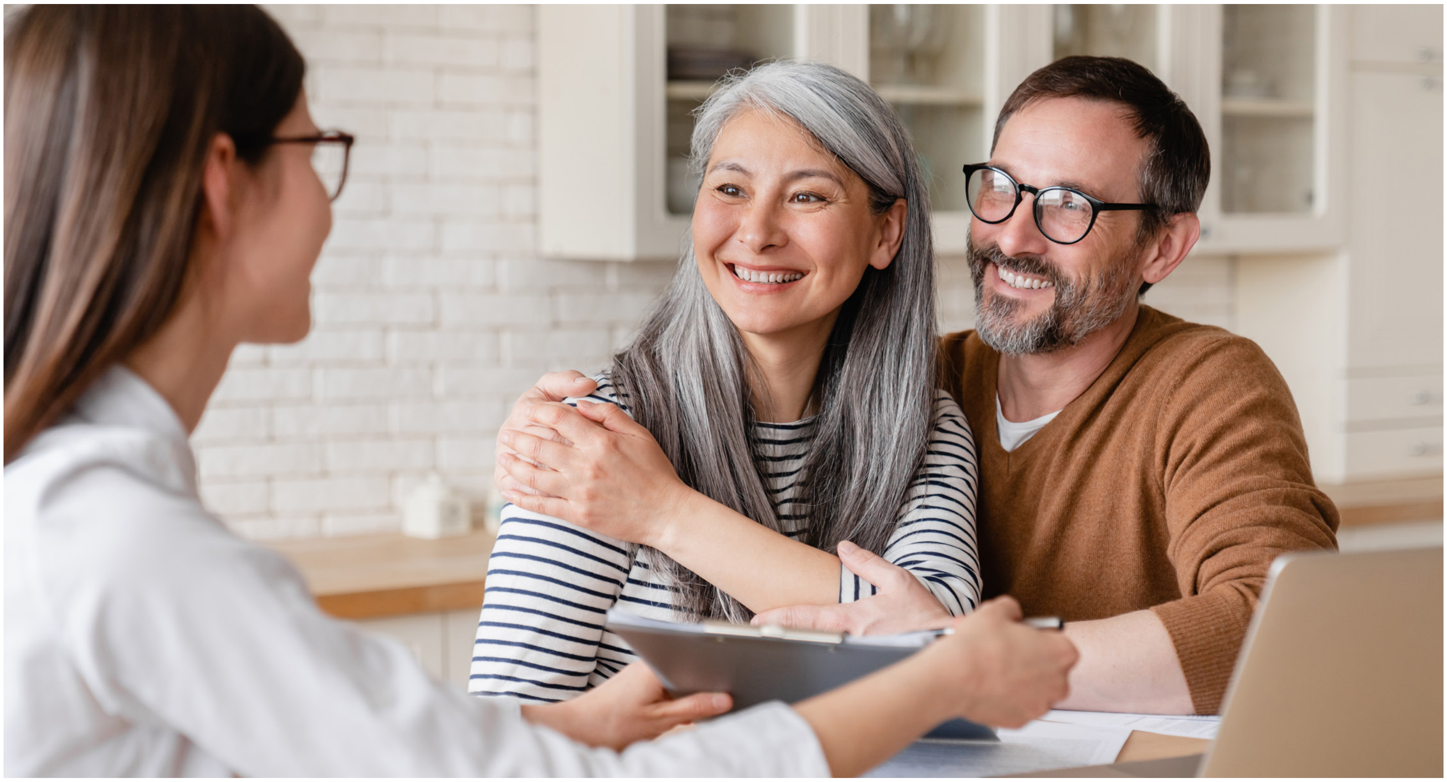
For Trusted Advisors

3rd QUARTER 2022

Three reasons why periodic reviews of estate planning documents are important.

By Eva Stark, JD, LL.M.



One thing people seem to have in common is a tendency to underestimate how much time has passed since they've done important tasks like see their dentist or replace the batteries in their smoke alarms.

The same can be said for updating legal and financial documents. Many people think that once they've established estate plans and written their wills, they are in good shape.

