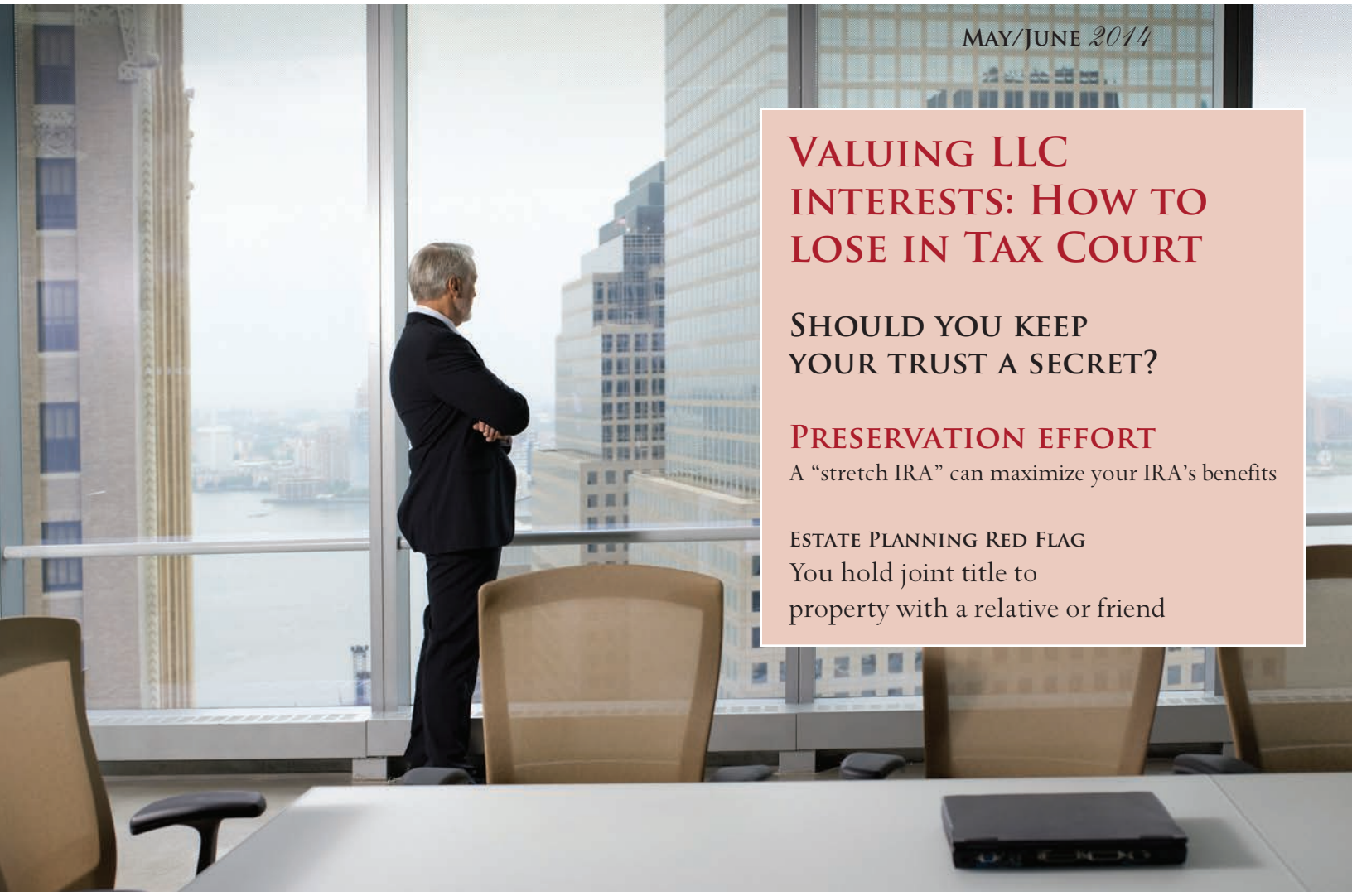
The Estate Planner



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Weston Hurd LLP

Attorneys at Law

Cleveland ▪ Columbus ▪ Beachwood

The Tower At Erieview
1301 East 9th Street, Suite 1900
Cleveland, Ohio 44114-1862
tel 216.241.6602 • fax 216.621.8369

10 West Broad Street, Suite 2400
Columbus, Ohio 43215-3469
tel 614.280.0200 • fax 614.280.0204

24100 Chagrin Boulevard, Suite 200
Beachwood, Ohio 44122-5535
tel 216.241.6602 • fax 216.621.8369

www.westonhurd.com

Valuing LLC interests: How to lose in Tax Court

A recent U.S. Tax Court case — *Estate of Tanenblatt* — offers an important lesson for executors and other personal representatives: When valuing assets for estate tax purposes, be sure you're satisfied with the valuator's methods and conclusions *before* you file an estate tax return. Offering new valuation theories in court can backfire.

