



NAEPC

# Journal of Estate & Tax Planning

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# PRACTICAL PLANNER®

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## PLANNING TIPS

**Summary:** The following are tips covering a wide range of planning considerations:

**Off Label Partnership Freeze:** Partnership freezes are receiving more attention as a wealth shifting tool, but they can do more. The common motivation for a partnership freeze is to achieve wealth transfer. But the senior generation may really want steady cash flow. So while transactions can be transfer tax advantageous this is another motive that can present interesting planning opportunities, even for smaller estates where the parent is not as concerned with transfer tax issues. For example, if Mom has a \$4M portfolio she may be primarily concerned with retaining the income from that portfolio (although saving state estate tax may be desired too). A large gift to the children would reduce her cash flow and might not be acceptable. Instead, a preferred partnership freeze is structured. Mom could retain a preferred interest and receive a payment that approximated the cash flow she had received before the transaction. While generally a preferred partnership freeze succeeds when the appreciation in partnership assets exceeds the payment to the preferred interests in this application the preferred partnership may still provide benefit and meet client goals if that hurdle return is not achieved. So a preferred partnership may entice the parent to plan.

**Trust Distribution to Irresponsible Beneficiary:** A trust is in a high tax bracket but the beneficiary is in a low bracket and not subject to the 3.8% Surtax. A distribution will carry income (DNI) out to a low bracket taxpayer. But the beneficiary is irresponsible and should not have access to the funds that would have to be distributed. The trustee can create an LLC and distribute 99% non-voting LLC interests to the beneficiary and retain in the trust a 1% managing interest. Make distributions into the LLC. The distribution out will appear on the income tax return of the beneficiary providing the desired tax result. This may lower overall income tax rate and thereby increase what beneficiary might receive, without putting excessive cash in the beneficiary's hands.

**Nexus:** It is increasingly common to form trusts in trust friendly jurisdictions. But will doing so avoid unintended tax or legal nexus elsewhere? The array of fiduciaries and other power holders who may reside in the home (or another) state may unintentionally create tax or legal nexus to that state. Example: Naming an investment adviser residing in NY will create tax nexus in NY. NY TSB

-A-04(7)I, (2004). Consider forming an LLC in the trust friendly jurisdiction and name LLC managers to serve as investment trustee, trust protector, etc. Expressly provide that the LLC cannot act if anyone is in the home state (or other state that should be avoided). Consider this technique for any self-settled trust (DAPT) formed by a client whose home state does not have a DAPTs.

**Directed Trust:** Directed trust, where someone other than the general trustee makes investment decisions, are common, e.g., when a trust will hold close business interests.

But is this really an appropriate structure for the long term? The Restatement (Second) Trusts Sec. 185 relieves a trustee if delegation occurs. Delaware has a comprehensive directed trust statute but do you really want to invoke this for the duration of a long term trust? Do you really want the trustee to have such a low level of responsibility? Should you draft to raise the liability and responsibility of the general trustee? Courts may not be willing to turn off or add direction structure if not addressed in

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## CHECKLIST: PROBATE TIPS

Even with a high exemption, probate tax and other planning remains vital to address:

✓ How should valuation of estate assets be handled in light of the new income and estate tax paradigm? If the estate is under the federal exemption amount \$5,430,000 (or double if there is a surviving spouse) the incentive for many estates will be to value assets higher to minimize capital gains costs heirs may eventually pay. New reporting requirements

✓ If a bequest under a will is a pecuniary bequest, i.e. a dollar amount, if it is satisfied with appreciated property that appreciation will be taxed. Given the high income tax rates this

is more costly than in the past and should be avoided if there are options. Consider paying these bequests in cash, or if property must be used pay them quickly before post-death appreciation creates an issue.

✓ Estate assets are generally valued as of the date of death. They may also be valued 6 months later called the alternate valuation date (AVD). Executors will have to exercise greater caution because if assets are valued lower the step-up (increase) in the tax basis of assets available as a result of death will be lower. This will result in a higher

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## ...LEAD ARTICLE TITLE

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the document. In *Re Trust Under Will of Wallace B. Flint for the Benefit of Katherine F. Shadek, C.A. No. 10593-VCL* (June 17, 2015).

### Backstop Prenuptial Agreement:

Prior to the marriage create a revocable trust designated as a separate property trust and maintain it as a separate property trusts and avoid commingling after the marriage. Preferable would be an irrevocable trust, such as a DAPT. A third party spendthrift trusts created by other family members might be even better. Consider a beneficiary defective trust (BDT) formed by a family member rather than a DAPT.

Prenup Tips: Comply with state law requirements for the agreement to be valid: Don't make an agreement that is unconscionable when executed.

