November
2011
Volume 3
Issue 1

BEAN KINNEY & KORMAN PC
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Wills, Trusts and Estates Newsletter

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Portability Rule Clarified

By Jonathan C. Kinney, Esquire

In early October, the Internal Revenue Service ("IRS") issued regulations establishing formal requirements for a surviving spouse to preserve the unused portion of their spouse's estate tax "exemption." The IRS declared that in order to preserve the spouse's exemption, the executor of the deceased spouse must file an estate tax return listing assets and their values if the portability election is to be preserved. Under current law (effective at least through December 31, 2012), the amount of assets exempt from the estate tax is $5 million per person or $10 million per married couple.

The portability provision, which was added to the tax code last December, allows a surviving spouse to preserve the unused portion of their deceased spouse's estate tax "exemption." The effect of the IRS ruling is that executors will be inclined to file an estate tax return to preserve the portability expenses even when the total assets of the deceased are below the current $5 million "exemption" amount.

By way of example, John and Susan have a total estate of $8 million. $2 million is in John's name, $4 million is held jointly and $2 million is in Susan's name. If John were to pass away this year, only $2 million of his $5 million "exemption" would be used, so in effect $3 million of his "exemption" is unused. To preserve this $3 million "exemption," Susan must make sure the executors file an estate tax return listing her deceased husband's assets and their value at the date of death (even though his estate is tax free). If the estate fails to file the return, the portability "exemption" is lost. In Susan's case, that could be very costly since even assuming John did not give any of his estate to her (which may or not be accurate), her estate on death would be $6 million (the $4 million in joint assets plus the $2 million in her name). That would result in an estate tax on $1 million. If John left everything to his wife outright, then her estate would be $8 million, but only $5 million would be covered by the "exemption," so $3 million would be taxable.

Obviously John and Susan could set up revocable trusts, which would achieve the same purpose as the portability provisions. The portability provision was put into effect to cover situations where married couples with assets over $5 million did not have a full estate plan.

To some extent, this does not resolve the current predicament in estate and gift tax law (i.e., that the current estate and gift tax exemptions are set to expire at the end of 2012). While most estate tax commentators believe that the portability provision is likely to be renewed, there isn't any guarantee; so, it may be more

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important to file the estate tax return if the current "exemption" amounts are reduced at the end of 2012. In the meantime, the best course of action is to file the estate tax return if it is at all likely that the spouse might need the additional "exemption" amount that the portability provision provides.

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Transferring Family Vacation Homes

By John M. Bryan, Esquire

Many families have vacation or other homes that they want to keep in the family and allow children and grandchildren to continue to enjoy. A typical scenario is a family retreat, such as a farm or beach property that has been held for a generation or longer. The parents are aging and want to preserve the property for the benefit of their children and grandchildren. Some of the children regularly enjoy the property, while others may have moved away and rarely use it. The property requires regular infusions of cash to pay taxes, maintenance, utilities, other operating expense and improvements.

There are a variety of ways to transfer property to achieve the parent's objective. This article focuses on use of a limited liability company ("LLC") to put a structure in place to facilitate ownership in lower generations. Alternatives to an LLC would include use of a trust structure (including qualified personal residence trusts) or direct transfers to children.

A preliminary consideration in deciding whether to transfer family property to an LLC should be a candid assessment of the likelihood that it will achieve the desired objective. Successful ownership of property in the next generation depends on a number of factors, including:

- The relative interest and use of the property by the children;
- The costs of maintaining the property;
- The ability of the parents to endow or otherwise provide funds to meet expenses and the capacity of the children to contribute to these costs if the parents do not; and
- Family dynamics that impact the ability to make decisions, including the decision to sell, mortgage or improve the property.

Other issues to consider are whether the property is subject to a mortgage, in which case lender consent would generally be needed. Some lenders are less comfortable with LLCs than others. Insurance policies also need to be revised to reflect a change in ownership. Some insurers treat an LLC differently than a property owned by individuals. Finally, certain property tax benefits that flow to individuals may be lost if the property is owned by an LLC. Each of these issues needs to be explored in advance.