LLC owned Manhattan real estate

The sole issue to be decided was the fair market value of the deceased's 16.667% interest in a New York limited liability company (LLC). The LLC's principal asset was a 10-story commercial building in Manhattan that contained retail and office space. The deceased's interest was held in a revocable trust.

The LLC was owned by three family groups, and its operating agreement restricted transfers outside those groups. A nonfamily member couldn't become a member of the LLC without the unanimous consent of all members. Without such consent, a nonfamily transferee would be entitled to share in the LLC's profits and losses but would have no right to participate in management.

The deceased died in 2007. Her personal representative timely filed a federal estate tax return, which valued the LLC interest at $1,788,000 based on a professional appraisal. To value the interest, the appraiser started with a real estate appraisal, which valued the building at $19,960,000 using an income capitalization approach.

Adding the LLC's cash and other current assets and subtracting its liabilities, the appraiser determined that the LLC's net asset value was $20,628,221 ($3,438,106 for the deceased's interest). The appraiser applied a 20% discount for lack of control and a 35% discount for lack of marketability to arrive at the interest's $1,788,000 value. (See "How LLCs and FLPs save taxes" on page 3.)

The IRS determined that the estate had underreported the value of the interest. Although it accepted the estate's calculation of net asset value, it allowed discounts of only 10% for lack of control and 20% for lack of marketability. On that basis, the IRS valued the interest at $2,475,882 and assessed an estate tax deficiency of $309,547.

Estate attacks its own valuation

In Tax Court, the estate offered a new appraisal, prepared by another professional appraiser, which valued the LLC interest at $1,037,796. Because this figure was lower than what was reported on the estate tax return, the estate sought a refund.

The estate challenged not only the IRS expert's valuation methodology, but also the methodology of its own original appraiser, on which it had previously relied. Based on the second appraisal, the estate argued that:

1. The interest should have been treated as an assignee interest, which is less valuable than a member interest, and

2. The LLC's value should have been based, at least in part, on its history of earnings and distributions, not just its net asset value.

As to the first argument, the court found that the deceased's trust held a member interest in the LLC, and that was the interest being valued. Any restrictions that would apply to a purchaser of that interest were reflected in the discount for lack of marketability.

The court acknowledged, however, that the second argument might have had some merit. The LLC was not just a real estate holding company; it also managed the building's rental activities as a going concern. As an operating company, it was appropriate to value the LLC, at least in part, using income-based valuation methods, which might have resulted in a lower value.

But there was a significant problem with this argument: The estate had no evidence to back it up. Because the second appraiser wasn't available to testify (apparently because of a fee dispute with the estate), and for other procedural reasons, the court refused to admit the second appraisal into evidence.

The court noted that values reported on an estate tax return may be considered admissions, "restricting an estate from substituting a lower value without cogent proof that those admissions are wrong." In this case, with no admissible expert testimony to the contrary, the estate failed to meet this burden.

Lessons learned

Tanenblatt serves as a cautionary tale for people planning their estates as well as for their personal representatives. In order for your asset values to hold up before the IRS or in court, be sure they're supported by qualified appraisals. And if you decide to change your valuation strategy, make sure you can back it up with the testimony of a qualified valuation expert. ✤

How LLCs and FLPs save taxes

Family limited liability companies (LLCs) and family limited partnerships (FLPs) can be powerful tools for transferring valuable assets to family members, usually at deeply discounted gift and estate tax values, without giving up control.

In a typical arrangement, parents establish an LLC or FLP, retaining all of the membership or partnership units. Next, they contribute assets to the entity, such as real estate, securities or business interests. Finally, they transfer (by gift or sale) LLC interests or minority limited partner interests to their children, either outright or in trust.

Structured properly, this technique allows the parents to retain management control over their assets while shifting ownership to the younger generation. And because the children's rights to sell their interests or to participate in management are strictly limited, the transferred interests are entitled to substantial valuation discounts — often as high as 40% or more — for gift tax purposes.

