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THE BOVE & LANGA REPORT: ADVISOR'S FORUM

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As advisors and clients alike may know, tax planning, wealth management, and estate planning often demand an appreciation for, and a thorough understanding of, an excruciating level of detail in order to produce the desired result. In what we hope will become an annual tradition, this Report is more technical in nature than our usual publication. In it, we respond to some common questions raised by advisors.

OFFSHORE VS. U.S.-BASED LIFE INSURANCE

Q: Some of my clients have received proposals suggesting they purchase "offshore" life insurance. Why would this be better than the usual domestic life insurance policy?

A: If a domestic policy clearly satisfies all of the client's needs for life insurance, then there may be no need to go "offshore." But if that is not the case, offshore insurance issued in certain jurisdictions offers features sometimes not available with domestic policies. For instance, if one of the objectives in the client's plan is asset protection, that may be available to resident-owners of some states but not others. Florida and Michigan, for instance, protect life insurance and annuity contracts from potential creditors of the owner, but Massachusetts only protects life insurance, and even then, only if the policy and the circumstances meet certain criteria. If a client wants asset protection features that are not available in the state where that client resides, the only option is an offshore product.

Further, all U.S. states have a four year open period during which a creditor can attack the acquisition of the contract as a fraudulent transfer. The more popular offshore jurisdictions, such as Liechtenstein, the Bahamas, and Bermuda, protect both life and annuity contracts from creditors and generally have only a two year open period, regardless of the domicile of the purchaser. In addition, the creditor has a high standard of proof to establish the debtor's fraudulent intent in acquiring the contract, which proof must be offered in the foreign court. In short, unless the client has a clean four years ahead of her, no U.S. policy could match the protection of an offshore policy.

In addition to the creditor protection features, many U.S clients use offshore policies for their flexibility of investments. In recent years, the so-called Private Placement Life Insurance ("PPLI") contracts have offered U.S clients the option of "designing" their own contract as to investments and coverage, an arrangement not offered to the same extent by U.S. insurance companies.

If there is a drawback to the offshore contract, it is the U.S. reporting requirements and the U.S. excise tax that apply. Section 4371 of our tax code imposes a 1%, one-time excise tax on the amount of cash paid for the acquisition of a foreign insurance or annuity contract, so for example, a U.S. person who paid $100,000 into a foreign annuity would pay a $1,000 excise tax. In addition, the U.S. owner of any foreign contract (life insurance or annuity) with a cash value that, when added to the value of all other foreign financial accounts, exceeds $10,000, is required to file a foreign bank account report annually (FinCEN Form 114). And if the year-end value of the account exceeds $50,000 ($100,000 for joint returns) a Form 8938 must also be filed annually. Note that these forms are simply to *report* the accounts and do not require the payment of any tax. Furthermore, the foregoing numbers may change with circumstance; be sure to check the applicable figures on our website.

It should also be noted that the major offshore companies are regarded as financially safe institutions, and the policies offer the same tax benefits and treatment as their U.S. counterparts. In short, the pros and cons of onshore vs. offshore must be weighed in light of the client's objectives.

CONSOLIDATING RETIREMENT ACCOUNTS AND ASSOCIATED CREDITOR PROTECTION

Q: In the interest of efficiency, I plan to suggest that my client consolidate her 401(k), rollover IRA, contributory IRA, and SEP IRA. Are there are any drawbacks to this approach?

A: Yes. Varying levels of protection from certain creditors are afforded to different types of retirement plans, either by federal law or state law depending on the plan. Such protection can be reduced or lost altogether where different types of retirement plans are consolidated. Title I of ERISA, a federal law, provides that benefits under a "pension plan" (such as a 401(k) plan) may not be subject to a creditor's reach by means of an assignment or alienation, subject to certain exceptions, divorce and child support for example. Note that ERISA does not apply to SEP plans, SIMPLE plans, government plans, or IRAs.

To determine protections afforded to a <u>non</u>-ERISA plan in a <u>non-bankruptcy</u> case, the account owner must look at applicable state law, usually the law of the state of account owner's residence. Most states provide some level of protection to IRAs, with the majority (excluding Massachusetts) favoring complete exemption. In lieu of a simple approach, Massachusetts exempts 100% of a person's interest in a Keogh, 401(a) plan, 403(b) plan, SEP, or IRA, but the exemption for plans maintained by an individual, whether or not self-employed, does not apply to contributions that exceed 7% of such person's total income during the five year period preceding the entry of judgment.[1] Got that? Assume the income of Barney, a Massachusetts resident, for the five year period preceding entry of judgment was $1 million in the aggregate. If Barney had deposited $100,000 into a SEP during this time, $70,000 of deposits would be exempt, while the remaining $30,000 would not.

