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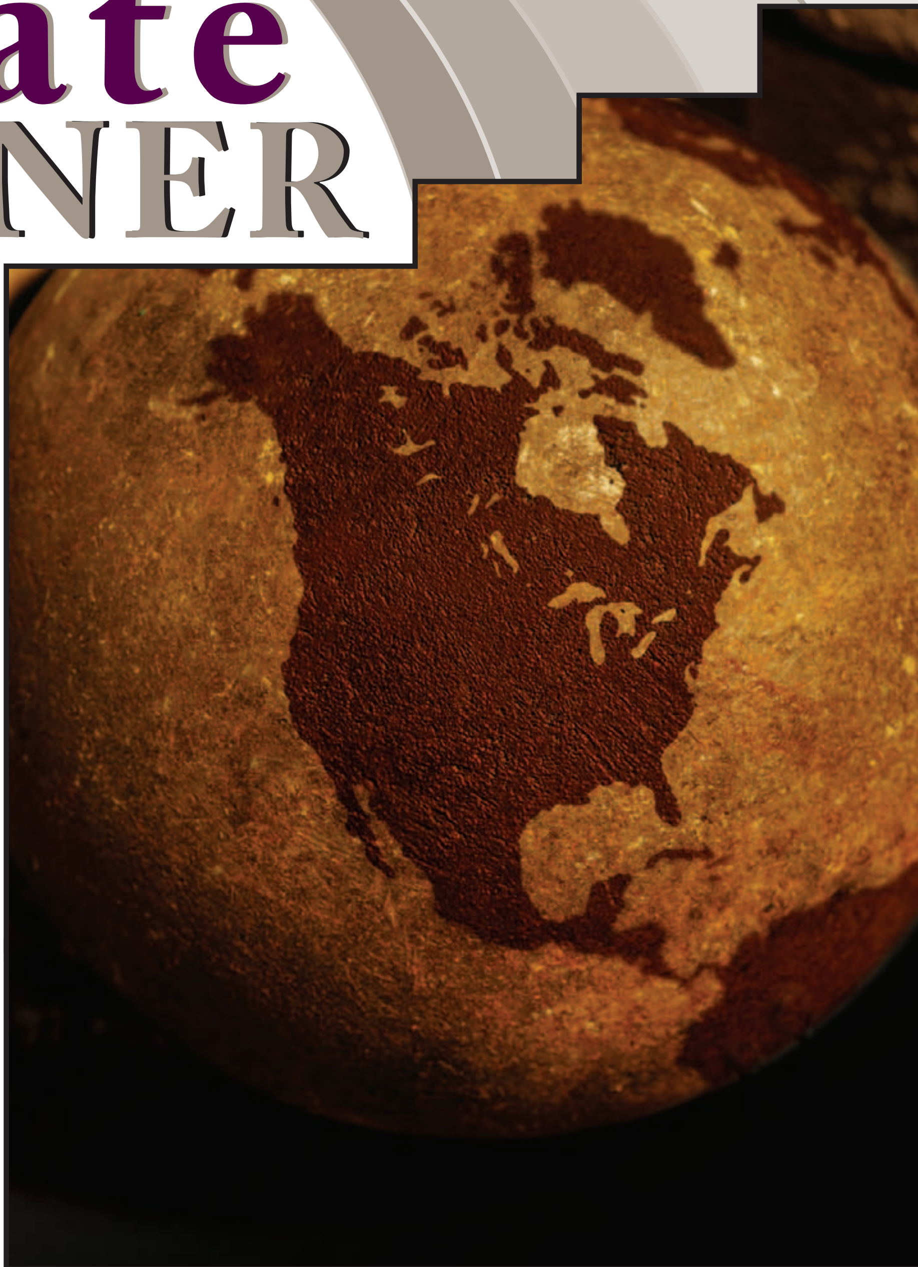

Domestic tranquility

How to protect your assets without going offshore

Redemption agreements: Reap the benefits, avoid the tax traps

Document it or lose it

Substantiation rules for charitable gifts

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An estate includes property that has declined in value since the date of death

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Domestic tranquility

How to protect your assets without going offshore

A well-crafted estate plan can ensure that you achieve a number of personal and family objectives and that your wealth is transferred in the most cost-effective way possible. But it may not shield your assets from unexpected liabilities and other uncertainties.

