The Estate Planner

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Private annuities can offer big tax savings

5 tips for donating artwork

A successful family business requires strong governance

Estate Planning Red Flag
You haven't planned for long-term care

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Private annuities can offer big tax savings

Now that the federal exemption is permanently set at an inflation-adjusted $5 million ($5,340,000 in 2014), fewer families are subject to gift and estate taxes. But affluent families remain exposed to potentially significant tax liabilities, particularly if they plan to transfer family businesses, real estate holdings, investment portfolios or other large assets to the younger generation.

A private annuity can be a powerful strategy for passing assets to your heirs in a tax-efficient manner. Although this strategy isn't risk-free, the U.S. Tax Court recently gave its stamp of approval to a *deferred* private annuity, which, under the right circumstances, can minimize the risk.

What are the benefits?

In a typical private annuity transaction, you transfer property to your children or others in exchange for their unsecured promise to make annual payments to you for the rest of your life. It's "private" because the annuity is provided by a private party rather than an insurance company or other commercial entity. The amount of the annuity payments is based on the property's value and an IRS-prescribed interest rate.

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A properly structured annuity is treated as a sale rather than a gift. So long as the present value of the annuity payments (based on your life expectancy) is roughly equal to the property's fair market value, there's no gift tax on the transaction. And the property's value, as well as any future appreciation in that value, is removed from your taxable estate. In addition, a private annuity provides you with a fixed income stream for life and enables you to convert unmarketable, non-income-producing property into a source of income.

Until relatively recently, private annuities also provided a vehicle for disposing of appreciated assets and deferring the capital gain over the life of the annuity. Proposed regulations issued in 2006 (although not yet finalized) effectively eliminated this benefit, requiring you to recognize the gain immediately. It's still possible, however, to defer capital gain by structuring the transaction as a sale to a defective grantor trust in exchange for the annuity.

Another potential benefit: Because the transferee's obligation to make the annuity payments ends when you die, your family will receive a significant windfall should you fail to reach your actuarial life expectancy. In other words, your family will have acquired the property, free of estate and gift taxes, for a fraction of its fair market value. On the other hand, as discussed below, if you outlive your life expectancy your family will end up overpaying.

Keep in mind that private annuities can't be "deathbed" transactions. If your chances of surviving at least one year are less than 50%, the IRS actuarial tables don't apply and the transfer will be treated as a taxable gift.

What are the risks?

A disadvantage of many popular estate planning techniques is "mortality risk." For example, the benefits of a grantor retained annuity trust are lost if you fail to survive the trust term. Private annuities, on the other hand, involve "reverse mortality risk." If you outlive your life expectancy, the total annuity payments will exceed the property's fair market value, causing your family to overpay for the transferred property and potentially *increasing* the size of your taxable estate.

To avoid this result, consider a *deferred* private annuity, which delays the commencement of annuity payments, reducing reverse mortality risk. (See "U.S. Tax Court approves deferred private annuity" at right.)

There's also a risk that your child or other transferee will be unable or unwilling to make the annuity payments. Private annuities are unsecured obligations, and if the recipient defaults, the IRS may challenge the arrangement as a disguised gift.

A powerful tool

Affluent families looking for ways to reduce estate and gift taxes should consider a private annuity. Under the right circumstances, this tool allows you to transfer substantial wealth to your children or other loved ones at a minimal tax cost. ✤

U.S. Tax Court approves deferred private annuity

Last year, in *Estate of Kite v. Commissioner*, the U.S. Tax Court approved a deferred private annuity transaction, even though the annuitant died before the annuity payments began. As a result, her children received a significant amount of wealth free of estate and gift taxes without having to make any payments.

Virginia Kite sold interests in a family limited partnership to her three children in exchange for three private annuities. The annuity agreements, which were executed in 2001 when Mrs. Kite was 74 years old, called for each child to pay just over $1.9 million per year to Mrs. Kite's lifetime revocable trust beginning in 2011 and ending on Mrs. Kite's death. Mrs. Kite died in 2004, so her children were never required to make any payments.

The IRS challenged the arrangement, seeking to collect more than $11 million in federal estate and gift taxes. It argued that there was no real expectation of payment, so the transaction was merely a disguised gift.

The Tax Court rejected this argument, finding that the annuities served as adequate consideration for the transfer. Although Mrs. Kite had serious health issues in 2001, a letter from her physician stated that he didn't believe she had "an incurable illness or other deteriorating physical condition" which would bring about her death within one year, and that there was "at least a 50% probability that she will survive for 18 months or longer." Therefore, it was appropriate to rely on IRS life expectancy tables in determining the value of the private annuities. The court found that there was a real expectation of payment, noting that Mrs. Kite's life expectancy in 2001 was 12.5 years and that her children had the financial means to make the payments when they came due.