Estate planning practitioners know better, however, and likely come across situations like this on a regular basis:

A couple has 20-year-old wills that they believe are probably "fine." They decide to see their professional advisors at the urging of some friends who recently had a death in the family. The couple have two children, a son and a daughter, whom they would like to treat equally in their estate plan. The daughter lives near the clients and helps them daily—she even accompanies them to doctors' appointments. The clients share that their son, unfortunately, is suffering from alcohol and gambling addictions and they would like to ensure that his inheritance is used wisely for his treatment and support.

When the attorney reviews their wills, the clients are shocked: the documents were drafted to leave everything to the son outright and disinherit the daughter!

The son is even named the executor of their estates!

The clients recall that when the documents were drafted, the son was well into a successful career while the daughter was estranged from the clients and had not spoken to them in years.

Circumstances and goals may change

As the scenario above illustrates, circumstances and goals often change—sometimes over an extended period, sometimes suddenly. When a change occurs, it is generally prudent to review the client's estate plan. Changes where a review is generally beneficial include:

- Birth or adoption of a child;
- Marriage;

- Divorce;
- Death of a spouse or a beneficiary;
- Incapacity or disability of a family member;
- Changes in net worth or assets owned;
- Relocation to a new state; or
- Changes in client goals and objectives.

Named fiduciaries may no longer be appropriate

Wills, trusts, durable powers of attorney, health care proxies and other documents all name fiduciaries such as the executor, trustee, attorney-in-fact, or agent. These individuals have tremendous powers over the clients' property, financial affairs, medical treatment, and aspects of their estate plan or life. Persons chosen for these roles are typically trusted family members, friends, or professionals who, at the time of selection, possess the right characteristics and skillset.

Over time, of course, circumstances change. Individuals may pass away, lose competency, or simply may no longer be the person the client would choose to serve in that role.

Laws may change, causing existing documents to operate in unintended ways

Changes in laws, including tax laws, may cause an estate plan to operate in an unexpected manner.

For example, The Tax Cuts and Jobs Act of 2017 doubled the federal estate tax exemption amount, adjusted for inflation (the amount in 2021 is $11,700,000 per spouse). As a result, estate plans which funded a "Bypass Trust" with the decedent's federal estate tax exemption amount could see "over funding" of the Bypass Trust as compared to the amount that was expected to pass to the trust at the time of drafting.

For some clients, the impact may be insignificant. For others, the change could unnecessarily increase income taxes on the next generation, change the proportion of assets that may be available to the surviving spouse versus descendants, or result in numerous other unanticipated outcomes depending on the specific language used in the documents and the client's particular circumstances.

The rule of thumb

Due to the many changes that may occur, either as a result of changing client circumstances or a changing legal or tax environment, many practitioners recommend that estate plans should be reviewed every three to five years at a minimum.

For certain clients, more frequent reviews may be beneficial, especially in the event of a significant change in tax laws.

