly designed formula clause can help you hedge your bets, reducing the risk that a revaluation will result in an unwelcome gift tax bill.

Here's an example: In 2015, Stuart transfers a 40% interest in his closely held business to his daughter, Zoe. A professional appraiser values the interest at $5 million, well within the lifetime gift tax exemption ($5.43 million in 2015).

In 2017, the IRS audits Stuart's gift tax return and determines that the actual value of the interest is $7 million and assesses gift taxes of $628,000 [($7 million - $5.43 million) × 40%] plus interest and penalties.

Hedging your bets

A properly designed formula clause can help you hedge your bets, reducing the risk that a revaluation will result in an unwelcome gift tax bill. These clauses work by adjusting:

- The amount of property transferred,
- The way assets are allocated among various transferees, or
- The amount of consideration paid by the transferee to the transferor, to protect the transferor against additional gift tax liability.

There are several types of formula clauses (see "4 formula approaches" to the right), but the end result is generally the same: The value of the transfer is limited to an amount that's exempt from federal gift taxes or to some other amount that you specify.

For a formula clause to pass muster with the IRS or the courts, it's critical to draft it carefully. Historically, the IRS and the courts have rejected value- and price-adjustment clauses as invalid "savings clauses." In other words, the clauses operate subsequently to *reverse* a portion of a gift and return it to the transferor or adjust the price.

During the last several years, however, the U.S. Tax Court and several federal appeals courts have accepted value-allocation and defined-value clauses. Although the end result is substantially the same, the clauses provide for a gift of a specified dollar amount that's *fixed* on the date the gift is made, even though the percentage interest or number of ownership units necessary to produce the gift may be adjusted down the road. Value-allocation clauses are more widely accepted than defined-value clauses, but defined-value clauses may be more appropriate for transferors who want to keep assets in the family, rather than donating them to charity.

4 formula approaches

Generally, there are four types of formula clauses you can use to limit the value of gifts:

1. Value-adjustment clause. If, as a result of a revaluation, the value of transferred assets exceeds the gift tax exemption or other desired value, a portion of the assets — equal to the excess value — is returned to you.

2. Price-adjustment clause. The transferee is required to pay consideration to you (or increase the amount of consideration paid) so that the excess value is treated as a transfer for full and adequate consideration rather than a gift.

3. Value-allocation clause. The transferee receives a specified value of transferred assets (say, $5.43 million). In the event the IRS determines that the value of the assets exceeds that amount, a portion of the assets (equal in value to the excess amount) passes to a charity or other tax-exempt transferee.

4. Defined-value clause. This clause defines the value of the transferred assets at the time of the transfer. In the event of a revaluation, instead of *returning* assets to the transferor or adjusting the purchase price, the excess is treated as though it had never been gifted, and therefore *remains* with the transferor.

Bear in mind that the courts generally have rejected the first two types of formula clauses, but in recent years they've accepted the third and fourth types in several cases.

Handle with care

If you wish to make substantial gifts of closely held business interests or other difficult-to-value assets, consider using a defined-value or value-allocation clause to minimize the risk that the IRS will revalue these assets and assess gift taxes. In recent years, these clauses have increasingly been accepted by the courts, but keep in mind that the IRS continues to challenge them in many cases. To increase your chances of success, seek your estate planning advisor's help in drafting transfer documents to ensure your formula clause is treated as fixing the value of the gift on the transfer date rather than adjusting it after-the-fact. ▮

Paying for LTC insurance using a tax-free exchange

Nothing can throw a monkey wrench into an estate plan like incurring long-term care (LTC) expenses. These expenses — for nursing home stays, assisted-living facilities, home health aides and other care — can quickly deplete funds you've set aside for retirement or to provide for your family after your death.

An LTC insurance policy can offset these costs, but the premiums can be expensive — especially if you wait to purchase it at or near retirement age. One potential source for funding LTC insurance premiums is a total or partial tax-free exchange of an existing life insurance policy or annuity contract.

