Sentinel

Personal Financial Management Ideas

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Giving Away The Family Business

By Benjamin C. Sullivan, EA, CFP®

Which would you rather receive: a check for $1 million or one-tenth interest in a private company worth $10 million — an interest over which you would have minimal control and which you would have limited ability to liquidate?

Each is ostensibly worth $1 million, and most people would not turn down either gift. However, most would take a million-dollar check if they had a choice, because a check offers immediate access to the funds, control over how and when the money is spent, and no need to deal with the complications of owning a private business. This fact has allowed many Americans to transfer fractional shares in private businesses for less than their proportional values. Incidentally, it is one reason public companies are often bought out at a premium to their share prices: The whole is worth more than the sum of its tiny parts.

These economic realities make sense to most people, but new regulations proposed by the U.S. Treasury Department and the Internal Revenue Service assert that, if the company in question is family owned, they should be ignored and both gifts should be worth the same amount for tax purposes.

Business valuation experts will often discount the value of an interest in a privately held business under certain circumstances — for instance, if the share represents a minority, noncontrolling interest or if there is no readily available market in which beneficiaries could liquidate their interest. If two unrelated parties come to an agreement based on these discounts, the proposed regulations will generally continue to allow them. There is nothing for the government to lose in these situations. When the federal gift and estate tax comes into play and transactions are among related parties, however, the IRS takes a different view.

Although there are several nontax reasons to form a family investment holding company, valuation discounts led some families to set up family limited partnerships (FLPs) and family limited liability companies (FLLCs) primarily to minimize estate, gift and generation-skipping transfer taxes. The older generation established the "wrapper" entity and contributed marketable securities or real estate, and later made gifts of minority partnership interests to the younger generation. The gifts were valued at a discount because the interests lacked marketability, control or both. But given the family relationship among the involved parties, the younger generation can sometimes in practice have nearly unfettered access to the full, undiscounted value of its share of the company.

The IRS has argued for years that this technique is abusive, so many estate planners expected a regulatory change eventually. Mark Mazur, the assistant secretary for tax policy at the Treasury Department, recently vilified this technique. The Wall Street Journal reported that he said in a statement, "By taking advantage of these tactics, certain taxpayers or their estates owning closely held businesses or other entities can end up paying less than they should in estate or gift taxes."

Up to this point, the IRS has mainly disputed the size of the discounts taxpayers have claimed, but the newly proposed regulations would sharply limit the use of valuation discounts

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The Life Insurance Time Bomb

By Larry M. Elkin, CPA, CFP®

Any senior citizen with a retirement nest egg understands what it means to live in an era of financial repression and near-zero interest rates. It means savings cannot grow without a greater level of risk than might have been taken in the past.

But the war on savers doesn't only affect people who have savings accounts; a lot of other financial instruments are savings by another name. Any product that relies on a third party getting between you and your money for a long period of time is now suspect, because the world's central banks have changed the rules of the game.

Take life insurance. The chance that a 40-year-old man will die sometime in the next year is quite a bit lower than the chance that a 90-year-old man will die in the same period. That is why the cost of insuring a 40-year-old is so much lower. This is a basic function of insurance, but it plays out differently for different types of coverage.

For a term life insurance policy, low interest rates are not a huge problem. As people get older, the need for such insurance typically diminishes. Many people who purchase term life insurance do so to cover a finite period of risk — for instance, the period between their children's births and adulthood. While it is usually possible to renew term policies at increasing premiums, most people eventually let their term policies lapse at some point before they die. The premiums they pay are never recovered — but then, neither are the premiums for fire insurance on a house if there is never any fire.

But some life insurance policies are intended never to lapse. The two most common types are whole life insurance and universal life insurance, both of which are usually designed to stay in force indefinitely. Instead of replacing the insured's earning potential for a set period, the benefit in these policies is meant to provide, say, funds to support a business or to pay estate taxes or to provide an inheritance to heirs.

Insurance companies typically invest the premiums from a permanent life insurance policy conservatively, so that even after paying death benefits for the occasional premature death, with interest and some capital gains there will be enough money left over to eventually cover the insured's death benefit, no matter when the person dies. This "leftover" money is the policy's cash value. As a policy's cash value grows, the insurer's own risk of loss shrinks. Therefore, cash value is really just another form of savings.

