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THE PLANNER

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A monthly newsletter for Accounting, and Financial Professionals with a focusing on Estate Planning, Elder Law, and Special Needs Persons.

The Planner is a newsletter to inform and educate Accounting and Financial Professionals of the ever changing areas of estate taxes, and elder law to better service their clients.

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Planning with the $5 Million Gift Tax Exemption

In this issue of The Planner, we will look more closely at the powerful planning opportunities that exist for the next two years with the $5 million gift tax exemption. Let's begin with a quick review of the new law.

Gift, Estate and GST Exemptions and Tax Rates:

In 2011 and 2012, the gift, estate and generation-skipping transfer tax exemptions are all $5 million and the tax rate is 35%. If Congress does not act again, in 2013 the exemption will be $1 million and the top tax rate will be 55%. This is the current law and must be considered in all planning. The portability of the gift and estate tax exemption between spouses was also introduced, but only for spouses who both die between January 1, 2011, and December 31, 2012.

Planning Tip: Note that, unlike a surviving spouse's ability to use a predeceased spouse's unused unified credit, the new law does not allow a surviving spouse to use the unused GST tax exemption of a predeceased spouse. This is just one weakness of the new portability provision.

Planning Tip: Be cautious when deciding how to plan for insurance needs, disclaimers and how to fund the bypass trust, considering whether to plan for a $5 million exemption or some lower (e.g., $1 million) exemption. Also, the portability of exemption between spouses may not be around after 2012. Be sure your clients understand the exemption is scheduled to revert to $1 million in 2013, that these uncertainties exist, and that their planning will need to be updated as the laws change.

Income Tax: We also have lower income tax rates for the next two years, but President Obama has made it clear he wants higher tax rates in 2013. Unless there are changes in the next two years, in 2013 the long-term capital gains rate will increase to 20%, the maximum tax on qualified dividends will go back to 39.6%, and the additional 3.8%

surtax will be introduced.

Planning Tip: Take advantage of the lower income tax rates that we have for the next two years, and look for opportunities to accelerate income into 2012. Choose an 11/30 year-end for any estates currently being administered to maximize the lower income tax rates for as long as possible.

2010 Planning Revised

The estate tax was reinstated for 2010, with a $5 million exemption and 35% tax rate. Estates may elect out and pay no estate tax, but the modified carryover basis rules would apply. The gift tax exemption in 2010 remains at $1 million with a 35% gift tax rate.

Planning Tip: Because of the "sunset," there may be only a two-year window of opportunity to make substantial gifts using the $5 million gift exemption.

Tax Planning Opportunities in 2011 and 2012

With the gift tax exemption at $5 million per person, we can expect a huge transfer of wealth over the next two years. Those who have already used their $1 million exemption now have an additional $4 million to use for gifts. And while we cannot be absolutely certain that the $5 million gift tax exemption will be honored if it returns to $1 million in 2013, it would certainly make sense for Congress to do so. Let's look at some of the planning opportunities that will immediately maximize these transfers.

Planning Tip: Start meeting with your wealthier clients now to discover which properties they could give away now that will be relatively painless for them.

Spousal Access Trusts

The general concept of a Spousal Access Trust is that one spouse can transfer up to $5 million in trust for the benefit of his/her spouse, children and future generations. Benefits include asset protection, estate tax protection, direct descendent protection (property stays within the bloodline) and income shifting. Risks are the reciprocal trust doctrine and grantor trust rules.

In U.S. Estate of Grace, 395 US 316 (1969), the Supreme Court developed a two-part test to determine whether trusts will be ignored because they are "reciprocal": a) the trusts must be inter-related and b) the trust creation and funding must leave the grantors of the trusts in essentially the same economic position as they would have been in if they had created the trusts naming themselves as life beneficiaries. If both parts are met, the IRS and/or the courts will uncross the trusts and include the value in each of the grantor's gross estate, nullifying their careful planning.

Planning Tip: To avoid the reciprocal trust doctrine, the lawyer on the planning team must take care to draft outside of the Grace doctrine and not make the trusts identical. Be sure to file the gift tax return and allocate the GST exemption if desired rather than rely on the automatic allocation rules.