In a bankruptcy context, traditional and Roth IRAs are exempt up to $1 million (indexed for inflation), whereas rollover IRAs from qualified plans, 403(b) and 457 plans are exempt without limitation. Note, however, that rollover IRAs whose source of funds are SEP and SIMPLE IRAs do not qualify for the unlimited rollover protection. Further, in a landmark case decided this past June, *Clark v.*

[1] Mass. Gen. Laws Chap. 235 § 34A.

Rameker,[2] the Supreme Court ruled unanimously that inherited IRAs are not protected in bankruptcy under federal law. Although one may be inclined to think of such an account like any other retirement plan, the Court found certain characteristics of an inherited IRA were inconsistent with a true "retirement account", namely, an inherited IRA beneficiary can't add money like an IRA owner may; must generally begin to take RMDs beginning in the year after she inherits the account, regardless of how far away she is from retirement; and, may take a total distribution of her account without penalty.

Accordingly, if a client lives in, or is about to move to, a state where IRA protections aren't strong, he may want to consider leaving the assets in an ERISA-protected plan in lieu of combining them with other funds in a rollover IRA. If the client insists on transitioning out of the ERISA-protected plan, then he should consider segregating rollovers whose sources are qualified plans (or 403(b) or 457 plans) from SEPs, SIMPLEs, and contributory retirement accounts, or at the very least document the source of funds for each plan.

STREAMLINED FILING PROCEDURE

Q: My client just told me about her inherited bank account in Spain. She has not been reporting it to the IRS. Will she have to pay a huge penalty on this?

A: For some time now, the IRS has been focusing its attention on U.S. persons with offshore assets, and the attention seems to be yielding results. Specifically, U.S. taxpayers who have not reported certain offshore assets on the Foreign Bank Account Report (FinCEN Form 114, or "FBAR") and other relevant forms face severe penalties. Because the efforts of the IRS have made big headlines, people worldwide are increasingly aware of U.S. reporting and filing obligations. It is important and valuable for a taxpayer to correct past reporting errors, but the path for late reporting of offshore accounts has been arduous and expensive, even if the failure to file was for good reason, such as reliance on professional advice. For taxpayers whose failure to file was non-willful, there is recent, good news!

On June 18, 2014, the IRS announced an attractive new procedure, called the "Streamlined Domestic Offshore Procedure," for certain taxpayers who have failed to report offshore accounts. This procedure is only available if the failure to file was "non-willful." As part of this procedure, the IRS has defined the term: "Non-willful conduct is conduct that is due to negligence, inadvertence, or mistake or conduct that is the result of a good faith misunderstanding of the requirements of the law." For taxpayers who qualify, this procedure imposes only a 5% penalty on the highest year-end balance of offshore accounts in the past 6 years. Compared to the alternatives, this 5% penalty can be very attractive.

What are the alternatives to the streamlined procedure? For many years, the only IRS-approved method to resolve unfiled or incorrect FBARs was to enter the Offshore Voluntary Disclosure Program (also called the Offshore Voluntary Disclosure Initiative, "OVDP" or "OVDI"). This program offers taxpayers affirmative acceptance from the IRS and relief from criminal prosecution in the event of willful failure to file. In exchange, the taxpayer pays a 27.5% penalty on the highest balance of certain unreported accounts in the past eight years. Because the penalties under OVDP and OVDI are so high, many taxpayers over the years have instead elected to simply file past returns with the hope that their returns will not be selected for audit and that the IRS will not pursue civil and criminal willfulness

[2] *Clark v. Rameker*, 573 U. S. __ *(*2014*).*

penalties. This practice is called a "quiet filing." The IRS has repeatedly warned against quiet filings, but despite the inherent risks, in some cases taxpayers decide that quiet filing is the most practical solution.

By comparison, the streamlined procedure looks like a good option for many taxpayers. As with all good things, there are catches. The streamlined procedure was released without any prior opportunity for public comment and there are some circumstances when it may not produce the best result, even if the taxpayer's conduct was non-willful. Most significantly, the streamlined procedure imposes a 5% penalty on any foreign financial asset that "should have been, but was not, reported on an FBAR for that year." There is some debate regarding whether or not this includes accounts over which the taxpayer was only a signatory and had no financial interest, and the latest word we have heard from the IRS is that signatory accounts will be subject to the 5% penalty. In contrast, the Offshore Voluntary Disclosure Initiative excludes such accounts from the penalty calculation. Also, the streamlined procedure does not ever result in an "acceptance letter" or other affirmative statement from the IRS. All returns filed under the streamlined procedure will be subject to audit until the statute of limitations runs.