Once a decision is made that a transfer makes sense, implementation of the plan involves addressing a variety of factors which are key to its effectiveness. There are variations to the structure, but the following serves to highlight core issues and factors that should be addressed.

1. **Structure.** An LLC would be set up to hold title to the property. The jurisdiction of formation is generally a matter of choice and convenience. The property would then be deeded into the LLC. If the transferring owners own the LLC immediately after the transfer, recordation and transfer taxes may be avoided, depending on the jurisdiction where the property is located.

The governing document for an LLC is called an Operating Agreement and it sets forth the various rights and obligations of the members and the provisions for governance and operation of the LLC. It is often easiest to denominate ownership in units, much like shares of a stock in a corporation.

2. **Ownership.** Typically, the goal is that the LLC will ultimately be owned equally among the children. This is not required but is common. There are several ways to achieve this goal. A common approach is for the parents to contribute the property to the LLC and then gift ownership in the LLC to the children.

A significant issue in the formation of the LLC and the transfer of ownership to children are the tax consequences. These will vary with the tax objectives and circumstances of the client. With the current increased exemption for gift, estate and generation skipping taxes – $5 million for each parent, at least until December 2012 – there may be opportunities to move a family property to the lower generation at significantly reduced tax cost.

In larger estates with significant estate tax exposure, clients will want to structure transfers to leverage gift tax exemptions and annual exclusions under rules that allow discounts for transfers of minority interests in illiquid assets. While there are proposals to limit these techniques, they currently remain viable.

In estates where a client's estate/gift tax exemption will cover or shelter the client's estate from estate/gift exposure, consideration needs to be given to potential income tax consequences which the structure might create on ultimate disposition of the property– assets given away during the lifetime take the donor's basis for purposes of calculating capital gains on sale, while property held until death generally takes a basis equal to its value at the time of death.

3. **Management.** Parents may initially want to maintain control of the LLC. Within limits, this can usually be accomplished with careful drafting but care needs to be taken to structure management to minimize the risk that the value of the property is pulled back into the estate of the parents because of retained controls. If the parents will continue to use the property, it is often necessary to establish a fair market rent for their use to avoid certain retained use rules under the Internal Revenue Code.

At some point, operating control of the LLC will need to pass to the children. Based on experience, family LLCs usually work best if there is one person acting as managing member with control and authority over day-to-day ownership of the asset. Significant acts would require approval of the owners.

Typical matters for which member approval would be required are: sale of all or any part of the property; subdivision; agreement to mortgages or expenses above a threshold amount (e.g. $25,000); decisions whether to rent the property; or dissolution of the LLC. Additional consent items could be added as appropriate. A unanimity standard is generally not recommended unless there are only two children because it gives every owner veto power and can frustrate the consensus decision of the group.

There should also be a succession mechanism for the managing member, including provisions for removal. Again, the threshold required for action should generally be less than unanimous.

4. **Funding.** The Operating Agreement should set out the members obligations to fund the expenses of the LLC. These expenses would include taxes, utilities, insurance and regular maintenance. Absent an endowed LLC, it is typically a good idea to build a reserve for extraordinary expenses (the proverbial new roof). Generally, each member should have an obligation to contribute his or her share of the expenses of the LLC. In practice, this works best if there is a budget developed and each member funds into an account at periodic intervals based on that budget. Issues arise if there are unexpected needs, such as a new roof. In that case, there are several options.

The managing member should generally have the authority to borrow funds (up to the threshold for member consent) as necessary to cover expenses. If bank borrowing is impractical or unattainable, then a member should have the right to advance the funds as a loan to the LLC, with terms for interest and repayment. Failing either of these, the members have to be obligated to contribute their share. In most instances, it is not a discretionary expense that triggers the need – if the roof fails, it needs to be fixed.

The inevitable and unpleasant consequence of requiring additional contributions to fund expenses is the need to address the failure to do so. It is possible to be silent on the issue but generally not recommended.