Gifts to an Irrevocable Life Insurance Trust

Life insurance can be used to provide income for a family, pay estate taxes, and as an income tax shelter. If structured properly so that the trust maker does not have any incidents of ownership, none of the assets (policy proceeds) of an irrevocable life insurance trust (ILIT) will be included in the trust maker's taxable estate, making them free of both income and estate taxes. ILITs will become more popular as income tax rates increase, in 2013, from the current 35% rate to39.6% or even to 43.4% for clients subject to the 3.8% surcharge.

The general concept is that the ILIT is the owner and beneficiary of the policy on the trust maker's life. The trust maker makes gifts to the trust to cover the insurance premiums, and the trustee makes the premium payments. At the trust maker's death, the proceeds are paid to the trustee who can use the funds to purchase assets from the estate and provide liquidity for estate taxes and other expenses. The trustee can make discretionary distributions of income and principal during the lifetime of the trust's beneficiaries, which can include the trust maker's spouse, children and future generations. Assets that remain in the trust are not included in the beneficiaries' estates and are protected from creditors.

Planning Tip: Using the $5 million gift and GST exemption amounts can provide substantial amounts of life insurance (think single or 2-pay premium) and benefit the grantor's children without future estate, gift and/or GST tax.

Planning Tip: Be very cautious about canceling existing insurance policies now. If possible, wait until 2013 nears, when we will know what the exemption will be at that time.

Dynasty Trusts

Generally, a dynasty trust is one that benefits multiple generations, and none of the trust assets are included in the trust maker's or any of the beneficiaries' taxable estates. Not being taxed at each generation (historically at 45-55%) allows the assets to grow tremendously over the years.

However, there is a generation-skipping transfer tax that applies when a transfer is made by the grantor to a "skip person" (grandchild, great-grandchild, or other person more than 37.5 years younger than the grantor). Currently, each grantor is allowed a lifetime GST exemption on the first $5 million of taxable transfers directly to a skip person or to a trust that could benefit a skip person. A husband and wife can combine their GST exemptions. This perhaps temporary GST exemption increase will make dynasty trusts even more popular over the next two years.

The dynasty trust established in the right jurisdiction can theoretically go on forever, with the trustee making discretionary distributions for the lifetime of each beneficiary in each generation. Advantages include creditor protection, divorce protection, estate tax protection, direct descendent protection, spendthrift protection and consolidation of capital, which typically results in higher returns and better management options.

Planning Tip: The choice of situs is critical. Choose a state with no income tax, good creditor and divorce protection, and no Rule against Perpetuities. Make sure you file a gift tax return. If the trust maker allocates enough GST exemption to cover the entire gift, neither the gift nor any distribution from the trust will ever be subject to the GST tax.

Planning Tip: Be aware of the President's budget proposal to limit GSTT-exempt trusts to 90 years, regardless of the applicable rule against perpetuities. While this was introduced in 2011 and will not likely gain support in the current Congress, this may gain support in the future.

Income-Shifting Trusts

The concept here is to shift income to younger family members to reduce income taxes. Parents can move up to $10 million ($5 million each) in income-producing assets gift tax-free to their children who can then use the income to invest or purchase insurance.

Example: A husband and wife gift $10 million of non-voting S-Corporation stock to their four children (15% each) via using Qualified Sub-Chapter S Trusts. There is no gift tax because the parents use both of their $5 million gift tax exemptions. After the gift, 15% of the income generated by the S-Corporation will pass through to each child.

Benefits include creditor protection on the assets; estate tax savings because the assets are being transferred to the children and out of the parents' estates; and income tax savings because the children will pay income taxes at a lower rate than their parents. Over time, this can save a tremendous amount in income taxes.

Long-Term Tax Planning Opportunities
Lifetime Gifting

After the $5 million exemption has been used, it may be advantageous to give away more and pay the gift tax at the current 35% gift tax rate. Also, the gift tax is "tax-exclusive" while the estate tax is "tax-inclusive." A taxable gift of $1.00 makes the donor liable for a $0.35 gift tax, for a total of $1.35. On the other hand, $1.35 in a decedent's estate taxed at 35% nets only $0.88 to the heirs.