If you're in a profession that exposes you to the hazards of the legal system, or if you simply want some comfort that your wealth will be there for your family when they need it, you might consider an asset protection trust.

Offshore, or foreign, trusts continue to provide the most robust protection, but they're not for everybody. Fortunately, an increasing number of states are authorizing domestic asset protection trusts (DAPTs) as an alternative. Recently, Oklahoma and Missouri passed DAPT laws, raising the total number of states that offer DAPTs as of this writing to seven. (DAPTs also are available in Alaska, Delaware, Nevada, Rhode Island and Utah.) Several other states are considering similar legislation.

Staying in control

The most effective way to protect assets from creditors' claims and other liabilities (and to remove them from your taxable estate) is to relinquish control over them, either through outright gifts or transfers in trust. But if you're not inclined to give your wealth away without any strings attached, this may not be an option for you.

A DAPT can protect assets from your creditors even if you retain a discretionary beneficiary interest.

Most estate planning trusts contain spendthrift provisions, which prevent beneficiaries from selling or assigning their interests and shield the assets from their creditors. But, traditionally, a spendthrift trust won't protect assets from *your* creditors if you retain a beneficiary interest in the trust. In addition, because you can use the assets to satisfy creditors' claims, transfers to these self-settled trusts aren't considered completed gifts, so the assets are included in your taxable estate.

One solution is to transfer assets to a trust in a debtor-friendly foreign jurisdiction. Properly structured, such a trust places assets beyond your creditors' reach while removing them from your taxable estate.

But offshore trusts can be expensive to set up and maintain and are subject to stringent U.S. reporting requirements.

Bringing it home

Beginning with Alaska and Delaware in the late 1990s, a handful of states have recognized that asset protection is a legitimate financial planning tool and now offer similar protection "onshore." A DAPT can protect assets from your creditors even if you retain a discretionary beneficiary interest. And it

What's unique about Oklahoma's DAPT laws?

Oklahoma's Family Wealth Preservation Trust Act is unique among domestic asset protection trust (DAPT) laws because it extends asset protection to *revocable* trusts. An individual grantor may transfer up to $1 million in assets to an Oklahoma Preservation Trust and shield those assets from future creditor claims. (Other states allow *unlimited* contributions to a DAPT but require the trust to be irrevocable.)

The Oklahoma law also requires that the trustee be an Oklahoma bank or trust company and that the trust contain only Oklahoma assets. Oklahoma assets are:

- Stocks, bonds or debentures issued by an Oklahoma-based company,
- Bonds or other obligations issued by the state of Oklahoma or by a county, municipality or other governmental agency,
- Bank accounts or certificates of deposit in an Oklahoma bank, and
- Real estate located in Oklahoma.

Distributions from the trust must be limited to qualified beneficiaries, including the grantor's spouse, children, grandchildren and certain charities.

appears that the IRS will treat transfers to these trusts as completed gifts, removing them from your taxable estate.

You don't have to reside in one of the seven states to take advantage of this protection, but you do need to comply with several requirements. As with any asset protection device, a DAPT protects your property against only *future* liabilities. Fraudulent conveyance laws prohibit transfers that hinder, delay or defraud known creditors.

Also, the trust must be irrevocable — except in Oklahoma (see the sidebar "What's unique about Oklahoma's DAPT laws?") — and some or all of the assets must be located in the state and administered by a bank or trust company in that state. The specific requirements vary from state to state, and each statute lists exceptions to liability protection that you should consider in deciding which state is right for you.

