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LAW FIRM

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To: Clients and Friends

From: The Attorneys at Bove & Langa

Re: Important Developments and Planning Opportunities: October 2007

FIRM UPDATE

Firm Update. Passports held by the attorneys of Bove & Langa are getting a lot of use this year! Melissa travelled to Vancouver, British Columbia this month to lecture on asset protection trusts to members of the American Bar Association. As well, Alexander has been invited to lecture on the use of US trusts by non-US residents at an international conference of European attorneys in Rome, Italy, as you read this. Closer to home, Deborah Dong has decided to open her own law firm, which will focus primarily on business planning and contractual work, as well as trusts and estates. We wish her the best of luck. Joining the Bove & Langa team is Kathy Dominguez, who will serve as Melissa's "right hand woman", and she looks forward to getting to know all of you and helping make all your interactions with the firm efficient and rewarding.

NEW DEVELOPMENTS

Did You Know That Tuition For A Medically Challenged Child May Qualify As A Medical Care Expense? As a general rule, the cost of ordinary education does not qualify as medical care that may be deductible to the extent such expenses exceed 7.5% of adjusted gross income. However, in recent Private Letter Ruling 200729019, the IRS held that a taxpayer may deduct as a medical expense the cost of a mentally challenged child's self-contained course designed to meet the child's needs. The cost of attending a special school for a mentally or physically challenged child will be treated as a deductible medical expense if the resources of the institution for dealing with the child's needs are a principal reason for the child's presence in the institution. This may apply, for example, to costs incurred on behalf of a child with severe learning disabilities to attend a special school.

Ditch, Dump, Disavow, And Discard – Proposed Regulation On How To Abandon A Security. It seemed like a good investment at the time, but now the stock is hopelessly underwater with no market in sight. Can the taxpayer simply declare the security as worthless and take a capital loss deduction under Section 165(g) of the Internal Revenue Code? Under proposed regulation Section 1.165-5, the IRS states that a simple declaration is not enough. Rather, the taxpayer must "permanently surrender and relinquish all rights in the security and receive no consideration (value) in exchange …" This test will be applied subjectively, with the IRS looking at all the facts and circumstances evidencing the abandonment.

Collecting On Your Life Insurance Policy Without Dying. Generally, we buy a life insurance policy to provide financial protection for family members (e.g., income for a spouse or educational costs for children). The usual lament, however, is that we pay into the policy for years, but the benefits only come when we die. Some refer to it as death insurance. Of course, some policies build a cash value which can be withdrawn, but with most, the cash value is so far below the death benefit, we are often reluctant to cash in the policy. As an alternative, a loan on the policy means only more costs, since we have to pay interest to the insurance company for borrowing our own money.

Over the past several years, this situation has changed dramatically for many as a result of the development of a secondary market for life insurance policies – sometimes called the "life settlement" option. Note that this is not a viatical settlement, under which the insurance company that issued the policy will pay the death benefit in advance to an insured whose death is expected to occur within two years after a diagnosis of serious illness.

The life settlement proposal may be made by a totally different company and is an offer to purchase the policy for an amount between the cash value and the face value or death benefit. Previously, your only option was to cash in the policy with the issuing company for the policy's cash value, and if it had no cash value (as with a term policy or one with a large loan outstanding) then you may receive nothing. With a life settlement, however, even a term policy with no cash value may be the subject of a buy-out for a substantial amount of cash, depending on the age and health of the insured. Since the offer is based on an actuarial valuation, the offer would be less for a younger, healthier person than for an older person who is not in the best of health. In fact, most companies will not be interested in purchasing a policy from an insured who is under age 70. Receipt of the cash payment is treated in part as return of the premiums paid and the balance may be capital gain. It is also interesting to note that the life settlement option, where applicable, could be carried out by the trustee of a life insurance trust that owns the policy.

For individuals who do not want to continue to pay high premiums, who would like to access the cash in the policy, and who have no further need for the life insurance coverage, the life settlement option can be an attractive opportunity that was not previously available.