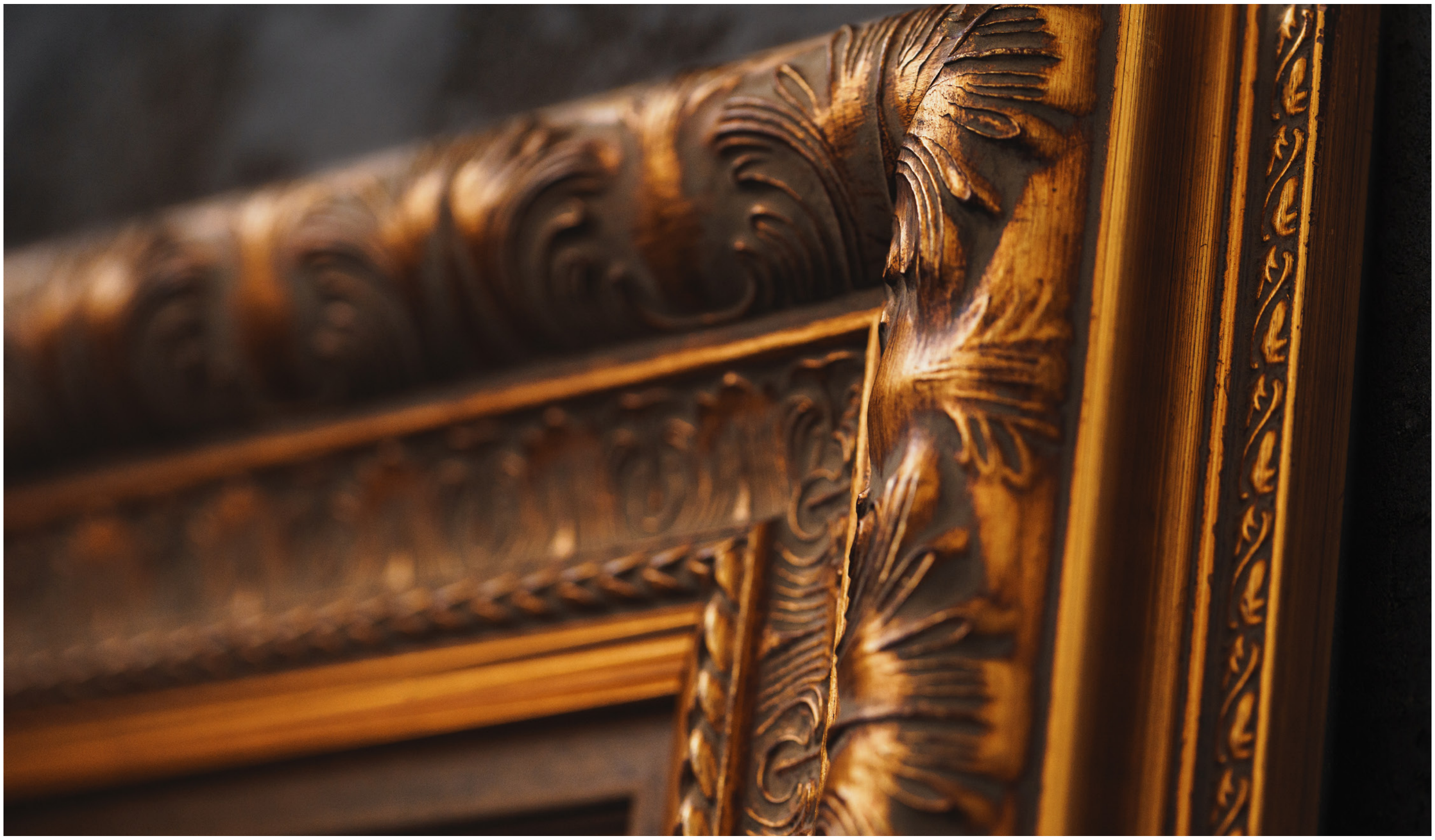
Astute financial professionals are alert to these changes and routinely encourage their clients to review and update their estate plans in a timely manner, knowing that is the best way to avoid unintended outcomes.

Eva Stark, JD, LL.M., joined The Nautilus Group in 2014 to assist with the development of estate and business plans. She also performs advanced tax research. Eva graduated summa cum laude with a BS in economics and finance from The University of Texas at Dallas. She earned her JD, with honors, from Southern Methodist University, where she served as a student attorney and chief counsel at the SMU Federal Taxpayers Clinic. She received her LL.M. in taxation from Georgetown University Law Center. Prior to joining Nautilus, Eva worked in private practice in tax controversy, business law, and litigation.

Taxation - Income, Estate, and Gift

Planning for art collections: Rules and tax considerations.

By Patricia M. Annino, Esquire



Years ago, in the process of probating a client's estate, I suggested to her son that he hire an appraiser to value the items in his mother's home as some of them, to a layman's eye, seemed valuable. He called me the following week in shock: the lamp in the hallway where he played football as a child turned out to be a real Tiffany worth more than $200,000.

Another client bought his wife a very famous Norman Rockwell painting at a New York auction. One month later Rockwell was the hottest game in town and the value of that painting had tripled. An untitled Jean-Michel Basquiat painting sold at a Christie's New York auction in 1984 for $19,000; it was sold in 2017 at a Sotheby's New York auction for $110,500,000.

The value of art is subjective and volatile. Sometimes clients think that the art they own is valuable when it isn't, and sometimes clients think the art they own is not valuable when it is. Those who choose to collect art may have a significant part of their investment portfolio in art, which can be a fickle and illiquid asset. Those who love art are very attached to it and can view its preservation and legacy as a very personal responsibility.