Weighing the risks

The primary disadvantage of DAPTs is that, because they are still relatively new, they raise a number of legal issues that haven't been definitively resolved. It's not certain, for example, whether courts in other states will recognize DAPT laws under their conflicts-of-law or choice-of-law rules. These rules guide the court in deciding whether to apply the law of the state where the trust was created or the law of the state where the lawsuit was filed.

And it's not yet clear whether, under the full faith and credit clause of the U.S. Constitution, a DAPT will stand up against an adverse judgment issued by a court in another state. Finally, under the U.S. Constitution's supremacy clause, there's a risk that a bankruptcy court will invalidate a DAPT and bring the assets into the debtor's bankruptcy estate.

DAPT advocates believe that the trusts will withstand legal challenge, but until these issues are decided by the courts, there's a risk you could lose a DAPT's asset protection and tax benefits.

Making a decision

If you're in a high-risk profession or otherwise are concerned about significant future liabilities, an offshore trust remains the most effective and well-established option for protecting your assets while retaining a beneficiary interest. But if you seek a simple, relatively inexpensive option that will provide you with added security, a DAPT may be worth a look. ▮

Redemption agreements: Reap the benefits, avoid the tax traps

If you own a business, a buy-sell agreement should be an integral part of your estate and succession plans. It can help ensure an orderly business transition and provide your family with liquidity to pay estate taxes and other expenses when you die or if you become disabled.

But if you own a C corporation and your buy-sell agreement is a corporate redemption type — where the corporation, rather than the other shareholders, buys back your shares — the transaction's treatment can have significant tax implications.

Buy-sell benefits

A buy-sell agreement governs the disposition of stock when a shareholder dies or becomes disabled, or when some other triggering event occurs. It may promote a smooth business transition by:

- Providing shareholders' estates with liquidity by creating a market for the stock,
- Protecting surviving shareholders from being forced into business with a deceased shareholder's family or other heirs,
- Protecting the business by giving shareholders a right of first refusal if a shareholder wishes to sell his or her shares to a third party, and
- Preventing shareholders from competing with the company or soliciting its customers if they leave the business.

A buy-sell agreement also may help establish the value of closely held stock for federal estate tax purposes if certain requirements are met.

Two types of agreements

Buy-sell agreements come in two basic types: 1) a redemption agreement, which requires the company to repurchase its own shares and 2) a cross-purchase agreement, which requires the remaining shareholders to buy the departing shareholder's shares, usually funded by life insurance.

The advantage of a redemption agreement is that the *business* is responsible for funding the stock purchase, not the shareholders. But bear in mind that there are risks as well.

If the redemption agreement is funded by life insurance, the proceeds could trigger corporate alternative minimum tax (AMT) liability. A corporation can avoid this problem by funding the redemptions with corporate savings rather than insurance, though that approach can trigger accumulated earnings taxes.

Cross-purchase agreements offer advantages as well. Life insurance proceeds that fund the purchase are generally income-tax free, and the remaining shareholders receive a stepped-up tax basis in the acquired shares, lowering their taxes in the event they later sell the shares.

Dividend or sale?

Depending on how the buy-sell agreement and the transaction are structured, a corporate stock redemption may be treated as a dividend payment or as the sale or exchange of a capital asset — taxed at capital gains rates. And though long-term capital gains and dividends are both currently taxed at a top rate of 15%, capital gains treatment is preferable in most cases because the taxable income amount is reduced by the selling shareholder's tax basis in the redeemed stock.

If the stock is redeemed from a shareholder's estate or other successor in interest — such as the shareholder's revocable or, more appropriately, formerly revocable trust — its tax basis is stepped up to its fair market value on the date of the shareholder's death. If the redemption price is equal to

the stock's fair market value, taxable income is reduced to zero. So sale treatment usually is advantageous.

Suppose, for example, that Joe owns stock that he originally purchased for $200,000. The corporation redeems the stock for its current fair market value of $1 million. If the redemption is treated as a dividend, Joe is taxed on the entire amount: 15% x $1 million = $150,000. If it's treated as a sale, Joe's gain is reduced by his basis in the stock: 15% x ($1 million – $200,000) = $120,000.