But in a repressed world, cash values cannot grow as quickly, so the insurer's risk cannot decline as quickly. Unfortunately for insurers, financial repression has no effect on how quickly their customers age. This leaves insurance companies with three options. They can raise premiums. They can make up the shortfalls from some other source. Or they can fail.

Obviously, companies will try to avoid the third option in any way they can. That leaves options one and two. After years of interest rates hovering near zero, insurers must face the reality that many decades-old policies were designed for a different world, and act accordingly. As The New York Times reported in August, in many cases that translates into drastic premium hikes. It can also take the form of chasing higher returns through riskier investments, as was the case with MetLife's foray into hedge fund investing. The experiment, however, proved short-lived, as MetLife has said it will drop most hedge fund investments after a spate of poor performance.

The risks of financial repression manifest similarly in long-term care insurance, about which my colleagues and I have written previously on multiple occasions, as well as disability insurance and fixed annuities. Financial repression is a time bomb for the insurance industry, with a slow-burning fuse. The longer central banks hold interest rates down, the more likely it is that the bomb will detonate.

These consequences are almost certainly not part of the calculation when the Federal Reserve and other central banks decide that the best way to promote growth today is to penalize savers — and thus, to shortchange the needs of tomorrow. But the effects will continue to spread, with insurance customers in line to feel the pain.

An Online Sampler

EDITOR'S NOTE: Our October issue of *Sentinel* offers a sample of the material we publish on our website. This year's edition is drawn largely from Current Commentary, a blog published every business day. We also offer a *Sentinel* feature on our site in every month a print edition does not appear. You can receive our articles by subscribing to our daily email at www.palisadeshudson.com/insights/current-commentary/, or by liking us on Facebook or following us on Twitter.

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INVESTMENT FOCUS

Protecting Assets In A Child's Divorce

By David Walters, CPA, CFP®

As anyone who has survived a messy divorce knows, common sense is not always a reliable measure of what the law actually says.

Say you want to set up a trust for your children and grandchildren. You choose to create a discretionary trust in which distributions are controlled by a pair of trustees, and designed to see to the beneficiaries' comfort and well-being, ideally for years to come. If one of your children divorces his spouse, you would not expect his interest to become subject to claims by his ex.

Yet that is exactly what happened in the Massachusetts case of Curt and Dianne Pfannenstiehl.

Curt was a beneficiary of a trust his father created in 2004, one of 11 such beneficiaries at the time of his divorce proceedings. The trial judge in the divorce proceeding decided that Curt's share of the trust could and should be assignable to the marital estate, largely because of the argument that the trustees' discretion was subject to the "ascertainable standard" required by Massachusetts law. This standard requires trustees to consider beneficiaries' health, education, support and maintenance when deciding to make a distribution. Dianne's lawyers thus argued that the trust was not purely discretionary. The judge awarded Dianne 60 percent of Curt's share, valued at one-eleventh of the total trust assets at the time.

Curt appealed this decision, but the Appeals Court ruled against him, 3-2. In addition to leaning on the ascertainable standard, the Appeals Court also characterized the trust distributions as "woven into the fabric of the marriage." The two dissenting judges found Curt's interest in the trust too remote and speculative to include in the marital estate.

The Massachusetts Supreme Judicial Court agreed with the dissenters. Although the ruling acknowledged that judges have "considerable discretion in determining how to divide [marital] assets equitably," the justices found that whether an interest in a trust may be included is a matter of law, not judicial discretion.

> Common sense is not always a reliable measure of what the law actually says.

In the case of this particular trust, Curt's interest was characterized as an eligibility for distributions, with no "present or enforceable interest." Despite the ascertainable standard, the trustees will necessarily balance Curt's needs with those of his siblings, children, nieces and nephews. The trustees must also keep in mind the needs of future beneficiaries, a real possibility given the trust's structure. Distributions from the trust had not been equal from year to year, or from beneficiary to beneficiary, at the time the case was heard.