Road to tax-free exchanges

For many years, Internal Revenue Code Section 1035 has permitted taxpayers to exchange one life insurance policy for another, one annuity contract for another, or a life insurance policy for an annuity contract without recognizing any taxable gain. (Sec. 1035 doesn't permit an exchange of an annuity contract for a life insurance policy.)

In the late 1990s, the U.S. Tax Court approved *partial* tax-free exchanges, finding that these exchanges satisfy the requirements of Sec. 1035. A partial exchange might involve using a portion of an annuity's balance or a life insurance policy's cash value to fund a new contract or policy. For a transaction to be tax-free, the exchange must involve a *direct* transfer of funds from one carrier to another.

The Pension Protection Act of 2006 expanded Sec. 1035 to include LTC policies. So now it's possible to make a total or partial tax-free exchange of a life insurance policy or annuity contract for an LTC policy (as well as one LTC policy for another). Keep in mind that, to avoid negative tax consequences after making a partial exchange of an annuity contract for an LTC policy, you must wait at least 180 days before taking any distributions from the annuity.

Understanding the benefits

A tax-free exchange provides a source of funds for LTC coverage and offers significant tax benefits. Ordinarily, if the value of a life insurance policy or annuity contract exceeds your basis, lifetime distributions include a combination of taxable gain and nontaxable return of basis. A tax-free exchange allows you to defer taxable gain and, to the extent the gain is absorbed by

LTC insurance premiums, eliminate it permanently. Consider this example:

Tim, age 75, is concerned about possible LTC expenses and plans to buy an LTC insurance policy with a premium of $10,000 per year. He owns a nonqualified annuity (that is, an annuity that's not part of a qualified retirement plan) with a value of $250,000 and a basis of $150,000, and Tim wishes to use a portion of the annuity funds to pay the LTC premiums. Under the annuity tax rules, distributions are treated as "income first." In other words, the first $100,000 he withdraws will be fully taxable and then any additional withdrawals will be treated as a nontaxable return of basis.

To avoid taxable gain, Tim uses partial tax-free exchanges to fund the $10,000 annual premium payments. In an exchange, each distribution includes taxable gain and basis in the same proportions as the annuity: In this case, the gain is ($100,000/$250,000) × $10,000 = $4,000. Thus, each partial exchange used to pay LTC premiums permanently eliminates $4,000 in taxable gain.

Partial tax-free exchanges can work well for standalone LTC policies, which generally require annual premium payments and prohibit prepayment. Another option is a policy that combines the benefits of LTC coverage with the benefits of a life insurance policy or an annuity.

Typically, with these "combo policies," the death or annuity benefits are reduced to the extent the policy pays for LTC expenses.

A tax-free exchange provides a source of funds for LTC coverage and offers significant tax benefits.

Preserving your wealth

According to the *Genworth 2015 Cost of Care Survey*, at least 70% of people over the age of 65 will require some level of LTC service. LTC insurance can be an effective way to protect your nest egg against LTC expenses and preserve it for the next generation. And a tax-free exchange can be a cost-efficient strategy for funding LTC premiums. Discuss your options with your estate planning advisor. ▮

The family vacation home

Relax — but don't relax the rules

A shared family vacation home can be a great place for rest, relaxation and family bonding. But don't get too relaxed. A little planning — together with some clear rules about the usage of the home — can go a long way toward avoiding conflict and tension and keeping the home in the family.

Who owns it and how?

It may seem obvious, but it's important for all family members to understand who actually owns the home. Family members sharing the home will more readily accept decisions about its usage or disposition knowing that they come from those holding legal title.

If the home has multiple owners — several siblings, for example — consider the form of ownership carefully. There may be advantages to holding title to the home in a family limited partnership (FLP) or family limited liability company (FLLC) and using FLP or FLLC interests to allocate ownership interests among family members. You can even design the partnership or operating agreement — or a separate buy-sell agreement — to help keep the home in the family. For example, if a family member wants to sell his or her interest, the agreement might give the remaining owners a right of first refusal.