If Joe dies and the corporation redeems the stock from his estate, a sale or exchange eliminates the tax altogether. The estate's stepped-up basis in the stock equals the stock's fair market value of $1 million. So the tax is: 15% x ($1 million – $1 million) = 0.

Obtaining capital gains treatment

As a general rule, however, corporate redemptions are treated as dividends. To obtain capital gains treatment, you must fall within one of several exceptions. For purposes of buy-sell agreements, the most likely exceptions are:

Redemptions to pay estate taxes. An estate may treat the redemption of a deceased shareholder's stock as a sale or exchange up to the amount of estate taxes — including interest — and certain funeral and administrative expenses. To qualify for this exception, the estate's total stock holdings in the corporation must exceed 35% of the deceased shareholder's adjusted gross estate.

Substantially disproportionate redemption. A shareholder or his or her estate may treat a partial redemption as a sale if, immediately after the redemption, the shareholder holds:

- Less than 50% of the combined voting power of all classes of stock entitled to vote,
- Less than 80% of the voting stock he or she held before the redemption, and
- Less than 80% of the common stock he or she held before the redemption.

It may be difficult for family-owned corporations to satisfy these requirements. Under complex attribution rules, a shareholder is deemed to own stock held by his or her spouse, children, grandchildren or parents. In addition, estates and trusts are deemed to own stock held by their beneficiaries, and beneficiaries are deemed to own stock held by the estate or trust of which they are a beneficiary.

Termination of shareholder's interest. A redemption also may be treated as a sale if it terminates the shareholder's entire interest in the corporation and other requirements are met. The family attribution rules don't apply to this exception, so it may be easier for a family-owned corporation to qualify. But the estate and trust attribution rules generally do apply, so if another shareholder is a beneficiary of the deceased shareholder's estate or trust, the tax benefits of this exception may be lost.

Cover your bases

If your corporation has a redemption agreement, talk to your advisors about ways you can ensure that stock purchases under the agreement are treated as sales rather than as dividends. Depending on your circumstances, the tax savings can be significant.

Cross-purchase agreements: Beware of constructive dividends

One of the advantages of a cross-purchase buy-sell agreement is that, when the remaining shareholders purchase a departing shareholder's stock, the transaction is treated as a sale or exchange entitled to capital gains treatment. But there's a potential tax trap for the unwary.

Suppose a corporation's cross-purchase agreement provides that the remaining shareholders have a primary and unconditional obligation to buy a departing shareholder's stock, and that the corporation has a secondary obligation to buy the shares in the event the shareholders fail to do so.

A shareholder dies, and the corporation elects to redeem his stock. Because the corporation satisfies the shareholders' obligation, the purchase is treated as a constructive dividend to the shareholders.

You can avoid this trap by ensuring the agreement is drafted so the shareholders have the option, but not the obligation, to buy the stock.

Document it or lose it

Substantiation rules for charitable gifts

Charitable planning is an integral part of estate planning. The right combination of lifetime gifts and charitable bequests can help you minimize estate and gift taxes, reduce your income taxes, and help the organizations you care about.

When you make charitable gifts during your life, the federal government rewards your generosity by allowing you to deduct charitable gifts on your income tax return (provided you itemize). But the government isn't so generous when it comes to inadequate documentation of those gifts.

If you fail to properly substantiate a charitable gift, you lose the deduction. To help you protect your charitable deductions, it's worth your while to become familiar with the substantiation rules.

Cash gifts

You can substantiate cash donations of less than $250 with a canceled check, a receipt from the charity or other reliable written record that shows the name of the charity and the date and amount of your contribution. Separate contributions of less than $250 to a single charity aren't combined in determining whether you exceeded the $250 threshold. So, for example, if you donate $200 a month to a charitable organization, you can substantiate each donation with a canceled check.