As an illustration of this very point, Curt made an effort to obtain funds from the trust to pay Dianne the approximately $1.4 million mandated in the original divorce proceeding. The trustees, however, refused to distribute the funds. Dianne filed a complaint for contempt, but the Appeals Court set aside this judgment, since Curt hadn't willfully violated the original order.

On a human level, the lower courts' compassion for Dianne is somewhat understandable. Her income is significantly less than that of her ex-husband, and she was awarded primary physical custody of the pair's two children, both of whom have special needs. However, the Supreme Judicial Court's decision affirms that the trust's distributions are clearly in the hands of the trustees. In this case, that means that the interest should not be included in the marital estate. Curt's attorney argued that this stance was a matter of honoring the grantor's intentions as much as reasonably evaluating the situation.

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for intrafamily transfers at all. Moreover, the changes are set to apply to transfers of both holding companies and operating companies such as a consulting company, real estate development firm or local family-owned restaurant or store.

These changes really only affect those who expect to make lifetime gifts or transfers at death that exceed the federal gift and estate tax exemption (currently $5.45 million for an individual or $10.9 million for a couple). As The Wall Street Journal reported, the estate tax currently applies to only about 0.2 percent of Americans each year; in 2014, that worked out to about 5,200 estates nationwide.

If you are among those who need to consider the federal estate tax, many experts have urged immediate action in light of the new rules. The Treasury has said that the regulations will not apply retroactively, and a hearing on the proposed rules is not scheduled until December 1, meaning that the final regulations would not apply to transactions occurring before the beginning of 2017 at the earliest. This leaves a distinct but brief window to take advantage of existing rules.

That window will mostly benefit people who already have family partnerships or businesses in place. For families who already included such transfers in long-term estate plans, it will likely make sense to step up the time frame and complete the transfers before year-end if possible. But the new regulations should not be the only factor in this calculation. You will want to weigh other considerations, too. For instance, you could be forgoing a possible step-up in basis if you held the business until your death. You could also trigger unintended negative consequences, such as fragmenting control of the business or exposing assets to the younger generation's creditors. In addition, the older generation will need to consider whether it can afford to part with the assets sooner than originally planned. Simply securing tax benefits could be offset by drawbacks posed by some or all of these factors.

For a family that does not already have a closely held entity in place, it probably will not make sense to rush into setting one up just to try to capture the existing benefit. Establishing a partnership is complicated, and it is not the only estate-planning method available. If you handle all of the steps required to form a company and transfer interests to a younger generation in quick succession, the IRS is more likely to disallow the discounts and look at the overall planning as a sham to avoid taxes. For many people, there are alternative ways to eliminate their estate tax burdens while transferring assets to younger generations; consider whether a less risky technique would better serve your needs.

If you own a family business and are looking to transition ownership within the family at a discounted value, it is prudent to at least explore your options before year-end. If the regulations are finalized and the "loophole" is closed, family business owners will be penalized for keeping a company all in the family.

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It is not at all uncommon to use trusts to shield gifts to children from divorce settlements (as well as from other creditors). For instance, if a child and his or her partner resist the idea of a prenuptial agreement, a cautious parent may turn to a trust to protect the child's inheritance. In the case of a trust such as the Pfannenstiehls', a grantor can also provide for future generations, even without knowing exactly how many beneficiaries a trust will serve or what needs they will have.

As this case illustrates, however, a trust is not a cure-all. It is important to draft foundational documents carefully and to keep an eye on applicable state law. For instance, in some cases, an ascertainable standard may be omitted, which would make it clear that all distributions are at the trustees' discretion and that the beneficiary has no enforceable claim against undistributed trust funds. The Pfannenstiehl trust also illustrates one benefit of creating a single trust for all children and grandchildren that allows for unequal distributions.

No one wants to assume that his or her child or grandchild will endure the emotional and financial strain of a contentious divorce. But thinking ahead will allow you to create a foundation that rests on law, rather than hoping for common sense to win the day.

Rollover Foul-Up? IRS Says 'Chill Out'

By Anthony D. Criscuolo, EA, CFP®

If there's one thing the Internal Revenue Service is not known for, it's taking a laid-back attitude toward missed deadlines. But in a surprise move, the IRS has effectively told retirement savers not to sweat the small stuff.