A recent Bank of America study reported that one in three high income earners currently collect art. Of those, 58% have not integrated their art collection with their overall wealth strategy and only 21% of current collectors and 18% of those interested in collecting art have discussed the impact on their financial and estate plan with their advisors.

Planning what to do with that one very valuable piece of art or the entire art collection requires careful thought and an understanding of the rules that apply to art.

Valuation of art

Valuation of art is an inexact science. The Internal Revenue Service established an Art Advisory Panel in 1968 to help the IRS review and evaluate appraisals of art. The panel consists of up to 25 art experts, who serve without compensation, and their recommendations are strictly advisory. The panel currently has two subcommittees: the fine arts panel (which reviews items such as paintings, sculptures, watercolors, prints, and drawings) and the decorative arts panel (which reviews items such as antique furniture, decorative art, ceramics, textiles, carpets, and silver).

If a tax return (income, gift, or estate) containing a work of art or cultural property with a claimed value of at least $50,000 is selected for audit, the case must be referred to the Art Advisory Panel for review. The panel meets twice a year for one day and reviews hundreds of works. All meetings are closed to the public, although the donor/taxpayer may see the panel's notes.

> Sometimes clients think that the art they own is valuable when it isn't, and sometimes clients think the art they own is not valuable when it is.

In 2020, the Art Advisory Panel met once and reviewed 43 items with an aggregate taxpayer valuation of $57,672,000 on 14 taxpayer cases under consideration. The average claimed value of an item reviewed was $1,341,209. The panel recommended accepting the value of 12 items or 28% of the items submitted; it adjusted 31 items or 72% of the appraisals it reviewed and recommended total net adjustments of $12,372,565 to the appraised values – a 21.45% increase.

In addition to ascertaining an appropriate value, it is also important that the art be properly appraised and its provenance authenticated. IRS Publication 561 discusses the physical condition of the art (and restoration) and art appraisals. It defines qualified appraisals, qualified appraisers, and compliance—all of which are essential for tax reporting purposes.

Estate and gift tax consequences

Lifetime or death time gifting to family

A collector may wish to gift part of his collection to his children and wonder whether it makes sense to gift it now or at death.

Under the current law, it may be advisable to gift the art at death as the children or recipient will receive the stepped-up income tax basis in the art. This is particularly useful if the estate is under the federal exclusion threshold and is not taxable for federal estate tax purposes. However, the collector must always be cognizant of the changing value of art because when given at death, it is the date of death value that will be reported to the IRS and any state taxing authority.

It is also possible, if not likely, that more than the value of the art itself will be included in the taxpayer's taxable estate and the expenses of selling the artwork may not be deductible from the estate tax (unless the sale is necessary to pay the estate taxes or unless the will or trust specifically authorize the sale of the art at death).

In my experience, this is something many collectors do not know or pay attention to; one of the reasons for this is that they have not definitely decided whether to give it to a child and whether the child will want it. When that decision is not made and there is no specific direction to sell the art, it is important to understand that the estate tax can be significant.

It is also important, if giving a piece of art to one child, to review the tax clause in the will and trust and be sure that only the child who receives the art is responsible for paying the estate tax attributable to the art.

If a collector wishes to leave a Picasso to her daughter and apportion the estate tax so the daughter will be the only one of her children paying the estate tax, given the fluctuations in the value of the art, the collector should explore life insurance paid tax free to the daughter to cover that liability. Without proper planning the daughter may not be able to keep, insure, or enjoy the art.

If considering gifting art to a child at death, a collector should:

- Consider whether the child loves it as much as the collector does and has room in the home to show it.
- Consider if it makes economic sense for the child to tie up that much of an inheritance in an illiquid asset.
- Have an honest conversation with the child or children discussing these points.
- Review estate planning documents (will and trust) to ascertain if the child who will receive the art will be responsible for the payment of any estate taxes attributable to it or if the estate taxes will be paid by the estate (in essence, by all beneficiaries).
- Consider life insurance to cover the estate taxes due on the unique asset.