5 TIPS FOR DONATING ARTWORK

Valuable works of art may be ideal candidates for charitable donation. Generally, it's advantageous to donate appreciated property to avoid capital gains taxes. Because the top capital gains rate for art and other "collectibles" is 28%, donating art is particularly effective.

If you're considering a donation of art, here are five tips to keep in mind:

1. Get an appraisal. Given the subjective nature of art valuation and the potential for abuse, the IRS scrutinizes charitable donations and other transactions involving valuable artwork. Most art donations require a "qualified appraisal" by a "qualified appraiser," and IRS rules contain detailed requirements about the qualifications an appraiser must possess and the contents of an appraisal.

IRS auditors are required to refer all gifts of art valued at $20,000 or more to the IRS Art Advisory Panel. The panel's findings are the IRS's official position on the art's value, so it's critical to provide a solid appraisal to support your valuation.

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2. Donate to a public charity. To maximize your charitable deduction, donate artwork to a public charity, such as a museum or university with public charity status. These donations generally entitle you to deduct the artwork's full fair market value. If you donate art to a private foundation, your deduction will be limited to your cost. Keep in mind that the amount you may deduct in a given year is limited to a percentage of your adjusted gross income (30% for public charities, 50% for private charities) with the excess carried over to future years.

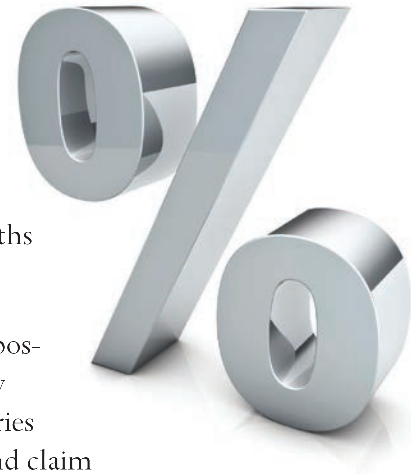
3. Beware the related-use rule. To qualify for a full fair-market-value deduction, the charity's use of the artwork must be related to its tax-exempt purpose. So, for example, if you donate a painting to a museum for display or to a university for use in art classes, you'll satisfy the related-use rule.

Even if the related-use rule is satisfied initially, you may lose some or all of your deductions if the artwork is worth more than $5,000 and the charity sells or otherwise disposes of it within three years after receiving it. If that happens, you can preserve your tax benefits by obtaining a certification from the charity stating that:

- Its use of the artwork before the sale or disposition was substantially related to its exempt purpose, or
- The charity intended to use the artwork in a manner related to its exempt purpose, but such use became impossible or infeasible.

4. Transfer the copyright. If you own both the work of art and the copyright to the work, you must assign the copyright to the charity to qualify for a charitable deduction.

5. Consider a fractional donation. Donating a fractional interest in art allows you to generate tax savings while still continuing to enjoy your art for part of the year. For example, if you donate a 25% interest in your art collection to a museum, the museum receives the right to display the collection for three months of each year. You deduct 25% of the collection's fair market value immediately and continue to display the art in your home for nine months of each year.



At one time, it was possible to give art away gradually using a series of fractional gifts, and claim increasing deductions if the art continued to appreciate. Under current rules, however, the deduction for future fractional gifts is limited to the value of the initial fractional gift (or, if lower, the fair market value of the later fractional gift).

The rules surrounding donations of art are complex. Your advisors can help you achieve your charitable goals while maximizing your tax benefits. ✤

A successful family business requires strong governance

When siblings George and Caroline took over the family's furniture business after their father's death, they viewed the company only as a means of gaining additional wealth. This single-mindedness led to a series of missteps — failing to hire competent managers, overpaying themselves and underpaying other employees, and not holding "insiders" accountable in the same manner as outsiders — that ultimately doomed the business.

The takeaway from George and Caroline's story is that, for a family business to provide financial security for current family members and future generations, the company must have strong governance.

Begin with the business structure

Good governance starts with the initial organization (or reorganization) of a business. For the sake of simplicity, we'll focus on governance issues in the context of a corporation, which is required by law to have a board of directors and officers and to observe certain other formalities.

Other business structures, such as partnerships and limited liability companies (LLCs), have greater flexibility in designing their management and ownership structures. But these entities can achieve strong governance with well-designed partnership or LLC operating agreements and a centralized management structure. For example, they might establish management committees that exercise powers similar to those of a corporate board.