The good news is that now we have an IRS-approved procedure for clients whose conduct was non-willful. It will not be the best choice for every client, but it is a welcome addition to the short list of available options.

MASSACHUSETTS ESTATE TAX PLANNING

Q: Given the significant increase in the federal estate tax exemption, are there any special estate tax planning opportunities available for MA residents?

A: Yes. The personal representative of an estate valued at over $1 million must file a Massachusetts estate tax return and pay Massachusetts estate tax at graduated rates as high as 16%. This law is similar to the law of many states which also impose a state-level estate tax. Massachusetts estate taxes are also imposed where the decedent has less than $1 million at the time of death, but has made one or more taxable gifts during life which, when added to the remainder, exceeds the $1 million filing threshold. So, although the $5.34 million federal estate tax exemption shelters many estates from *federal* estate tax, the estate of a surviving spouse dying as a Massachusetts resident with $5.34 million in her name would face a *Massachusetts* estate tax of $431,600.

To combat this effect, one spouse could make a completed gift to a special type of <u>irrevocable</u> trust, the acronym for which is "SLAT" (Spousal Lifetime Access Trust), for the benefit of the other spouse (descendants could also be named as beneficiaries), thereby reducing or eliminating the Massachusetts estate tax depending on the size of the gift. This strategy is effective because Massachusetts operates by looking at what the decedent has *in his or her estate* at death, and *does not tax transfers that he or she made during life*, unlike the federal tax system. If inflation rises and investments held outside of the SLAT return less than expected over time, the trustee could make a distribution from the SLAT to the donor's spouse even though the donor has irrevocably surrendered dominion and control over the gifted assets.

Remember also, that in addition to estate *tax* planning, trusts can be designed to achieve other goals, such as asset protection for beneficiaries, incapacity planning, income tax planning, charitable planning, and furtherance of other socially responsible goals, to name a few.

ASSET PROTECTION TRUSTS: HERE OR THERE?

Q: Now that many U.S. jurisdictions offer asset protection trusts, is it better to establish such a trust in the U.S. instead of offshore?

A: Asset protection trusts have been a popular topic for state lawmakers recently. In 1997, Alaska enacted the first affirmative U.S. asset protection trust legislation. Since then, 14 additional states have followed, creating a competitive domestic market for asset protection trusts. With all these choices available, domestic asset protection planning is widely discussed.

Domestic asset protection trusts have two significant advantages over offshore trusts: (1) no foreign reporting requirements, and (2) domestic administration. Regarding the foreign reporting requirements, an offshore trust likely will qualify as a grantor trust for U.S. tax purposes during the grantor's lifetime. However, the foreign trustee likely makes it subject to FATCA reporting, and certain foreign accounts and business interests must be reported by the taxpayer annually on the FBAR (as discussed earlier in this Report) and other forms. Keeping the trust as a U.S. trust avoids these complications. Regarding domestic administration, some clients simply are more comfortable with keeping their assets in the U.S.

Domestic asset protection trusts have the disadvantage of being arguably more vulnerable to creditor attacks than offshore trusts. This is because asset protection trusts take advantage of discrepancies among the laws of various jurisdictions, but the laws of U.S. states are somewhat intertwined. The Full Faith and Credit Clause of the U.S. Constitution requires states to honor judgments obtained by creditors in other states. It remains unclear whether or not that Clause will apply to U.S. asset protection trusts, although it is clear that offshore trusts would not be subject to it. Also, choice of law rules may cause a U.S. asset protection trust to be tested under the laws of a different jurisdiction, such as the debtor's residence or where the debt arose, and not the trust's chosen jurisdiction. This is a particular risk when, as seen in the recent case *In re Huber*[3], a debtor has limited ties to the asset protection jurisdiction.

The two significant advantages offered by an offshore trust that cannot be matched by a domestic trust are: (1) the short, sometimes non-existent, period of limitations within which transfers to the trust may be attacked; and (2) the non-recognition of U.S. judgments.

In the more desirable offshore jurisdictions (e.g., the Cook Islands and the Bahamas), an existing creditor must bring an action against the trust within two years of the transfer to the trust, and the action must be brought in the foreign jurisdiction. This two year period only applies to creditors existing at the time the trust is settled. Future creditors (those whose claims arose after the trust was settled) simply may not pursue a claim against the trust. A judgment of a U.S. court ordering the trustee of the offshore trust to pay a creditor will not be recognized by the foreign court.

In short, the clear consensus among asset protection specialists is that offshore trusts offer the ultimate creditor protection, short of not having any assets to protect.

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[3] *In re Huber*, 493 BR 798 (Bkrptcy. DC Wash., 2013).