Planning Tip: As was the case in 2010, gifting can be a wait and see scenario. As we get closer to 2013, we hope to know what the 2013 gift tax rate will be. If the rate is moving to 55%, it would be advantageous to make additional gifts and pay the 35% gift tax in

2012 rather than wait and pay a 55% gift or estate tax in 2013.

Grantor Retained Annuity Trusts (GRATs)

The creator of a GRAT retains an annuity payout for a fixed term. At the end of the annuity term, any residual assets remaining in the trust pass to the remainder beneficiaries, such as the trust creator's children, free of any gift and estate tax (but not free of GST tax exposure).

The tax treatment of a GRAT is based on the assumption that the GRAT assets will grow at exactly the Section 7520 rate in effect at the time the GRAT was established (2.4% in January, 2011). If the GRAT assets outperform the 7520 rate, there will be a larger than anticipated (for tax purposes) balance to transfer to the trust's remainder beneficiaries at the end of the annuity term. In addition, all income earned by the GRAT during its term is taxed to the trust's creator because the trust is "defective" for income tax purposes, allowing for an enhanced probability of having a tax-free gift to the remainder beneficiaries.

Planning Tip: GRATs are currently most effective for property that is extremely volatile or is difficult to value, or for large estates that have already used their $5 million exemption. Unlike a dynasty trust, a GRAT can only create a one-generation transfer unless GST exemption is allocated to it based on the actual value of the trust assets at the end of the annuity term.

Intentionally Defective Grantor Trusts (IDGT)

An IDGT is a trust that is a grantor trust for income tax purposes, but not for gift, estate, and GST tax purposes. IDGTs are especially powerful right now for wealthy clients because of the $5 million gift and GST tax exemptions and historically low interest rates.

Using an IDGT, a married couple can currently gift up to $10 million in undivided interests in highly appreciating assets, then sell additional interests in the same assets to the IDGT. The value of both the donated and the sold assets can be discounted due to minority interest. If the assets are wrapped in an LLC or limited partnership, their value may also be adjusted for lack of marketability and lack of control. The trust then pays an installment note back to the trust maker. Assuming the growth rate on the assets sold to the IDGT is higher than the interest rate on the installment note, the difference is passed on to the trust beneficiaries free of any gift, estate and/or GST tax.

Also, because the IDGT is a grantor trust (i.e., "defective" trust for income tax purposes), no capital gains tax is due on the installment sale, the interest income on the installment note is not taxable to the grantor, and all income earned by the trust is taxed to the grantor, effectively allowing for a tax-free gift to the trust's beneficiaries equal to the tax burden borne by the grantor. Discretionary distributions of income and principal are made to the trust beneficiaries during their lifetimes, and all assets in the IDGT remain outside of their taxable estates.

Planning Tip: The grantor should make an initial gift of at least 10% of the total transfer value to the IDGT or have other security for the financed sale so that the IDGT has sufficient capital to make its purchase of assets from the grantor commercially reasonable.

Conclusion: Estate planning professionals have an exceptional window for transfer opportunities in 2011 and 2012 with the $5 million estate, gift, and GST tax exemptions; lower income and estate tax rates; and still-depressed property values. And, as is often the case, these opportunities provide excellent opportunities to work with a team of advisors to provide the best possible results for mutual clients.

Using a Limited Liability Company (LLC) to Transfer a Family Business

Most of us have at least one client who has a family-owned or closely held business that is a major part of their estate, yet they have done nothing to plan for the succession of that business. Business exit/succession planning can be challenging because of the tax issues, family dynamics and egos. But it can also be very rewarding. As we help our clients solve these issues, we develop a closer relationship with them, and we begin to build a relationship with the next generation. This planning also strengthens our professional relationships, as we must work together with other professionals to bring about the best results for our mutual clients.

In this issue of The Planner we will examine a case study that uses a Limited Liability Company (LLC) in the transfer of a family business to the next generation.