Don't unfairly coerce the other spouse to waive disclosure. If you made disclosures include an acknowl-

edgement that it is fair and reasonable. If there is no disclosure have a waiver. Include estate planning provisions, e.g. wills and lifetime gifting. Specify whether filing income tax returns will be joint or separate.

Execute the agreement as required under state law, but use witnesses even if not required. Everything must be in writing. Do not rely on any oral arrangements. To waive the right to an ERISA plan the waiver must be re-documented after the marriage. Consider using a video or transcript if one spouse is high profile (e.g., a Hollywood star), if there is a wide disparity in wealth, or if it is signed close to the wedding date. Have each spouse formally retain separate counsel and document that fact. If no separate counsel must have acknowledgement by other party that other counsel is not representing them and that they had resources and the opportunity to hire their own counsel. Also consider whether separate counsel is equal counsel. If separate counsel is a new solo general practitioner and your attorney is an experienced published specialist it may not really be adequate representation of your spouse.

Cash flow for surviving spouse: If owner/decedent withdrew most of her economic benefits as salary how will a surviving spouse access cash flow from that business? Consider a deferred compensation or a salary continuation arrangement. If business interests are owned by a trust, how will the trustee vote shares for dividends or distributions? What if the surviving spouse is trustee? What if a child/business employee is the trustee? Are there non-business assets or insurance to fund the cash flow needs of the surviving spouse? Should a dividend pattern be created to set a precedent for the future?

GRATs: Compliance audits are occurring, get your ducks in a row. Does the agreement comply with the Code Section 2702 rules? Is the GRAT being operated in accordance

with its terms? The IRS is looking at concepts in the Atkinson case wherein a charitable remainder trust (CRT) set aside because not operated in accordance with its terms. If an IRS challenge succeeds the entire value would be deemed a gift at the funding of the GRAT entirely subject to

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gift tax. If hard to value assets are used to pay the annuity or you exercise a swap power to bring GRAT property back into the estate there may be a valuation issue. Use a defined value mechanism (e.g., Wandry) to protect it.

Trust Distribution Powers: Can a senior family member who contributed assets make distribution decisions, and under what circumstances, without adverse tax consequences? In *Estate of Cohen v. Comr.*, 79 TC 1015 (1982). The senior family member had distribution powers. But it had limits on the exercise of distribution discretion. The power to make distribution decision were subject to a reasonable limit on discretion (i.e., not sole and absolute) so Code Section 2036(a)(2) is not applicable and the trust property won't be included in the senior family member's estate. The court emphasized the fiduciary obligations a majority shareholder and corporate officer had in the landmark Byrum case. If the agreement gave the trustees unlimited discretion so that dividends could be arbitrarily and capriciously withheld or declared that would constitute a right under IRC Sec. 2036(a)(2). Structure distributions in a manner that will be arm's length. PP

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**Publisher Information:** Practical Planner (Reg. U.S. Pat. & Tm. Off) is published quarterly by Law Made Easy Press, LLC, P.O. Box 1130, Fort Lee, New Jersey 07024. For Information or subscriptions: email [news.letter@shenkmanlaw.com](mailto:news.letter@shenkmanlaw.com), or call 888-LAW-EASY.

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## ...CHECKLIST: PROBATE PLANNING TIPS.

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capital gains tax that could offset some of the estate tax savings. The impact of the income tax detriment might affect beneficiaries differently than the estate tax savings. If a post-death sale occurs with a reasonable time and with no intervening event that changed the value of the property, it should control. First Nat'l Bank of Kenosha, 763 F.2d at 894.

✓ New Code Section 1014(f), enacted as part of the Surface Transportation and Veterans Health Care Choice Improvement Act (HR 3236) July 31, 2015 requires that property included in estate for estate tax purposes gets new basis that cannot exceed value reported for federal estate tax purposes. This rule requires that estates report the values on the estate tax return to the recipient. Reporting obligation became effective August 1, 2015.

✓ Funding decisions, which assets to transfer to which trusts, is complex. Personal issues are important, e.g. which trustee will have authority over which asset. But you have to consider the different terms of each trust. Can the growth in the value of assets certain trusts be included in someone else's estate to get a basis step up on that person's later death? This requires a careful review of the different provisions of each trust, the likelihood of each asset appreciating, etc. All these decisions could be complicated by the possibility of being able to modify any one or more of the trusts involved via trust protector action or decanting.

✓ Can the state taxation of a trust be changed to a low tax state post-death? Can the trust have trustees residing in a high tax state resign and appoint trustees in a low tax state? If assets generating business income create nexus to a high tax state can the trust be divided into two trusts, e.g., one holding business interests that are connected to the high tax state, and securities, and then the securities sub-trust be moved?