SERVING AS TRUSTEE OF A TRUST THAT HOLDS A HEAVILY-CONCENTRATED POSITION

Q: A client wants to name me as trustee of a trust holding a large position in a family company. I know that as trustee I have a duty to diversify trust investments. What do I do in a case like this? Is it enough if we add a provision in the trust saying that I, as trustee, will not be liable for keeping the bulk of the trust assets in the family business?

A: The answer is an unequivocal maybe, and there is a better way to do it. There are numerous reported cases where attempts were made to exonerate a trustee for maintaining a disproportionately large position in a particular security or family investment, but which nevertheless ended up holding the trustee liable for losses. In those cases, material changes in circumstances warranted overriding the specific instructions to hold on to the investment.[4] In response to this potential "catch 22" situation, the theory of divided trusteeship was developed.

Of course a trust can have more than one trustee, but basic trust law requires all trustees to be equally responsible for all aspects of trust management. The "divided trusteeship" concept modifies this arrangement and divides certain responsibilities among trustees, or more typically, among trust advisors, so that the liability of one may not overlap to another. For example, the named trustee may be responsible for all administrative and dispositive aspects of the trust, while the named "investment trustee" or "investment advisor" would be responsible for all investment decisions for the trust. The trust document would provide that the administrative trustee would have no responsibility for selection or performance of investments, and would not be liable for any actions of the investment advisor, short of outright theft or fraud, or a direct breach of the terms of the trust. Even then, the administrative trustee could only be held liable if he or she could reasonably have known about such breach. Under the same theory, the trust terms could provide that the investment advisor would have no duty to monitor the actions of the administrative trustee, and liability of the investment advisor may be limited as noted above.

A trust with such a division of duties is known as a "directed" trust, and at least 35 states, including Massachusetts,[5] now specifically allow exculpation of a trustee where the duties are expressly divided. Remember, however, that a trustee can never be exculpated or exonerated for acting in bad faith or for willful misconduct.

MODIFICATION OF A SELF-CANCELLING INSTALLMENT NOTE (SCIN)

Q: Our Client is the holder of a self-cancelling installment note (SCIN) that was issued to Client by Client's irrevocable non-grantor trust (Trust), in exchange for the transfer of non-voting interests in Client's operating business. The terms of the SCIN require Trust to make interest-only payments to Client for 10 years, at which time the outstanding balance of the principal is due (provided Client is still alive). Trust has made interest payments for 9 years, but may not have sufficient funds to make the outstanding principal payment next year. Could Client and Trust modify the SCIN?

A: Generally, willing parties are allowed to modify agreements they have made, but with regard to the transaction you have outlined, the real question is whether modifying the terms of the SCIN will result

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[4] *In re Charles G. Dumont*, 791 N.Y.S.2d 868 (2004).
[5] Mass. Gen. Laws Chap. 203E § 808(b).

in a taxable exchange for income tax purposes under Treas. Reg. § 1.1001-1(a). In such a case, Client would have to immediately recognize gain on the sale of the non-voting interests to the Trust, which presumably Client would like to defer.

Treas. Reg. § 1.1001-3 (commonly known as the *Cottage Savings* Regulations) defines what a "modification" of a debt instrument (such as a SCIN) is, and provides the attendant tax consequences. Paragraph (b) of the Regulation stipulates the general rule: essentially, a "*significant* modification" of the debt instrument will result in a taxable exchange, whereas a modification that is not significant won't result in a taxable exchange.

A "modification" basically includes any alteration of a legal right of the holder of a debt instrument, whether by agreement or conduct of the parties. The general rule provides that a modification is significant if, based on all the facts and circumstances, the legal rights or obligations that are altered (either individually or collectively) are economically significant. For example, changes in the note's yield, the timing of payments, or the obligor (here, the Trust), are all considered significant changes – subject, however, to certain exceptions.

One such exception, pursuant to paragraph (e)(3)(ii), which deals with changes in the timing of payments, offers a safe-harbor period during which payments can be deferred: "the safe-harbor period begins on the original due date of the first scheduled payment that is deferred and extends for a period equal to the lesser of 5 years or 50 percent of the original term of the instrument." Thus, based on the original term of 10 years, Client and the Trust could agree to extend the term of the SCIN for an additional 5 years. In addition, note that if the period during which payments are deferred is less than the full safe-harbor period, the unused portion may be used for subsequent deferrals of payments. However, in order to rely on the safe-harbor exception, the deferred payments must be unconditionally due no later than the end of the safe-harbor period.

Other modifications, such as the note's yield, could also be made; it is also *possible* to make changes that are outside the safe harbor rule. The significance of a modification takes into consideration all facts and circumstances collectively, so be especially cautious when making multiple modifications.