"Whether 'Tis Nobler In The Mind To Suffer The Slings And Arrows" Of An IRS Challenge Or To Obtain A Qualified Appraisal? To obtain a qualified appraisal to determine the value of an estate asset or gifted asset or not to obtain a qualified appraisal – that is the question. Many of our clients are reluctant to obtain a qualified appraisal for estate and gift tax reporting purposes due to the cost associated therewith. We again reiterate that without a qualified appraisal there is a strong likelihood of an IRS challenge to the value of the asset. Additionally, as highlighted by a recent Second Circuit Court decision, *Thompson v. Commissioner*, an appraisal that is not truly qualified may still leave the value of the asset open to challenge by the IRS. For example, in *Thompson* the Court held that the decedent's minority interest in a closely held family business was severely undervalued (the estate claimed the interest was valued at $1.75 million; the Court held that the proper value of the interest was $13.5 million), and admonished the executors of the estate who chose to obtain an appraisal from a lawyer and an accountant from a different jurisdiction (the asset was in New York, the attorney and accountant were both in Alaska), both of whom had relatively little experience in valuing interests in closely held family companies, thus underscoring the importance of obtaining a qualified appraisal performed by a non-interested professional who has experience preparing appraisals for the type of asset you are seeking to value.

If the IRS does challenge the value reported on an estate tax return or gift tax return, and determines that the value was underestimated, not only can a larger tax be assessed on the value the IRS feels is more accurate (substantiated by a qualified appraisal obtained by the IRS), but an underpayment penalty of forty percent (40%) of the total tax owed can be assessed if the value claimed on the return is fifty percent (50%) or less of the correct value of the asset. Costs of such added taxes and penalties are likely to be many times the cost of obtaining a qualified appraisal.

Secret Foreign Accounts Not So Secret. Government agent Jason Bourne travels the world in search of his identity, and he always seems to have access to funds in the several countries he dodges through. When he finally discovers his identity, however, he may also discover that he is in deep doo-doo with the IRS for not reporting all those foreign bank accounts. While the bank secrecy rules of foreign countries are rigidly respected by those countries, that does not excuse US persons from complying with the federal rule that any US person with a foreign financial account in excess of $10,000 at any time during the year must reveal that secret and report the existence of that (or those) account(s) to the IRS each year. The penalty for failing to file can range from $10,000 to imprisonment.

Foreign accounts are reported on form TDF 90-22.1 (often called an FBAR form, for "Foreign Bank Account Report") which is a treasury form and NOT a tax form, so no taxes are paid with the form. Any interest on the foreign accounts must, of course, be reported on the individual's income tax return, because, contrary to what many seem to think, foreign bank interest is fully taxable to US persons. The fact that the foreign bank does not report the account or the income to the IRS is totally irrelevant.

The requirement to file applies to every US person (note that that includes a foreign individual who resides in the US) who has direct or indirect authority over a "foreign financial account." This could include not only the owner of the account but also someone acting for the owner who has authority over the account, such as a person holding a power of attorney, a trustee, or a joint owner who made no contribution to the account. And "financial account" does not only mean bank accounts. The reporting rule applies to brokerage accounts and foreign insurance or annuity contracts with the requisite cash value of $10,000 or more if the direct or indirect authority to withdraw is present. Note that the $10,000 is considered in the aggregate, so that a person holding five $2,000 accounts must file the FBAR form.

The form must be filed by June 30th of the year following the subject year of the report and is <u>not</u> filed with your tax return. It is filed with the Treasury department in Detroit, Michigan. For those who may fear consequences in disclosing their "secret" accounts to the IRS or the Treasury, it may help to know there is no evidence that the filing of the FBAR generates a tax audit, but if you haven't been reporting the interest on your foreign accounts, a not-so-secret agent may be calling on you.

PLANNING OPPORTUNITIES

Crafty Deductions. You enjoy making pottery, and have started selling your creations at craft fairs. Is this new business venture really a start-up company, or will the IRS consider it to be more of a hobby? If it is an actual business venture you are permitted to take current or amortized itemized deductions for many of the business expenses related thereto. If it is a hobby, however, you are only permitted to deduct expenses to the extent of the gross income derived from the activity.

To determine whether the activity is a trade or business for income tax purposes, or whether it is merely a hobby, the bottom line question is, "was the activity *engaged in for profit*?" There is a rebuttable presumption that if the gross income derived from the activity exceeds the deductions attributable to the activity in at least three of the past five consecutive years that the activity is engaged in for profit. A start-up company by its very nature will not fall into this "safe harbor" rule. Therefore, it will be up to the taxpayer to show that the facts and circumstances of the case support the claim that the start-up company is engaged in for profit, and should be taxed as a trade or business, and not as a hobby. In determining whether an activity is engaged in for profit,

a reasonable expectation of profit is not required; it may be sufficient that there is a small chance of making a profit.