Specifically, in Revenue Procedure 2016-47 the agency has made it easier for taxpayers who miss the 60-day window to roll over retirement account assets. This being the IRS, there are still plenty of details to consider, but overall, this change is taxpayer-friendly and will make life easier for the IRS as well.

When you leave a job that provides a retirement plan, such as a 401(k), you generally have the option to roll over the assets into an IRA or another qualified retirement plan account. You can also withdraw funds from one IRA and deposit the money into another IRA or retirement plan. Once you receive the rollover funds, you have 60 days in which to complete the transaction and ensure that the funds are deposited into the new retirement account. If you miss the window, the money is considered a distribution, which makes it subject to ordinary income taxes and potentially to early withdrawal penalties, depending on your age.

This sounds simple, but a lot of things can go wrong. A paper check can get lost, either in the mail or in the taxpayer's home. The taxpayer might get bad advice about how to handle the transfer or suffer a personal loss, such as a death in the family. A lot of taxpayers missed the window — so many, in fact, that Congress granted the IRS the ability to waive the 60-day rule if the delay was not the taxpayer's fault.

Unfortunately, until recently the only way to get relief for missing the 60-day window was to apply for a private letter ruling from the IRS. This process requires paying the IRS a hefty fee — recently raised to $10,000 — plus the cost of having a tax professional prepare the request. And then the taxpayer has to wait, effectively sitting on the money in question, until the IRS rules on the matter months later. As tax professionals, my colleagues and I would regularly see the IRS release whole batches of private letter rulings granting relief, evidently just rubber-stamping approvals, given the volume involved.

In an unexpected but sensible step, the IRS announced that taxpayers can now automatically receive a waiver of the 60-day deadline if they missed it for one of 11 fairly broad reasons. These include misplacing the check or depositing the funds into an account the saver mistakenly believed to be an eligible retirement plan. Taxpayers who meet the requirements can skip the private letter ruling process; instead, they can submit a letter, for which the IRS provides a sample, to the retirement account custodian.

The waiver process is not carte blanche to ignore the 60-day rule. The retirement account custodian must report the letter to the IRS, and the agency can ask for proof that the taxpayer qualified if he or she is audited. As for the timing, the official IRS guidance states that the late rollover contribution must be made "as soon as practicable" after the circumstance for missing the 60-day deadline no longer prevents the taxpayer from making the contribution. This requirement is deemed to be satisfied if the contribution is made within 30 days after the discovery of such circumstance. In some cases, such as the death of a loved one, it can be ambiguous as to exactly when the clock starts, so sooner is always better. And the rollover has to be valid in the first place — taxpayers should bear in mind that only one IRA-to-IRA rollover is permitted within a 12-month period, for example.

Overall, the new process will keep a lot of taxpayers from paying a significant price for a retirement rollover error. The idea of an innocent mistake wiping out years of tax-deferred savings is understandably a worst-case scenario for many savers, and Congress's decision to allow the IRS to waive the penalty suggests that lawmakers do not want situations such as a Post Office error to trigger such a result. Nor did the IRS, in the midst of its own budget and staffing struggles, see much benefit from spending time on large numbers of private letter ruling requests because taxpayers misplaced their checks.

Of course, in many cases taxpayers can avoid headaches by simply arranging for a direct transfer from one trustee — that is, the financial institution responsible for the retirement account in question — to another. If the assets never pass through the taxpayer's hands, there is no risk of missing the 60-day window. The IRS itself urged taxpayers to use this direct transfer approach in announcing the new rules in August.

Rollover mistakes will happen. The new self-certification procedure is a sensible step forward, one that is both taxpayer- and IRS-friendly. It simplifies the process and saves taxpayer money in the form of IRS employees' time, making this change an easy win for common sense as well as for retirement savers.

What's The Best Way To Pay For A New Car?

By David Walters, CPA, CFP®

Whether your old car has given up the ghost or you just like "new car smell," getting a new ride is a major financial decision.

For many people, used vehicles are a practical option (and are almost always the better financial option). Yet some buyers want a brand-new car, which offers the peace of mind offered by a warranty and no previous owner. Some drivers simply like driving a vehicle with all the latest bells and whistles. If you have settled on a new car, the next major decision is how you will pay for it. Before you start scheduling test drives, take some time to seriously consider whether you ought to buy or lease.