Again, there are several options to handle this. One is to provide that any member who advances on behalf of another member is treated as making a personal loan to the delinquent member, on whatever terms are set forth in the Operating Agreement – often such a loan carries a higher interest rate, with repayment made from the defaulting member's share of any distributions, sale of LLC assets or other source. A more pointed remedy is that the defaulting member's ownership interest is diluted as a result of failure to contribute. There are a variety of dilution formulas, some more punitive than others.

5. **Transfers.** Given the family nature of the LLC, transfers of ownership interests by a member are generally prohibited unless consented to by the requisite percentage of owners. Often there are exceptions for transfers made for estate planning purposes and transfers to other members. Transfers to spouses are sometimes permitted; however, more often they are not.

In addition, consideration should be given to provisions for repurchase of a member's interest if it is transferred outside the family pursuant to bankruptcy or divorce. Typically this is reflected in a buyout right held by the LLC and/or other owners. By the nature of the repurchase event, the purchase price usually must be the fair market value of the repurchased interest, although it should be possible to establish payment terms which stretch out payment to reflect the lack of resources in the LLC to fund a repurchase.

6. **Use.** Depending on the number of children and competition for use of the property, it is often advisable to adopt guidelines for use of the property and the responsibilities of users. In a beach property, for example, competition often can develop for peak periods. Having a system or guidelines in place for allocating use and the obligations that accompany use, such as restocking of supplies, cleaning, and guest provisions, can help head off disputes. While the rules can be flexible to accommodate specific situations, having a default structure in place can be very helpful.

With proper planning, transferring a valued family property can provide a variety of benefits, both personal and tax-related. A key to a successful outcome is advanced planning to ensure that the issues involved are thoughtfully considered and appropriately addressed.

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Provisions For Pets: How To Include Four-Legged Family Members In Your Estate Planning

By Heidi E. Meinzer, Esquire & Jennifer J. Lee, Esquire

Forlorn family members took Bonnie, a five-year old Golden Retriever mix, to a local shelter when her owner passed away and they were unable to care for her. Bonnie was lucky – she was adopted by a shelter veterinarian the same day she went up for adoption.

Not all dogs are as lucky as Bonnie. The Humane Society for the United States estimates that animal shelters across the country care for six to eight million animals a year, and approximately three to four million are euthanized each year. These numbers are down drastically from the 1970s, when 12 to 20 million animals were euthanized each year, but we still have a long way to go. One way to avoid this unfortunate scenario is to provide for your pets in your estate planning.

Beyond Leaving Money to Your Pet

Many people scoff at the idea of including pets in their estate plans, pointing to stories such as billionaire New York City hotel operator Leona Helmsley. When Helmsley – nicknamed the "Queen of Mean" – died in 2007 at the age of 87, she left a $12 million trust to care for her ill-tempered Maltese, Trouble.

Of her $4 billion estate, Helmsley left $5 million in cash and $10 million in trust to her brother, and $5 million in cash and $5 million in trust to two of her four grandchildren. Helmsley cut the other two grandchildren out completely. Not surprisingly, the family filed suit, and the court cut Trouble's trust from $12 million to $2 million.

Planning for your pets is about much more than just leaving money to your dog or cat. If you fall ill or are in an accident, everyone around you will be devastated and may not think about your pets. In that situation, your pets need immediate care, and your loved ones need guidance. The better you plan, the easier it will be for your grief-stricken relatives and friends to help.

Recent changes in estate law and the manner in which courts view pets have made planning for the future easier. The following are a few of the tools you can use to plan for the care of your pet. Because of differences in state law and the considerations unique to each pet owner and pet, it is recommended you consult an attorney to determine the best tool for your particular situation.

Your Will

Some pet owners make provisions for the care of their pet in their will. However, a will has several drawbacks – it can take a long time to probate a will, or someone may contest it. Your wishes may not be put into effect until the conflict is resolved or a court may refuse to enforce your instructions. Additionally, a will is only effective upon your death.