If, on the other hand, a collector gifts the art during his lifetime, the benefit is that any future appreciation will be removed from the collector's taxable estate (even though the basis may not step up).

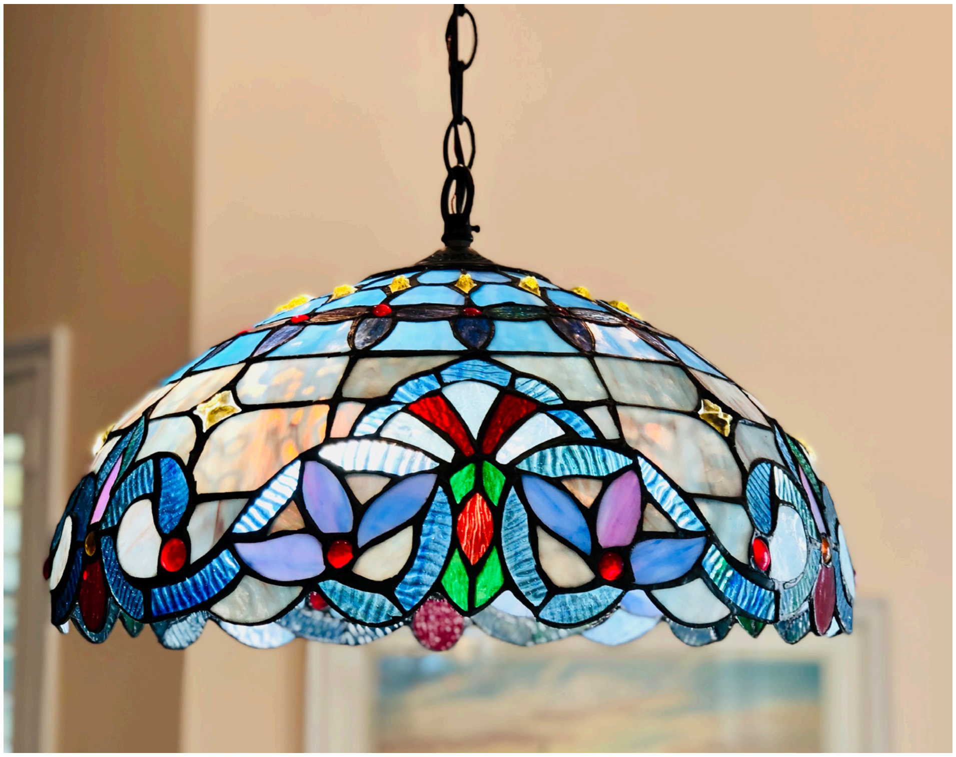
A key issue with a lifetime gift is that the collector must in fact give up the art, and the art must leave his home and his present enjoyment. If the collector claims to have gifted the art but continues to enjoy it as if he still owned the art, current tax rules will bring the art back into his taxable estate at the value as of the date of his death.

If a collector wants to keep the art in the family "forever," believes it will appreciate, and is willing to relinquish enjoyment of it now, it is important to take the following steps:

1. Sign a deed of gift.
2. Have a written acceptance by the donee.
3. Have the art appraised and file a gift tax return.
4. Change the property and casualty insurance policy to reflect ownership.
5. Deliver the artwork to the new owner.

The collector also may decide to make the gift not to a child directly, but to an irrevocable trust that will keep the art and its future appreciation out of the child's gross estate and subsequent estates. The irrevocable trust can hold title to the art, ensure its careful maintenance, and protect the collector's intentions for the art, all while keeping the art and its future appreciation out of the child's estate (and perhaps the estates of many subsequent generations).

If the art is very valuable and will be gifted to one child, the collector also should consider how to equalize that gift to other children. Sometimes life



insurance can be an appropriate way to accomplish this equalization.

Death time gifting of art to charity

Unlike the income tax charitable deduction, the estate tax charitable deduction is unlimited. If the collector wishes to gift the art at his death to a museum, or some other qualifying charitable organization, it is important that the collector have a frank discussion with the museum first. The acquisition of that art may not fit in with the museum's strategic plan and they may decline the gift. The museum may only accept (or prefer to accept) gifts of art if cash is also included to cover the costs of storing it and maintaining it. Donating funds with the art for its maintenance and storage may be prudent. Today, very few museums will promise to never sell the art that is given to them or promise not to put the art in storage. To preserve the charitable deduction, the collector should consider including in his will and trust a provision that if the museum does not wish to accept it, the fiduciary must give it to a tax-exempt charitable institution.