For a corporation, the business's articles of incorporation and bylaws lay the foundation for future governance. The organizational documents might define and limit the authority of each executive, establish a board of directors, require board approval of certain actions and create nonvoting classes of stock to provide equity to family members who aren't active in the business but without conferring management control.

For many family businesses, governance concerns don't arise until the business passes to the next generation. When a founder remains active in the business and isn't ready to cede control to a board, it may be appropriate to delay implementation of certain governance practices until the founder retires or dies.

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Seek an independent board

Whether it's part of the business's structure from the beginning or implemented when the founder leaves, an independent board offers several important benefits. Outsiders on the board provide an objective voice on management issues and owners and managers can tap their expertise on financial, operational, legal or other matters.

To establish an effective board, the business's organizational documents should clearly specify the number of independent directors, as well as the length of their terms and the mechanism for electing them. Staggered terms help provide some continuity and stability to the board. And cumulative voting can help empower minority owners by enabling them to combine their votes to elect one or more directors.

Use estate planning strategies

Careful estate planning can ensure that a family business continues to benefit family members and that ownership of the business isn't diluted — at least until the business is ready to accept outside investors. For example, a well-designed buy-sell agreement can prevent owners from transferring their shares outside the family, while providing the liquidity they need to exit the business. And prenuptial agreements can prevent married owners from losing a portion of their shares in a divorce.

Owners' estate plans should use trusts or other mechanisms to restrict the ability of their heirs to transfer shares. If shares are held in trust, however, it's important to include mechanisms for providing beneficiaries with a say in the business's affairs — particularly if they work in the business.

Implement strong governance practices

A successful family business is an excellent means to provide financial security for the founder and his or her loved ones as well as employment opportunities for interested family members. However, the company must be run professionally to ensure its future success. Your estate planning advisor can help implement governance practices in your business, estate and succession plans. ✤

Estate Planning Red Flag

You haven't planned for long-term care

Too often, people planning their estates focus on tax and asset-protection issues and overlook long-term health care needs. But the high cost of long-term care (LTC) — which may include an assisted living facility, nursing home or home health care — can quickly devour resources you need to maintain your lifestyle during retirement and provide for your children or other heirs.

LTC expenses, which can easily reach into six figures annually, aren't covered by regular health insurance policies or Social Security. And Medicare provides little assistance, if any. So it's important to have a plan for financing these costs. Talk with your estate planning, investment and insurance advisors to be sure that LTC costs are considered as part of an integrated estate and financial plan. Your advisors can help ensure that you set aside sufficient funds to provide quality LTC for you and your spouse if necessary.

For example, consider an LTC insurance policy. Although these policies are expensive, under the right circumstances they can prevent LTC costs from depleting assets you've set aside for retirement and estate planning. And many of the newer policies provide for the return of principal or include a life insurance component. Each policy is different, so it's important to understand their terms, conditions and scope of coverage.

Also, find out whether an LTC policy is "tax-qualified." If it is, any benefits you receive will be excluded from your taxable income — subject to certain limited exceptions — and you'll be able to deduct a portion of your premium payments. Tax-qualified policies are guaranteed renewable and noncancelable, don't delay coverage of pre-existing conditions more than six months, and meet certain other requirements.

Experience. Responsiveness. Value.

At Shumaker, we understand that when selecting a law firm for estate planning and related services, most clients are looking for:

- A high level of quality, sophistication, and experience.
- A creative and imaginative approach that focuses on finding solutions, not problems.
- Accessible attorneys who give clients priority treatment and extraordinary service.
- Effectiveness at a fair price.

Since 1925, Shumaker has met the expectations of clients that require this level of service. Our firm offers a comprehensive package of quality, experience, value and responsiveness with an uncompromising commitment to servicing the legal needs of every client. That's been our tradition and remains our constant goal. This is what sets us apart.

Estate planning is a complex task that often involves related areas of law, as well as various types of financial services. Our clients frequently face complicated real estate, tax, corporate and pension planning issues that significantly impact their estate plans. So our attorneys work with accountants, financial planners and other advisors to develop and implement strategies that help achieve our clients' diverse goals.

Shumaker has extensive experience in estate planning and related areas, such as business succession, insurance, asset protection and charitable giving planning. The skills of our estate planners and their ability to draw upon the expertise of specialists in other departments — as well as other professionals — ensure that each of our clients has a comprehensive, effective estate plan tailored to his or her particular needs and wishes.

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We welcome the opportunity to discuss your situation and provide the services required to help you achieve your estate planning goals. Please call us today and let us know how we can be of assistance.

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