Power of Attorney

Should you become incapacitated, a power of attorney with special provisions for your pet can be very useful. Those provisions should authorize your agent to care for your pet and spend your money for your pet's care. You can also give your agent the power to place the pet with a long-term caregiver if necessary. However, a power of attorney is only effective while you are alive.

Pet Trusts

Perhaps the best option is to have a power of attorney along with a pet trust. A pet trust is a legally enforceable method to arrange for the care and maintenance of your pet in the event you become incapacitated or die. Depending on the laws of the state in which a pet trust is established,

a pet trust can continue for the life of your pet or 21 years, or whichever occurs first.

One of the most important decisions is to designate a trustee of your pet trust. The trustee will hold, manage and administer the trust funds according to the terms of the trust. You must also decide who will be the pet's caregiver on a day-to-day basis. It is crucial to name someone who is willing and able to take on this duty. You should name alternate trustees and pet caregivers in the event the original trustee or caregiver becomes unable to serve in their respective functions for whatever reason.

In a pet trust, you can be as specific as you wish about the care of your pet. Consider the standard of living you want your pet to have and the type of care your pet is to receive. You can specify your preferred brand of pet food, veterinarians, walking/exercising instructions, training, behavior concerns and other special instructions. For instance, when owner Ken Kemper of Hagerstown, Maryland died several years ago, Kemper left $400,000 and his house to his three rescues – a beagle and two lab mixes named Buckshot, Katie and Obu-Jet. He also left instructions that the dogs were to have a special weekly dinner. The dogs' caretaker continues Kemper's tradition of a Friday night spaghetti dinner, complete with meatballs and garlic bread.

How Much is Enough?

Determining what sums are reasonable for your pet's care is important so you can fund the trust appropriately. Expenses to be considered include food, housing, medical care and grooming.

As with Leona Helmsley, courts will not hesitate to scale back a pet trust that is out of line with the amount someone has left for their loved ones. The amount you should leave in a trust for the care of your pets must factor in not only the size of your overall estate, but also the needs and age of your pets.

The American Society for the Prevention of Cruelty to Animals (ASPCA) estimates annual costs for a small dog at $1,314, for a medium dog at $1,580 and for a large dog at $1,843. Paul Sullivan, a writer with the New York Times, questions whether the ASPCA's numbers are too low, with stories about pet costs that far exceed the ASPCA's estimates, including Moose, a Labrador retriever who needed to have a sock surgically removed from his stomach – to the tune of $6,000 in vet bills.

No Time Like the Present!

Bonnie was very fortunate she found someone right away to care for her. But not all dogs in her situation are as lucky. With careful estate planning, you can give your loved ones the guidance they need to provide for your pets in the unfortunate event of your death or incapacitation. There is no time like the present to get your estate planning in order – for you and your pets!

*Originally published in NOVADog Magazine, Winter 2011 issue, and republished in abridged form with permission.

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Details Matter

By Jonathan C. Kinney, Esquire

The IRS continues its successful challenge of family limited liability companies and 1031 Exchanges for failure to follow basic requirements. In Ralph E. Crandall, Jr., et al. v. Commissioner, the U.S. Tax Court denied the effect of a 1031 Exchange because the taxpayer did not meet the needed technical requirements to facilitate a 1031 Exchange. In this case, the taxpayer failed to use a qualified escrow agent and failed to restrict the funds from settlement in accordance with the requirements of Section 1031, although it was the clear intent of the taxpayer to conduct a Section 1031 Exchange. The Tax Court made it clear that the technical requirements of Section 1031 must be followed or the exchange will not be recognized.

In recent years, the IRS has successfully challenged Section 1031 Exchanges and family limited partnerships/limited liability companies for failure to maintain minimum requirements. Failure to follow these minimum requirements has resulted in valuation discounts being denied in family limited partnerships and in limited liability company settings; and, as the Crandall case shows, Section 1031 Exchanges being denied, which shows that in some instances form does matter over substance.

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