Split interest gifting

It is also possible to split the gift between individuals and charitable organizations. A split interest trust is an irrevocable trust in which the beneficial interest in the trust is split between charitable and non-charitable beneficiaries. There are two types of split interests trusts: charitable remainder trusts and charitable lead trusts.

With a charitable remainder trust the non-charitable beneficiary (who could be the donor/collector) benefits now and the charitable beneficiary benefits when the trust ends. The trust can be established as either an annuity trust (in which a fixed dollar amount each year, regardless of the fluctuations in the value of the trust, is distributed to the non-charitable beneficiary each year), or a unitrust (in which annual payments are made at a variable rate to the non-charitable beneficiary each year). Regardless of whether the charitable remainder trust is an annuity trust or a unitrust, when the trust ends the remaining assets pass to the charity or charities.

Benefits of the charitable remainder trust include a distribution of income for a term of years and an income tax charitable deduction at funding. No capital gain tax is due when the underlying asset is sold and therefore the investable base should be higher. If art is contributed to a charitable remainder trust, the trust must be funded with enough cash to make the annual payments, or the trust must be directed or at least empowered to sell the art to make such payments.

When funded with art, there are special valuation rules. If the art was created by the donor, special rules also apply. It is very common to couple the technique of a charitable remainder trust with a funded irrevocable life insurance trust, the thought being that the insurance will replace (free of income and estate tax) the value of the asset that will pass outside of the family to the charity.

A charitable lead trust, on the other hand, provides the charitable beneficiary with benefits now and passes to the non-charitable beneficiaries (usually family members or a trust for family members) when the trust ends. As with the charitable remainder trust, the charitable lead trust may be either an annuity trust (in which annual payments are fixed each year regardless of fluctuations in the value of the trust) or a unitrust (in which annual payments to the charitable beneficiary fluctuate with the value of the trust).

Leverage occurs when there is a gift tax charitable deduction for the charity's right to the income stream, so the donor's taxable gift is reduced by that value, and depending on whether the trust is considered a grantor trust (the donor being considered as the owner of the trust assets for income tax purposes) or non-grantor trust (the donor is not considered the owner of the trust for income tax purposes), the donor may or may not be responsible for the income tax attributable to the trust income and able to benefit from an income tax charitable deduction.

The charitable lead trust is an especially valuable estate planning technique if the taxpayer has used most of his federal gift exclusion. The income, gift, and estate tax consequences should be carefully reviewed by the collector's advisors.

Conclusion

In summary, the decisions and choices as to how the collector can protect herself, her family, her artwork, and her charities require careful and thoughtful consideration. When deciding about art and the choices the collector has, the collector should communicate early and take the time to have a frank discussion with her intended family beneficiaries and any museum or charitable organization she is considering gifting the asset(s) to.

Planning for art has unique rules that should be integrated into the entire estate plan.

It is important that the collector work with all advisors (financial, legal, accounting, and life insurance professionals) to ensure that the goals are planned for and met, and the plan is integrated.

Patricia M. Annino, Esquire, is a partner at Rimon, PC, in the Trust and Estates Group. A nationally recognized authority on estate planning and taxation, Patricia has spent more than 30 years in all aspects of private client work, including estate planning, will and trust planning, incapacity planning, pre- and post-nuptial agreements, estate litigation, advising executors, trustees and beneficiaries, and administration of estates and trusts. A leading voice on estate planning matters, Patricia has been quoted extensively in a wide variety of local and national publications.

Estate Planning

Connelly v. U.S. decision allows proceeds of corporate-owned life insurance to be included in estate tax value of shares.

By Steve R. Akers, JD

Using life insurance is a popular way of funding an obligation to purchase a decedent's interest in a business entity under a buy-sell agreement. A recent federal district court case, *Connelly v. U.S.*,[1] addresses the valuation for federal estate tax purposes of stock of a closely held corporation. The stock was purchased at Michael Connelly's death pursuant to a requirement in a buy-sell agreement that the corporation purchase the stock, and the corporation had funded the purchase obligation by owning a life insurance policy on Michael Connelly's life.