Keep in mind that, to ensure the desired tax result, the LLC or FLP must have a legitimate nontax business purpose, such as maintaining family control over a business, consolidating management of an investment portfolio or protecting family assets from creditors.

Should you keep your trust a secret?

When planning their estates, many affluent people agonize over the impact their wealth might have on their children. Bill Gates famously said, "I won't leave a lot of money to my heirs because I don't think it would be good for them."

Even parents of more modest means worry about how the prospect of a large inheritance might affect their kids. Is it a disincentive to staying in school, working or otherwise becoming productive members of society?

To address these concerns, some people establish "quiet trusts," also known as "silent trusts." In other words, they leave significant sums in trust for their children; they just don't tell them about it. An interesting approach, but is it effective?

A questionable strategy

Many states permit quiet trusts, but arguably the risks associated with them outweigh the potential benefits. For one thing, it's difficult — if not impossible — to keep your wealth a secret. If you live an affluent lifestyle, it's likely that your children expect to share the wealth some day, and using a quiet trust won't change that. Even if your children are unaware of the details of your estate plan, their expectations of a future inheritance can encourage the same irresponsible behavior the quiet trust was intended to avoid.

> *One good approach is to design a trust that provides* incentives *to behave responsibly — sometimes referred to as an "incentive trust."*

Another disadvantage is that a quiet trust may send the wrong message. Once your children discover the trust's existence, they may interpret your failure to disclose it as reflecting a lack of trust or a lack of faith in their ability to lead productive lives.

A quiet trust may also increase the risk of litigation. The trustee has a fiduciary duty to act in the beneficiaries' best interests. When your children become aware of the trust years or decades later, they'll likely seek an accounting from the trustee and, with the help of counsel, may challenge any past decisions of the trustee that they disagree with.

A better alternative

The idea behind a quiet trust is to avoid disincentives to responsible behavior. But it's not clear that such a trust will actually accomplish that goal. A better approach is to design a trust that provides

incentives to behave responsibly — sometimes referred to as an "incentive trust."

For example, the trust might condition distributions on behavior you wish to encourage, such as obtaining a college or graduate degree, maintaining gainful employment, pursuing worthy volunteer activities, or avoiding alcohol or substance abuse. One drawback to setting specific goals is that it may penalize a beneficiary who chooses an alternative, albeit responsible, lifestyle — a stay-at-home parent, for example. To build some flexibility into the trust, you might establish general principles for distributing trust funds to beneficiaries who behave responsibly, but give the trustee broad discretion to apply these principles on a case-by-case basis.

Keep quiet or provide incentive?

Perhaps the most important benefit of an incentive trust is that it provides an opportunity for you or the trustee to help shape the beneficiaries' future behavior. With a quiet trust, you keep your beneficiaries' inheritance a secret and hope that, without the negative influence of future wealth, they will behave responsibly. With an incentive trust, on the other hand, you provide positive reinforcement by communicating the terms of the trust, letting beneficiaries know what they must do to receive their rewards, and providing them with the help they need to succeed. ✤

Preservation effort

A "stretch IRA" can maximize your IRA's benefits

Estate and retirement planning go hand in hand. Therefore, you should consider how an estate planning strategy might affect your retirement plan (and vice versa). For example, did you know that, by structuring your IRA as a "stretch IRA," you can preserve its benefits for many years? Using this strategy can benefit both your estate and retirement plans. Let's take a closer look at the ins and outs of stretch IRAs.

Stretch IRA in action

Setting up a stretch IRA is simple: You designate a young person — a child or grandchild, for example — as the IRA's beneficiary. After you die, your beneficiary must begin taking annual required minimum distributions (RMDs), but distributions generally can be spread over his or her life expectancy. This minimizes the amount

that must be withdrawn each year and maximizes the IRA's growth potential.

For example, Debbie, a widower, dies at age 76 with a prior year end IRA balance of $1.2 million, and her grandson, Sam, is the designated beneficiary.

Before her death, Debbie hadn't taken her RMD for the year. Because, according to the applicable IRS table, the distribution period for someone age 76 is 22 years, her RMD for the year would have been $1.2 million divided by 22 — or $54,545. Sam, as beneficiary, will be required to take the distribution and pay tax on it.

One drawback of a stretch IRA is that nothing prevents your beneficiary from withdrawing more than the RMD, or even emptying the account, defeating the purpose of the strategy.