Buying

If you can afford to buy the car you want outright, with no financing, this may be the soundest financial option in the long run. You will not be responsible for any interest or finance charges, and will be able to avoid some of the disadvantages of both financing and leasing.

However, most people don't have the cash necessary to buy the car they want. This is why most vehicle owners end up financing their purchases one way or another. Even with financing, however, buying is the better deal than leasing unless you know you plan to trade in your vehicle every few years. The longer you own a particular car, the more you save over leasing an equivalent vehicle. And, assuming you have a well-made car and do not run afoul of any major accidents, you may have years with no car payments at all once you pay it off.

In addition to the overall cost difference, buying means that you have the freedom to sell or trade in your car at any time. You also have the freedom to keep it as long as you like. This can create much more flexibility down the line than lessees can expect. If you sell a car you own outright, the cash value is yours to use any way you want.

Buying a car also frees you from worry about incidents that can trigger fees in a lease. For example, you can drive the car as many miles per year as you like; go ahead and take that spur-of-the-moment road trip. Wear and tear on the car, whether inside or out, only matters inasmuch as it might affect the car's ultimate resale value and your own comfort. And if you want to customize your car in any way, the choice is yours.

While these advantages are substantial, purchasing a vehicle does come with downsides. Most dealerships require a higher down payment for a financed purchase than for a lease, in many cases 10 to 20 percent down. Monthly finance payments will also be higher than lease payments on an equivalent vehicle, because you are paying off the entire purchase price, plus interest and finance charges. If you know you are the type of person who will want a new car in a few years regardless of how well your old one runs, you may end up paying enough in finance charges that leasing is the more logical option for you.

If you own your vehicle, you also roll the dice on its potential resale value. Most drivers know that a car starts to depreciate the moment you drive it off the lot. How fast it depreciates, and how its condition fares over time, will become your problem if you plan to trade it in or sell it one day. You will also be responsible for maintaining that condition; after the warranty expires, repairs and upkeep will be entirely your responsibility.

Leasing

Many people think of leasing a car as equivalent to renting a home. While the two arrangements do have some aspects in common, leasing a car is a little bit different from renting real estate.

When you lease a car, you borrow the car's entire value, less any down payment or trade-in value specified in your lease arrangement, just as you would if you were financing a purchase. As in a regular car loan, you will be charged interest. However, when you lease, you only pay back the depreciation, rather than the vehicle's full cost. At the end of the lease, you return the car to make up the rest of the loaned amount. Some leases may give you an option to purchase — often known as "lease to own" arrangements — but your lease payments do not mean you have built any equity in the car. First you lease, then you buy, even if you arrange to buy at a discount.

One of the biggest reasons people lease rather than buy a car is because leases offer lower monthly payments for an equivalent vehicle most of the time. You are covering depreciation plus "rent charges," or interest, rather than

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paying off the car's full value. The down payment is usually lower too; sometimes a dealer will waive a down payment altogether for a lease, which seldom if ever happens when financing a purchase.

A lease also relieves a driver of the hassle of disposing of a car once he or she is done with it. As long as the vehicle is in good shape, at the end of the lease you hand over the keys and walk away. This also means depreciation is not your problem. The future resale value is set in the original lease agreement, so if the car turns out to be worth less than expected, it is the dealer's problem, not yours.

Lease terms are usually such that the car's factory warranty covers repairs for most or all of the period in which you will lease the car. And for some people, the appeal of knowing they will have a new car every two or three years is so attractive that leasing makes sense when factoring in finance charges and interest on an equivalent purchase cycle.

The two major downsides of leasing are lack of equity and lack of flexibility. As with any property you rent rather than own, you do not have the benefit of knowing each monthly payment is building an increased interest in the property. This also means that a lease costs more than an equivalent loan in the long run, even if it is cheaper month to month, because you do not recover any portion of your payments in trade-in or resale value.

A lease is also a commitment for a set period of time. You cannot just sell a leased car if you find yourself in a cash flow crunch or return it if you no longer need it. If you do need to end the lease early, the early termination charges will often end up just as expensive as sticking to the contract. Breaking the lease may even cost more once you factor in early termination fees.