Buy-Sell Agreement and Purchase of Decedent's Shares

The buy-sell agreement required the company, which was owned by Michael and his brother, Thomas Connelly, to purchase a decedent's shares following his death. The pricing provision called for the parties to agree annually on the company value, and if an annual value had not been agreed on, the price would be determined by securing two or more appraisals (that would not consider control premiums or minority discounts).

The company funded the agreement with life insurance policies on the two brothers' lives. The brothers never entered into any agreement about the company value. On the death of Michael Connelly, who owned about 77% of the company, the estate and the company did not comply with the appraisal requirement in the agreement, but the company agreed to pay the estate $3 million (using part of the $3.5 million of life insurance proceeds paid to the company).

1 128 AFTR 2d 2021-5955 (E.D. Mo. September 2, 2021).

The estate reported the value of the shares at $3 million, but the IRS assessed an additional $1 million of estate tax, maintaining the $3.5 million of life insurance proceeds should have been taken into consideration in setting the value. The estate paid the additional estate tax and sued for a refund. The IRS and the estate stipulated that the value of the decedent's shares was $3.1 million if the life insurance proceeds were not considered, and the open issue was whether the life insurance proceeds should be considered in determining the value of the shares for estate tax purposes.

Buy-Sell Agreement Did Not Fix the Value for Estate Tax Purposes

The initial consideration was whether the purchase price was binding as the value for federal estate tax purposes because of the buy-sell agreement. Section 2703(a) of the Internal Revenue Code provides generally that the value of property for transfer tax purposes is determined without regard to an agreement to acquire the property at a price less than its fair market value. A "safe harbor" exception in §2703(b) applies if three requirements are satisfied, but the court held that exception did not apply for Mr. Connelly's stock. The buy-sell agreement met the first condition – that the agreement was a bona fide business arrangement – but it did not meet the other two requirements. It failed to meet the second requirement – that it was not a device to transfer property to the decedent's family for less than full consideration – because the purchase price did not include the life insurance proceeds in determining the company's value, the process of selecting the redemption price indicates the agreement was a testamentary device, and the agreement prohibited considering control premiums or minority discounts. The agreement also failed to meet the third requirement – that its terms were comparable to similar arrangements by persons in an arms' length transaction – because the estate "failed to provide any evidence of similar arrangements negotiated at arms' length."

In addition, the agreement did not satisfy requirements recognized by various courts for buy-sell agreements to fix estate tax values:

- The agreement did not provide a fixed and determinable price;
- It was not binding at death (evidenced by the fact that its procedures were not followed); and
- It was a substitute for a testamentary disposition for less than full consideration.

Value Should Be Determined Taking into Consideration Life Insurance Owned by the Corporation for Funding the Buy-Sell Obligation

Having determined that the agreement did not fix the estate tax value of the decedent's shares, the court determined the value of the stock without regard to the agreement. The court concluded that the life insurance proceeds should be considered, disagreeing with the rationale of the Federal Court of Appeals for the Eleventh Circuit in *Estate of Blount v. Commissioner*[2] that the value of life insurance proceeds on the decedent's life paid to the company was offset by the contractual obligation of a company to purchase the decedent's shares. The court in *Connelly* disagreed with the Eleventh Circuit's analysis, preferring the reasoning of the Tax Court in *Blount*: a redemption obligation is not a "value-depressing corporate liability when the very shares that are the subject of the redemption obligation are being valued."

The court pointed out that a hypothetical willing buyer purchasing a company subject to a redemption obligation would not reduce the value of the company by the redemption obligation "because with the purchase of the entire company, the buyer would thereby acquire all of the shares that would be redeemed under the redemption obligation." The buyer would merely be obligated to redeem the shares the buyer then held, and "the buyer would not consider the obligation to *himself* as a liability that lowers the value of the company to *him*." The court observed that "construing a redemption obligation as a corporate liability only values [the company] post redemption (i.e., excluding Michael's shares), not the value of [the company] on the date of death (i.e., including Michael's shares)."