✓ Powers of appointment are rights trust may give to beneficiaries to designate where the trust property will be distributed, either during life or more commonly at death. Powers of appointment come in varying shades make the planning environment more flexible, but also more treacherous. What steps can be taken to identify if powers exist and whether or not they were exercised? If someone of modest means dies executors might pole family members to inquire whether the decedent was granted powers in trusts those other family members created.

✓ Investment decisions can be vital to the success of tax planning strategies. How should documents be drafted differently to address this type of planning? What should be in a client

investment policy statement so that the client's wealth manager can carry out the intended tax plan?

✓ Estate tax attributable to interest in a closely held business can be paid in 2 – 10 installments, and deferred up to 4 years after the date the tax is due. This provides up to a 14 year deferral. The executor must apply for extension of time to pay estate tax under Sec. 6166 and must file an agreement with the Service as described in Code Section 6324A(c). Be careful that swapping assets with trusts before death could change the percentage requirements enabling the estate to qualify for this benefit, or preventing qualification. The value of the business asset could also be critical to qualifying. PP

## RECENT DEVELOPMENTS

**Gift Tax Returns:** the documentation of the gift on the gift tax return didn't rise to the level of disclosure required to trigger the running (tolling) of the gift tax statute of limitations. IRS Field Attorney Advice 20152201F. Evaluate the sufficiency of disclosures made on all returns.

**State Taxation of Trusts:** Can NC tax a trust merely because a trust beneficiary is a NC resident? If the income was distributed to a NC resident than NC could tax that income. But can undistributed income still held in the trust be taxed? A beneficiary residing in state was not sufficient connection for NC to tax the trust. Connections that might be adequate is where did settlor reside when he set up the trust? Where is the trust administration conducted? When designating trustees consider state income taxation exposure. *Kaestner Family Trust v. North Carolina*, 2015 WL 1880607 (NC Super. Ct).

**Business Entity estate Planning:** Two children were active in a business, and the son got control pursuant to the estate plan but the shareholders agreement gave stock in equal shares to both children. Should the trust or shareholders' agreement controlled. This was relevant to which child would have control over the business. The court determined the later and more specific document controls. Consider implications of this litigation. Did the same draftsman produce the estate plan and stock purchase agreement? Even if a subsequent representation the coordination should have been pursued. *Jimenez v. Corr.*, 766 S.E. 2d 115 (Va. 2014). Everyone should verify that entity and estate documents are all coordinated. Sometimes they are not with devastating results.

**Decanting:** If decanting is to be effected under the terms of a state statute then compliance with the terms of that statute is essential, e.g. such as a notice requirement, . *Harrell et. Al. v. Badger* 2015 WL 3631639 (2015).

**Estate Tax Returns:** *West et al v. Koskinen*, No. 1:2015cv00131 (E.D. Va. 10/19/2015), the court held that the executors of an estate did not have reason-

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**Newsletter:** The 3rd quarter 2015 issue was missed. This is the 4th quarter 2015 issue and quarterly issues will continue in 2016.

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## PLANNING POTPOURRI

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**Family Business Succession:** there are 5 million+ family businesses in the US. The percentage of family businesses transitioning successfully to the next generation is surprisingly small. 30% from 1st to 2nd generation. 12% from 2nd to 3rd generation. 3% from 3rd generation to later generations. Planning is essential. What's in your wallet?

**Mediation and Arbitration.** An in terrorem or forfeiture clause, a disinherence clause in a will, may be inadequate. You might not really want a forfeiture, and in many instances that type of clause may not address the challenge that actually occurs. Is an in terrorem clause enforceable?

Arbitration may not be viable unless the parties agree to it and state law permits it. As an alternative direct that the will be probated in a state that will enforce mandatory arbitration, like FL. Arbitration could be

mandated for more than just a will's validity but also in a trust instrument for a challenge to, for example, a trustee's investment decisions. An arbitration provision could require the parties to keep the proceedings confidential and to waive any rights to appeal. Payment of a bequest could be made contingent on the beneficiary executing a binding arbitration agreement. An in terrorem clause treats the objectant as if she predeceased the testator. Enforceability depends on and state law which varies. The Uniform Probate Code enforces in terrorem only if there is no reasonable basis to object to the will which is a tough standard to meet. If you are domiciled in state that will not enforce an in terrorem clause, direct that the laws of a state that will enforce the clause should govern. Preferable approach would be to transfer assets to a trust and designate a state law govern-

ing that inter-vivos trust that will enforce the provision. Bear in mind that many perhaps most challenges to a will are not what is typically considered a will contest. There may be a challenge to the construction of the will, the choice of fiduciaries, fiduciary actions, and so forth. The majority trend is that in terrorem clauses are not valid unless the contest is found to have been brought in bad faith (did not have reasonable prospect of success). Issue – what does a “good faith” contest “look like”? What are “reasonable grounds” for a challenge? What suit is not “frivolous?” PP

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