The Estate Planner

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SCIN protection
Shield your estate from excessive tax exposure

The conservation easement: Handle with care

Are you familiar with fraudulent transfer laws?

Estate Planning Red Flag
You're lending money to family members

SCIN PROTECTION

Shield your estate from excessive tax exposure

The $5.12 million gift and estate tax exemption is scheduled to drop to $1 million next year, and it's not yet clear whether Congress will intervene. In light of this uncertainty, it's a good idea to make the most of the $5.12 million exemption while it lasts. If you've already exhausted your exemption through lifetime gifts, however, there are other techniques you can use to transfer wealth to your loved ones tax-free.

One such technique that's particularly attractive now is the self-canceling installment note (SCIN).

How does a SCIN work?

To take advantage of a SCIN, you sell property — a family business interest or real estate, for instance — to your children or other family members in exchange for an installment note. Unlike an ordinary note, however, a SCIN is structured so that, if you die before the note is paid in full, the remaining payments are canceled and the unpaid balance is excluded from your estate. (With an ordinary note, if you die during the term, the value of the right to receive future payments is included in your estate.)

A SCIN offers several other benefits:

- The sale removes the property from your estate and transfers all future appreciation to the buyer — even if you retain control over the property. (This would be the case if, for instance, you sold a minority interest in your business and kept the majority interest.)
- So long as the sale's terms are commercially reasonable, there's no gift tax.
- You receive an income-producing asset (the installment note).
- If you sell appreciated property, you can defer taxes by spreading the capital gain over the note's term.
- The buyer receives a stepped-up basis equal to the purchase price, minimizing taxable gains if he or she later sells the property.
- The buyer may be able to deduct the interest payments.
- If you die before the note is paid off, the buyer is excused from making further payments, enjoying a significant, tax-free windfall.

For a SCIN to be effective — that is, to ensure that it won't be treated, in part, as a taxable gift — its terms must be comparable to those that would be negotiated in an arm's-length transaction. That means you must charge interest at the market rate, the note's face value must be no less than the property's fair market value and the note's term cannot exceed your actuarial life expectancy at the time of the sale.

Also, you must charge the buyer a "risk premium" to compensate yourself for the risk that the note will be canceled. (See "Placing a premium on risk" at right.)

What are the downsides?

The potential benefits of a SCIN are significant, but they can come at a cost. The risk premium essentially increases the purchase cost. So, if you survive the term, the buyer will end up paying more than the property is worth, reducing or even eliminating the estate tax benefits. There are other disadvantages as well:

- If the buyer is a family member, he or she won't be able to sell the property for two years without adverse tax consequences.
- The buyer will be responsible for financing the purchase. Ideally, the property will generate enough income to cover the note payments, but if it doesn't, the buyer will have to use other funds or risk default.
- If you die before the note is paid off, the unrecognized gain will be taxable to your estate.
- If the IRS determines that the property was undervalued, you may be hit with an unexpected gift tax bill. So it's a good idea to obtain a professional appraisal.

If necessary, you can help the buyer with the note payments by making tax-free gifts within the annual exclusion amount — currently, $13,000 per year ($26,000 if you and your spouse split the gift).

You bet your life

A SCIN involves a bit of gambling. You're betting that the property's appreciation in value over the note term will exceed the buyer's note payments, resulting in a tax-free transfer of wealth. The odds of success are greatest, therefore, when 1) property values are depressed and interest rates are low, and 2) you have reason to believe you won't reach your actuarial life expectancy (provided you're not terminally ill).

Under the right circumstances, a SCIN can be a good estate planning option, so long as you understand the potential costs and risks involved. If the gamble pays off, your family will enjoy sizable winnings in the form of income, gift and estate tax savings. To improve your odds, consult with your estate planning advisor. Your SCIN must be carefully drafted and its terms diligently observed to avoid an IRS claim that the arrangement is a disguised gift. ✤

Placing a premium on risk

To ensure that a self-canceling installment note's (SCIN's) cancellation feature isn't treated as a gift, you must be compensated for its value in the form of a risk premium. The premium can take the form of a higher purchase price, a higher interest rate or a combination of the two. Placing a value on the risk of nonpayment is a complex undertaking that requires the assistance of your estate planning advisor.

The way you structure the premium can have significant tax implications. If you incorporate it into the purchase price, you'll increase the buyer's tax basis as well as the portion of each payment that's taxed as capital gain. If you incorporate it into the interest rate, you'll increase the portion of each payment that's taxed as ordinary income, but you may also increase the buyer's interest deductions.

The optimal structure, from a tax standpoint, depends on the parties' financial circumstances.

The conservation easement: Handle with care

A conservation easement can be a powerful estate planning tool, enabling you to receive significant income and estate tax benefits while continuing to own and enjoy your property. So it's no surprise that the IRS scrutinizes easements to ensure that they meet the tax code's requirements.