The court concluded that the Eleventh Circuit's opinion in *Estate of Blount* is "demonstrably erroneous" and there are "cogent reasons for rejecting [it]." The life insurance proceeds used to redeem Mr. Connelly's shares must be taken into consideration in determining the fair value of the company and of the decedent's shares.

Buy-Sell Agreement Structuring

A very important issue in structuring a buy-sell agreement is whether an entity purchase or cross purchase arrangement will be used. For example, the Connelly agreement gave the surviving shareholders the first option to purchase a decedent's shares, but if that option was not exercised, the agreement required the corporation to buy the shares.

ENTITY PURCHASE. The parties may feel more comfortable with the entity taking steps to fund the purchase agreement rather than relying on other owners to accumulate funds (or purchase

2 428 F.3d 1338 (11th Cir. 2005).

life insurance) to fund a purchase obligation, but the funding in the entity (such as life insurance) may increase the value of the entity (as in *Connelly*). For a corporation, tax considerations include whether the redemption of stock by the corporation will be given sale or exchange versus dividend treatment.

CROSS PURCHASE. The parties must rely on the remaining owners to purchase their interests at death; funding will be outside the entity, not increasing the entity's value at the death of an owner, and a basis step up for the units purchased will be permitted. These advantages are quite significant. Cross purchase arrangements are often used and if an entity has multiple owners, one approach is to have the owners form a separate partnership to own a life insurance policy on each owner's life rather than having each owner purchase a life insurance policy on each other owner's life.

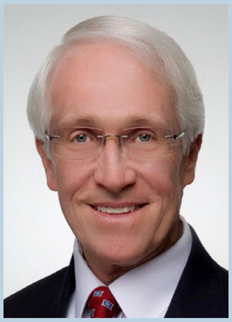
Buy-Sell Agreement with Life Insurance Funding

One of the factors in determining whether to use a corporate purchase or a cross-purchase arrangement in structuring a buy-sell agreement that will be funded with life insurance is that life insurance proceeds received by the company may be included in the estate tax value of the decedents' shares, resulting in escalating values of the shareholders' interests in the company. (If the purchase price is fully funded with life insurance, as each owner's interest is purchased at death using the life insurance proceeds the company value remains constant, but the remaining owners have increasing percentage interests in the entity as each owner dies, which increases the value of their interests and requires more life insurance funding.) A pricing formula that does not include the full amount of insurance proceeds is very suspect as failing to satisfy the §2703(b) safe harbor (as evidenced by the *Connelly* opinion).

The economic impact of not including insurance proceeds in valuing a decedent's shares would produce a huge windfall to the surviving shareholders. They end up owning the company free of the decedent's shares without having to pay anything personally following the decedent's death. The windfall to the surviving shareholders may be greatly reduced by including the amount of the insurance proceeds on the decedent stockholder's life in the value of the corporation. However, this approach will be circular and thus greatly increase the amount of insurance coverage needed in order to fully fund the buy sell agreement. But including life insurance proceeds in determining the value of the company following a shareholder's death reflects the economic reality of the value of the company at that time, so it is not surprising that the IRS maintains that the estate tax value of the decedent's shares following an insured shareholder's death should reflect that economic reality.

Conclusion

This ruling is being appealed, so the final outcome of this case remains uncertain. For now, however, taxpayers and their financial advisors should keep the District Court's ruling in mind when creating buy-sell agreements that are funded with life insurance and carefully choose a structure for the agreement that can help avoid a similar valuation whipsaw.



Steve R. Akers, JD, is a Managing Director with Bessemer Trust Company, N.A., in Dallas, TX, where he is Senior Fiduciary Counsel and chairs the Estate Planning Committee. Akers also is a member of the Advisory Committee to the University of Miami Philip E. Heckerling Institute on Estate Planning and past president of the American College of Trust and Estate Counsel. He is a recipient of the Distinguished Accredited Estate Planner Award from the National Association of Estate Planning Councils and the Lifetime Achievement Award from the State Bar of Texas Real Estate, Probate and Trust Law Section. He earned his bachelor's degree from Oklahoma State University and his J.D. degree from the University of Texas School of Law.