You also may find yourself responsible for an assortment of fees when you return your leased car. If you drive over the mileage limit, which is typically 12,000 or 15,000 miles per year, charges can add up quickly. The same is true if your car shows wear and tear beyond what the dealer considers "normal," which is a major reason drivers with young children or pets often find leasing impractical. Lessees will also want to be sure they are diligent about oil changes, tire rotation and other upkeep to avoid more than "normal" wear. And if you have made any modifications to your car, they must be reversible or you will be charged for residual damage.

Leasing a car typically involves more complex paperwork than does buying, even if you finance. Moreover, you will almost always need excellent credit to qualify to lease at all; buyers with bad credit have to shoulder higher interest rates but can typically still get a loan unless their credit is truly awful.

Unless you buy your new car outright, you will need to pay financing charges whether you buy or lease. But in general, finance charges are much higher for lessees than buyers, though in most states this difference is partially offset by a sales tax break on lease payments. Lessees may also need to pay lease initiation fees at the beginning of their leases or disposal fees at the end, expenses that buyers will not need to worry about.

Other Concerns

If the major sticking point for purchasing is the relatively higher monthly payment, you can consider opting for a longer term loan to bring the payment down. However, because cars depreciate over time, longer loan terms increase the chance of going "upside down" on the loan — that is, finding yourself in a situation where your vehicle is worth less than what you owe. Longer loan terms also often mean you will end up paying more interest over the course of the loan. Still, even with these concerns, a longer loan may offer advantages over leasing for many drivers.

Whether you buy or lease, you should always negotiate price with your car dealer. Some experts claim you will get a better deal if you negotiate as though you plan to buy the car, then say you plan to lease after you and the dealer settle on a price and trade-in value.

If you plan to finance a purchase, you should also beware of simply accepting the dealer's finance offer without shopping around. Apply to more than one lender so you can compare options. Do not only consider the interest rate, but also the loan term and any other fees, such as a prepayment penalty.

As with any major purchase, taking the time to fully weigh the pros and cons of car payment methods will yield long-term benefits. There is no one right answer, but if you successfully match your decision to your needs and lifestyle, you can drive off the lot ready to fully enjoy that new car.

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Duly Noted

An Earlier Deadline For Information Returns. American businesses have been enlisted in the fight against fraudulent tax filings, and it will require them to be on their toes after the year-end holidays. Businesses now are required to send W-2 forms reporting employee earnings and Forms 1099 showing payments to nonemployee contractors to the Internal Revenue Service by January 31. In the past, such forms needed to go to taxpayers by that date, but businesses had more time to file them with the IRS. The change will allow the IRS to verify compensation claims and tax withholding before issuing refunds claimed on returns filed early in the tax season. *P.L. 114-113.*

Domicile Fights Not Just A Coastal Thing. Large urban states such as New York and California are renowned for aggressively challenging claims by would-be former residents who say they now live elsewhere. But they know how to play hardball in Iowa, too, notwithstanding the state's self-image as a particularly friendly state. Clifford Wendt discovered the limits of "Iowa nice" when he claimed nonresident status on his 2010 tax return, a year in which he worked and dwelled in South Dakota while separated from his wife. The Iowa Department of Revenue claimed jurisdiction to tax Wendt as a domiciled resident because he retained co-ownership and was registered for a homestead credit on his Iowa house, failed to change his voter registration to South Dakota and had not changed his driver's license because — as they say in the colloquial way in the region — he was waiting until it "needed renewed." *Re Clifford W. Wendt*, 2016 STT 111-12.

New York Won't Tax Nonresident's 'Top Hat' Plan. A high-level employee who worked for a New York firm but lived elsewhere is not subject to New York tax on a lump-sum distribution from a so-called "top hat" plan. The plan provided deferred compensation benefits to employees whose income exceeded the ceiling for coverage under qualified retirement plans. The employee, whose name was not released, sought technical advice from the New York Department of Taxation and Finance. The department confirmed that under federal law, top hat plans are exempt from taxation by nonresident states if they only supplement qualified plans for employees whose compensation exceeds the limits. *2016 STT 111-23.*

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