Recently, the IRS updated its *Audit Technique Guide for Conservation Easements* (ATG). The fact that the ATG is more than 100 pages demonstrates how serious the IRS is about uncovering abusive arrangements.

4 conservation purposes

The ATG provides taxpayers with a road map for ensuring that a conservation easement qualifies, with an emphasis on valuation and substantiation issues.

A conservation easement is an agreement to *permanently* restrict some or all of the development rights associated with a property. You grant the easement to a conservation organization — usually a government agency or qualified charity — by executing a "deed of conservation easement" and recording it in the appropriate public records office. The organization is responsible for monitoring the property's use and enforcing the easement.

For you to qualify for tax benefits, the easement must be granted *exclusively* for one of the following conservation purposes:

1. To preserve land for public recreation or education,
2. To protect a relatively natural habitat of fish, wildlife or plants,
3. To preserve open spaces, either for the public's "scenic enjoyment" or pursuant to a governmental conservation policy that yields a "significant public benefit," or
4. To preserve a historically important land area or a certified historic structure.

It's critical to draft the easement carefully so there's no confusion about which land uses you're giving up and which ones you're retaining.

The tax benefits

For estate tax purposes, you can exclude up to 40% of the land's value (up to $500,000) from your gross estate (in addition to any reduction in value resulting from the easement itself). Certain limitations apply. For example, the exclusion is phased out as the easement's value falls below 30% of the land's unencumbered value.

For income tax purposes, a qualified conservation easement entitles you to deduct the easement's value (defined as the difference between the property's fair market value before and after the easement is granted) as a charitable gift. The deduction is subject to the same limitations that apply to other charitable donations. Generally, deductions are limited to 30% of the donor's adjusted gross income (AGI), with the excess carried forward for up to five years.

A 2006 tax law provision temporarily increased the limits for conservation easements to 50% of AGI (100% for farmers and ranchers who meet certain requirements) carried forward for up to 15 years. The enhanced limits expired at the end of 2011 and, as of this writing, have not been extended.

> *Draft a conservation easement carefully so that there's no confusion about which land uses you're giving up and which ones you're retaining.*

Like other noncash donations, conservation easements must be supported by a qualified appraisal.

Common mistakes

The ATG identifies several common mistakes taxpayers make when donating conservation easements. They include:

- Use of improper appraisal methodologies and overvalued easements,
- Failure to comply with substantiation requirements, including documentation of the contribution date, the conservation purpose, nature of the contribution and other information; a qualified appraisal; and written acknowledgment from the donee organization,
- Failure to restrict development of the land *in perpetuity*, allowing the easement to be abandoned or terminated, and
- Failure to ensure that any lenders' rights to the property are subordinated to the donee's rights and that the donee has the right to share in the proceeds in the event of a condemnation or other termination.

The ATG also notes that the reservation of property rights must be consistent with the claimed conservation purpose.

Follow IRS rules

If you're contemplating a conservation easement, know that the IRS is scrutinizing them. Be sure to work with tax, legal and valuation professionals to avoid losing valuable tax benefits. ✤

Are you familiar with fraudulent transfer laws?

Because asset values are low and the gift tax exemption is high, now is a good time to transfer your wealth. But before you do so, ask your estate planning advisor about fraudulent transfer laws. In a nutshell, if your creditors challenge gifts, trusts, retitling of property or other strategies as fraudulent transfers, they can quickly undo your estate plan.

2 fraud types

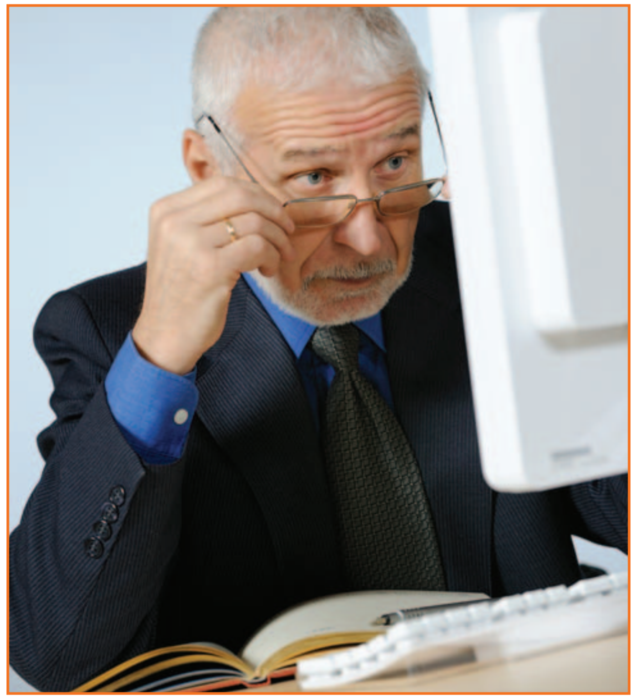
Most states have adopted the Uniform Fraudulent Transfer Act (UFTA). The act allows creditors to challenge transfers involving two types of fraud that you should be mindful of as you weigh your estate planning options:

1. Actual fraud. This means making a transfer or incurring an obligation "with actual intent to hinder, delay or defraud any creditor," including current creditors and probable future creditors. That doesn't mean the fraudulent transfer laws protect anyone who could conceivably become a creditor some day. If that were the case, asset protection planning would be futile.