Sam's future RMDs, however, will be significantly smaller: According to the applicable IRS table, for the first RMD based on his *own* age, his life expectancy is 63 years. His RMD will be determined by taking the balance in the account at the end of the year of Debbie's death and dividing that amount by 63.

For comparison, suppose the IRA balance is the same $1.2 million at that time. Sam's RMD for the year following Debbie's death will be $1.2 million divided by 63, or only $19,048. Although the divisor will go down each year, for many years to come the RMDs still will likely be much smaller than what Debbie's would have been, allowing the IRA to be stretched over a much longer period, continuing to grow tax-deferred.

Of course, Sam's RMD amount each year is included in his taxable income. But an added benefit of a stretch IRA is that a younger beneficiary may be in a lower tax bracket. If Sam is in the 15% marginal tax bracket, he'll owe only $2,857 of federal income taxes on the first RMD based on his own life expectancy. If Debbie were still alive, she'd not only have a larger RMD, but, presuming she was in the 35% tax bracket, she would owe significantly more tax.

Beware of a drawback

One drawback of this strategy is that nothing prevents your beneficiary from withdrawing more than the RMD, or even emptying the account, defeating the purpose of a stretch IRA. To avoid this result, you can designate a trust as beneficiary. One caveat, though, is that some custodians may not allow a trust as an IRA beneficiary. Be sure to verify that your custodian will respect your wishes, and be prepared to consider switching custodians if necessary.

Not all trusts qualify. You'll need to design the trust as a "see-through" trust, which means that the trust beneficiaries — all of whom must be individuals — are treated as the designated beneficiaries for purposes of calculating RMDs.

The easiest way to qualify is to set up the trust as a "conduit trust," which requires the trustee to pass all RMDs from the IRA to the trust beneficiaries.

Typically, trusts designate one or more "primary beneficiaries" (those who are first in line to receive the trust benefits) as well as "residual beneficiaries" (those who receive the benefits if a specified event occurs, such as the primary beneficiary's death).

Conduit trusts qualify as see-through trusts even if they have a nonindividual residual beneficiary, such as a charity. Also, RMDs are calculated based on the primary beneficiaries' life expectancies, even if the residual beneficiaries are older.

Is a stretch IRA right for you?

A stretch IRA is most beneficial if your IRA has a significant balance, but there are estate tax consequences to keep in mind — specifically estate and generation-skipping transfer taxes. As with other estate planning strategies, to be effective it's vital that the stretch IRA be designed properly. Your estate planning advisor can review your estate and retirement plans to determine if you can benefit from this strategy. ✤

Estate Planning Red Flag

You hold joint title to property with a relative or friend

Owning assets jointly with one or more of your children or other heirs is a common estate planning "shortcut." But like many shortcuts, it can produce unintended — and costly — consequences.

There are two potential advantages to joint ownership: convenience and probate avoidance. If you hold title to property with a child as joint tenants with "right of survivorship," when you die, the property is transferred to your child automatically. You don't need a trust or other estate planning vehicles and it's not necessary to go through probate.

Joint ownership offers simplicity, but it can also create a number of problems, especially if you add someone as a co-tenant instead of a joint tenant with right of survivorship, including:

Unnecessary taxes. Adding a child's name to the title may be considered an immediate taxable gift of one-half of the property's value. And when you die, the property's value then will be included in your taxable estate, although any gift tax paid with the original transfer would be allowed as an offset.

Creditor claims. Joint ownership exposes the property to claims by your co-owner's creditors or former spouses.

Loss of control. Your co-owner may be able to dispose of certain property without your consent or prevent you from selling or borrowing against certain property.

Unintended consequences. If your co-owner predeceases you, his or her share of the property may pass according to his or her estate plan or the laws of intestate succession. If you hold the property as co-tenants, instead of joint tenants with the right of survivorship, for instance, you'll generally have no say in the ultimate disposition of that portion of the property.

One or more properly drafted trusts can avoid each of these problems without the need for probate.

Weston Hurd LLP
Attorneys at Law

Angela G. Carlin is the Co-Chair of Weston Hurd's Estate, Trust and Probate Practice Group. She focuses her practice on estate, trust and probate administration and litigation, and tax matters. Angela is the author of the Merrick-Rippner Probate Law publication which is the recognized authority in Ohio on probate law. She received the Nettie Cronise Lutes Award from the Ohio State Bar Association in 1996 as the Outstanding Woman Lawyer and for many years, she has been named as an *Ohio Super Lawyer* by Law & Politics Media, Inc. and a *Leading Lawyer* by Inside Business Magazine.