There are a number of factors the IRS considers when determining whether to characterize an activity as a trade or business, or whether to characterize an activity as a hobby. Specifically, under regulation Section 1.183-2(b), the IRS considers (1) whether the taxpayer carries on the activity in a businesslike manner and maintains complete and accurate books and records; (2) the expertise of the taxpayer or her or his advisors in the accepted business, economic, and scientific practices of the activity; (3) the personal time and effort expended by the taxpayer in carrying on the activity, especially whether the activity has substantial personal or recreational aspects; (4) the taxpayer's expectation that assets used in the activity may appreciate in value, and thus turn a profit for the taxpayer; (5) the success of the taxpayer in carrying on other similar activities in the past; (6) the taxpayer's history of income or loss with respect to the activity; (7) the amount of profits in relation to the amount of losses incurred; (8) the financial status of the taxpayer, especially if the taxpayer does not have substantial income or capital from sources other than the activity; and (9) the presence of personal motives in carrying on the activity, especially elements of personal pleasure or recreation, which may indicate that the activity is not engaged in for profit.

A taxpayer's characterization will not be accepted when it appears that her or his characterization of the activity as a trade or business is artificial and cannot be reasonably supported under the facts and circumstances surrounding the activity. Therefore, we recommend keeping in mind the factors mentioned above from the inception of your start-up company to ensure you can support any IRS challenge to the characterization of the activity.

You Cannot Clap With One Hand. And your grandchildren did not simply spring from the loins of your children. It took two to tango, and you might consider including your daughter-in-law or son-in-law in your estate plan. This may seem counter-intuitive, as most clients fear a child's divorce and the dissipation of family wealth outside the bloodline. But what of the long-term happy marriage? Would your grandchild's remaining parent be adequately provided for should your child decease? If not, and if you care, you might consider structuring your child's legacy in a manner that anticipates this conundrum. Many options exist, from an outright gift, to a lifetime income interest in a portion of the legacy, to an annuity provided outside your trust. The latter may permit family benefits to be paid without giving control to the in-law. Blood may be thicker than water, but water is the staff of life. Think about it.

Trouble In Paradise. While we mere mortals cannot fathom what the afterlife holds for Leona Helmsley, we do know that she intended her beloved pet, Trouble, to occupy an earthly paradise in canine comfort. Will $12 million do it? Can you provide a trust for a pet? It depends – upon the terms of the trust that is. Here in Massachusetts, a trust directly for a pet is generally not allowed. Thus, when called upon to assist a client in providing for a pet, careful

thought must go into the trust's drafting. In most cases, the gift is left in trust for a prearranged pet caregiver (a family member or friend) on the condition that the caregiver shelter the pet and care for its needs. Each year the caregiver receives a trust distribution after first demonstrating to the trustee that the pet has received reasonable and ordinary care (visits to the veterinarian, for example). In some cases, a "pet protector" may be appointed, such as the Boston Animal Rescue League, who might undertake the task of monitoring the pet's well-being on a periodic basis (quarterly, annually, etc.) for a fee paid by the trust. As an advisor, we must also help our clients recognize that the pet trust should anticipate the inevitable, and incorporate a "living will" provision which permits the caretaker to compassionately end the pet's life if in the animal's best interest. So, is it trouble to provide for a beloved pet? Not at all.

FINANCIAL TIP

Tax compliance is often tricky, and no more so than in the ownership of rental property. To help landlords comply with the tax code, on July 27th the IRS issued fact sheet FS-2007-21 (Rental Property and the Tax Gap) which is a helpful checklist of deductible expenses and includible income. For example, did you know that tenant deposits used as final lease payments are considered advance rents and counted as income in the period they are received? If news to you, then off you go to www.irs.gov. Perhaps your time spent is deductible …..

SUMMARY

We hope you have found this newsletter informative. If you wish to discuss any of the ideas mentioned above or have suggestions for topics for future newsletters, please do not hesitate to contact any of us.