What are the rules?

Typically, disputes between family members arise because of conflicting assumptions about how and when the home may be used, who's responsible for cleaning and upkeep, and the ultimate disposition of the property. To avoid these disputes, it's important to agree on a clear set of rules on:

- Using the home (when, by whom),
- Inviting guests,
- Responsibilities for cleaning, maintenance and repairs,
- Acceptable activities, behavior and noise levels, and
- Dealing with emergencies or unexpected events.

Despite the informal nature of many vacation homes, it's a good idea to implement some sort of reservation system to avoid conflicts.

The tax implications of renting out a vacation home depend on several factors, including the number of rental days and the amount of personal use during the year.

If you plan to rent out the home as a source of income, it's critical to establish rules for such rental activities. The tax implications of renting out a vacation home depend on several factors, including the number of rental days and the amount of personal use during the year.

Who's responsible for the costs?

Generally, the costs of ownership — such as mortgage payments and major improvements — are borne by the owners according to their proportionate ownership interests. But the costs of usage — utilities, cleaning, maintenance and repairs — can be trickier to allocate fairly, especially when family members have different levels of usage and financial resources.

What about the future?

What happens if an owner dies, divorces or decides to sell his or her interest in the home? It depends on who owns the home and how the legal title is held. If the home is owned by a married couple or an individual, the disposition of the home upon death or divorce will be dictated by the relevant estate plan or divorce settlement.

If family members own the home as tenants-in-common, they're generally free to sell their interests to whomever they choose, to bequeath their interests to their heirs or to force a sale of the entire

property under certain circumstances. If they hold the property as joint tenants with rights of survivorship, an owner's interest automatically passes to the surviving owners at death. If the home is held in an FLP or FLLC, family members have a great deal of flexibility to determine what happens to an owner's interest in the event of death, divorce or sale.

Talk about it

There are many ways to own and share a family vacation home. To avoid conflicts and surprises, family members should discuss ownership and usage issues and establish rules.

Estate Planning Pitfall

You're selling your interest in a charitable remainder trust

Recently finalized regulations eliminate a potential tax shelter involving the sale of an interest in a charitable remainder trust (CRT). Here's an example that illustrates how the tax shelter worked prior to the regulations:

Susan establishes a charitable remainder annuity trust (CRAT), funding it with $150,000 worth of highly appreciated stock and retaining an annuity interest. Susan's basis in the stock is $50,000, so if she had sold it she would have recognized a $100,000 capital gain, leaving her with $120,000 after taxes (assuming a combined federal and state rate of 30%). For purposes of this example, let's assume that Susan's annuity interest in the trust is worth $135,000 and the charitable beneficiary's remainder interest is worth $15,000.

The trustee immediately sells the stock for $150,000 and reinvests the proceeds in other marketable securities. Because the CRAT is a tax-exempt entity, it's not subject to tax on the $100,000 capital gain and its basis in the new securities is equal to the $150,000 purchase price. Next, Susan and the charitable beneficiary simultaneously sell their interests to an unrelated third party for $135,000 and $15,000, respectively. The trust terminates and the trust assets are distributed to the third party.

Under the uniform basis rules, Susan receives a proportionate share of the trust's basis in the securities, which in this case is $135,000. The result: Susan receives the $135,000 purchase price tax-free — $15,000 more than she would have received had she sold the stock outright. Further, she would be eligible for a charitable contribution based on the value ultimately passing to the charity.

Under the new regulations, which generally apply to sales of CRT interests on or after January 16, 2014, Susan is required to reduce her basis by her proportionate share of the CRAT's undistributed ordinary income and undistributed net capital gain, resulting in a $90,000 gain. After the dust settles, Susan is left with $108,000 after taxes — $12,000 less than she would have received if she hadn't established the CRAT.

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