Karen A. Davey focuses her practice on estates, trust and probate administration. She also handles litigation in probate related matters, such as will contests, trust contests, and power-of-attorney disputes.

Jerrold L. Goldstein focuses his practice on estate planning, probate and corporate law. Jerry is also Co-Chair of Weston Hurd's Estate, Trust and Probate Practice Group. He represents clients in a wide variety of matters involving probate administration, probate litigation, estate and income tax compliance, wills and trusts, business formation, contract negotiations, and commercial real estate.

Gary W. Johnson advises clients on matters involving commercial litigation, business entities creation and maintenance, land use, construction law, zoning, estate planning and probate. Gary has been recognized as an *Ohio Super Lawyer* in the area of Business Litigation by Law & Politics Media, Inc.

Eugene (Gene) A. Kratus advises individuals in the areas of tax, business and estate planning and counsels privately-owned businesses and their owners on corporate, tax, mergers, acquisitions and business succession issues. His estate planning practice includes implementing various estate planning techniques, ranging from modest By-Pass Trusts to the implementation of sophisticated planning with family limited partnerships, family limited liability companies, charitable trusts and private foundations.

Samuel J. Lauricia III focuses his practice on tax planning, at both the Federal and state level, involving corporate, partnership, individual and gift tax issues, succession planning and general corporate transactions, contracts, mergers and acquisitions. Sam has been recognized as an *Ohio Rising Star* in the area of Taxation by Law & Politics Media, Inc.

Shawn W. Maestle is the Chair of Weston Hurd's Appellate section and a member of the firm's Litigation section. He focuses his practice in the areas of appellate, estate planning and probate litigation.

Teresa G. Santin is an Associate with Weston Hurd LLP. She focuses her practice on matters involving business, employment, estate planning, real estate, and white collar litigation.

Joseph B. Swartz focuses his practice on estate planning, estate administration, trust administration, and income tax for individuals, estates and trusts. Joe served as chair of the Ohio State Bar Association's Labor and Employment Law section for 2010-2012 and he has been recognized as an *Ohio Super Lawyer* for Labor and Employment by Law & Politics Media, Inc.

Carlin Comments
Is a Meal Part of a Funeral?
By Angela G. Carlin

Under Ohio Revised Code 2106.20, a surviving spouse or a person who is assigned in writing the right to direct disposition of decedent's remains after death and purchase goods and services related to the funeral under Ohio Revised Code 2108.70 is entitled to reimbursement from decedent's estate for funeral and burial expenses so long as the rights of other estate creditors are not prejudiced by such reimbursement.

House Bill 426, effective October 12, 2006, amended Ohio Revised Code 2117.25(A)(2) to increase the amounts (funeral expenses to $4000 other than those approved by the probate court, and burial and cemetery expenses to $3000) which have a priority of payment by an executor or administrator after the payment and expenses of administration, in addition to another $2000 that may be paid to a funeral director, over the first $4000 payment.

A decedent's will or a separate written document for excess funeral expenses may also provide specific instructions to the executor as to the arrangements and expenditures for his or her funeral, burial, or cremation (which of necessity should be transmitted to the executor long before death.)

The allowance for funeral expenses must be reasonable considering the size of the estate, decedent's station of life, and the customs of people in the same station.

In the recent past, an issue has arisen as to whether reasonable funeral expenses include a funeral luncheon for decedent's family and friends under Ohio Revised Code 2117.25(A)(2). A trial court in *In re Estate of Campbell*, 989 N.E. 2d 1090 (Ohio Ct. App. 6th Dist. 2013) ruled that a funeral luncheon did not qualify as a "funeral expense" under such statute. However, on appeal, an appellate court reversed, holding that a funeral luncheon did qualify as a funeral expense for three reasons. Although there is no statutory definition of "funeral expense," Black's Law Dictionary includes in such definition "the funeral or other ceremonial rite," which broad definition includes a funeral luncheon as an integral part following decedent's burial according to the appellate court in its reversal. In addition, the above statute appears to include expenses "other than those in the bill of a funeral director" and a funeral luncheon is such an expense.

Lastly, and perhaps most important, the appellate court recognized that a funeral luncheon is consistent with a "custom that has been widely observed for a millennia in connection with the funeral ceremony."

If you have any questions about this topic, please contact your Weston Hurd attorney.