Donations of $250 or more require a contemporaneous written acknowledgment from the charity describing:

- The amount of your contribution,
- Any goods or services you received from the charity (other than intangible religious benefits), and
- Intangible religious benefits provided by the charity, if any.

An acknowledgment is contemporaneous if you receive it on or before the earlier of either your tax return due date, including extensions, for the tax year the contribution is made or the date you actually file your return. It's critical to make sure you obtain all necessary acknowledgments before you file your return. If you don't, you'll lose the deduction, even if you receive a valid acknowledgment later.

Noncash gifts

For noncash gifts under $250, obtain a receipt that shows the charity's name, the date and location of the contribution, and a description of the property. Although the property's fair market value should be considered in determining the amount of detail included in the receipt, that value need not be stated on the receipt.

Noncash gifts of $250 or more require a contemporaneous written acknowledgment from the charity containing the information described above for cash gifts as well as a description (but not necessarily the value) of the property.

If you donate noncash property worth more than $500, then, in addition to the substantiation requirements described above, you also must maintain written records that document:

- The date you acquired the property,
- The manner in which you acquired the property (for example, via purchase, gift or inheritance), and
- Your adjusted basis in the property (except for publicly traded securities).

If your noncash gifts for the taxable year exceed $500, you also must prepare and file Form 8283 (*Noncash Charitable Contributions*). Note that the

$500 threshold is an aggregate of all noncash contributions; it's not an entity-by-entity calculation.

Qualified appraisal for large noncash gifts

If you donate property valued at more than $5,000 ($10,000 for closely held stock), acquire a qualified appraisal and include an appraisal summary, signed by the appraiser and the charity, on Form 8283. You can meet the $5,000 threshold by donating a single item or a group of similar items, even if you give them to different charities.

You don't need an appraisal for publicly traded securities. For closely held stock worth more than $5,000 but less than $10,000, an appraisal isn't required, but you need to complete a portion of the appraisal summary form.

For gifts of art worth $20,000 or more, include a copy of the signed appraisal with your return, not just the appraisal summary.

Your qualified appraisal must be prepared, signed and dated by a qualified appraiser, as defined by IRS regulations, and must include specific information required by the regulations. The appraisal can't involve a prohibited appraisal fee and has to be prepared no earlier than 60 days before the property is contributed and no later than the tax return due date, including extensions.

If you fail to properly substantiate a charitable gift, you lose the deduction.

Get the deductions you deserve

The requirements for substantiating charitable donations aren't difficult to meet, but they do require careful planning. Be sure you have your documentation in order before you file your return. If you don't, you'll lose the deductions, even if they're completely legitimate and supportable. ■

Estate planning red flag

An estate includes property that has declined in value since the date of death

Ordinarily, property included in your gross estate is valued on the date of your death. But under certain circumstances, your executor, personal representative or trustee may elect to use the alternate valuation date, which is six months later.

This may be desirable if your estate includes property whose value has dropped sharply since your death, such as stock or other securities. Why? Because using the lower alternate valuation reduces estate taxes.

The election can't be applied selectively to certain property types. It's available only if the overall value of your estate has declined and your estate tax liability would be reduced.

Once the election is made, it's irrevocable, and it applies to all of your estate's property. There's an exception, however, for property sold or otherwise disposed of during the six-month period between the date of your death and the alternate valuation date; it's valued on the date of the sale or other disposition.

Keep in mind that lower valuation amounts also will lower your heirs' tax basis in the property, potentially increasing their taxable gain should they sell the property. However, the estate tax savings may outweigh any additional income taxes.

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Ellis Painter Ratterree & Adams LLP's Wealth Transfer Planning and Estate Practice Group is comprised of attorneys with over sixty years of experience in representing clients in the areas of estate planning and taxation. The team is equipped to create and implement a wide variety of estate plans utilizing groundbreaking yet tested strategies to meet the goals of each client in passing wealth to successive generations. At all times the personal goals unique to each client are of the utmost importance.

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