But suppose a real estate investor discovers that one of his properties is contaminated with hazardous waste and immediately transfers all of his assets to an offshore trust. Clearly, that would be a fraudulent transfer even though no one has actually filed a lawsuit against the investor yet.

Just because you harbor no intent to defraud creditors doesn't mean you're safe from an actual fraud challenge. Because a court can't read your mind, it will consider the surrounding facts and circumstances to determine whether a transfer involves fraudulent intent. So before you make gifts or place assets in a trust, consider how a court might view the transfer.

2. Constructive fraud. This is a more significant risk for most people because it doesn't involve intent to defraud. Under UFTA, a transfer or obligation is



constructively fraudulent if you made it without receiving a reasonably equivalent value in exchange for the transfer or obligation *and* you either were insolvent at the time or became insolvent as a result of the transfer or obligation.

"Insolvent" means that the sum of your debts is greater than all of your assets, at a fair valuation. You're presumed to be insolvent if you're not paying your debts as they become due.

Generally, the constructive fraud rules protect only *present* creditors — that is, creditors whose claims arose before the transfer was made or the obligation was incurred. In some cases, however, a future creditor may challenge a transaction if it leaves you with assets that are unreasonably small or if you intend or believe (or reasonably should believe) that you'll be unable to pay your debts as they become due.

Know your net worth

Most estate planning strategies have an asset protection component. You may make gifts to your children or set up trusts to minimize taxes or to control how and when your beneficiaries receive your wealth. But as an added benefit, the assets are removed from your estate and protected from your creditors.

By definition, when you make a gift — either outright or in trust — you don't receive reasonably equivalent value in exchange. So if you're insolvent at the time, or the gift renders you insolvent, you've made a constructively fraudulent transfer, which means a creditor could potentially undo the transfer.

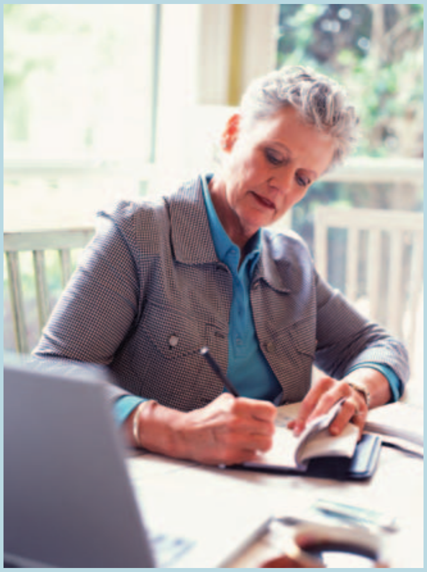
To avoid this risk, analyze your net worth before making substantial gifts. Even if you're not having trouble paying your debts, it's possible to meet the technical definition of insolvency, especially in the current economy.

Protect your plan's integrity

Fraudulent transfer laws vary from state to state, so be sure to ask your advisor about the law in your specific state. Remember, your assets and the integrity of your estate plan are at stake. ✤

Estate Planning Red Flag

You're lending money to family members



The simplest way to provide financial assistance to a child or other family member is to get out your checkbook and make a gift. But if you're concerned about gift taxes, a loan may be preferable. Intrafamily loans must be structured and managed carefully to ensure that the IRS will treat them as bona fide loans rather than disguised gifts.

In a recent case, the U.S. Tax Court identified seven factors to consider in determining whether a loan between related parties is legitimate:

1. Existence of a promissory note or other instrument,
2. Payment of a reasonable rate of interest,
3. A fixed repayment schedule,
4. Adequate collateral or other security,
5. Actual repayment of the loan,
6. Whether, at the time the loan was made, the borrower had a reasonable prospect of repaying the loan and the lender had sufficient funds to make the advance, and
7. The conduct of the parties.

The seventh factor is a catch-all that encompasses one of the distinguishing characteristics of a bona fide loan: the parties' intention that the money advanced will be repaid. An examination of the first six factors may reveal conduct that's inconsistent with a loan, such as failure to execute a promissory note or to repay the loan. But other conduct may also indicate the lack of a debtor-creditor relationship, such as executing a promissory note after the fact or the lender's failure to make reasonable collection efforts.

If you wish to make a loan to a loved one, be sure to plan and document the transaction carefully. If you treat the transaction like a "real" loan, it's more likely that the IRS will treat it as a loan as well.