Case Study Facts: Frank (age 62) is married to Betty (age 58). Frank has an older son, Tom, from a previous marriage who is active in Frank's business. Betty has a daughter, Susan, from her previous marriage. Together they have a son, Charlie, who is a minor. Betty, Susan and Charlie are not involved in Frank's business.

Frank owns 100% of an S-corporation. It has a fair market value of $10 million and generates very good cash flow. Frank and Betty have significant other assets, including a home and investments. They own some jointly and Frank brought some into the marriage - they are held in his individual name. Their $5 million lifetime gift/estate/GSTT exemptions are fully available.

Consequences of No Planning: If Frank does nothing, according to the probate laws of the state in which they live, Betty will receive 50% of Frank's estate including the business; his son Tom will receive 25% of Frank's estate including the business; and Charlie will receive 25% of Frank's estate including the business. Because Charlie is a minor, Betty will control his share until he is 18. So, in effect, Betty will control 75% of the business if Frank dies intestate. Susan, Betty's daughter, will receive nothing.

Planning Objectives: Frank would like to ensure that ownership of the business will go to his son Tom, and Tom would like the security of knowing that one day the business will be his. Tom does not have the cash to buy the business. Frank would also like to control the timing of the transfer of the business and he would like to treat his stepdaughter and younger son fairly. He is concerned about maintaining enough cash flow to support himself and Betty now, and providing for Betty if he dies first. And he would like to minimize estate taxes.

Recommended Plan

Phase 1: Reorganize and Recapitalize the S-Corporation In a tax-free reorganization, the S-corporation is converted to an LLC that is taxed as an S-corporation. The LLC is organized under the laws of a "charging order only" state. Frank's ownership is changed from 100% voting shares in the corporation to 1% voting and 99% non-voting memberships in the LLC. Frank still effectively owns and controls 100% of the business, but now it is comprised of 10 LLC membership units (1%) that are voting units and 990 (99%) that are non-voting units.

Phase 2: Create Dynasty Trusts. Frank next establishes three irrevocable trusts, one for each child, in a jurisdiction that permits perpetual trusts. The trusts (irrevocable grantor trusts, aka intentionally defective grantor trusts) are disregarded by the IRS for income tax purposes, but not for estate and gift tax purposes. (Alternatively, one trust with three separate shares can be established.) The trusts are also designed to own life insurance on Frank's life.

Frank makes an initial gift of $600,000 to each trust. These are taxable gifts that must be reported on Form 709, but no gift tax will be due because it will be applied to Frank's and Betty's lifetime gift tax exclusions. $600,000 of their generation skipping transfer tax (GSTT) exclusions will also be allocated to each trust, giving each a zero inclusion ratio - so that it is not subject to GSTT in the future.

The trustee of Susan's and Charlie's trusts uses their initial gifts to purchase life insurance policies on Frank and/or Betty, providing substantial assets upon Frank's or their deaths.

Phase 3: Tom's Trust Buys All Non-Voting Units with an Installment Note. A business valuation is performed to determine the fair market value of Frank's business. As part of this process a qualified valuator first values the assets the business owns (real estate, equipment, good will, inventory, etc.). The valuator then determines whether and to what extent the value of the assets should be adjusted due to lack of control, liquidity and marketability.

When these valuation adjustments are applied to non-voting interests in an LLC, the fair market value is often depressed by a significant amount when compared to the fair market value of the entire business: in this hypothetical case, 40%. In other words, the non-voting units will each have a value of $6,000, making the total value of the 990 non-voting units $5,940,000. Alternatively, voting units will have a premium value to reflect the control value. In this hypothetical case, the voting units have an appraised value of $12,000 per unit, making the total value of the 10 voting units $120,000.

Tom's dynasty trust buys Frank's 990 non-voting units for $5,940,000 using a 20-year installment note, payable annually. Based on the current IRS published interest rates, the trust will pay Frank $447,197 every year for 20 years. The note is adequately secured by the LLC units and the $600,000 of other assets in Tom's trust. The cash flow from 99% of the business is more than sufficient to cover the note payments.

Planning Tip: The installment note should be handled just like an installment sale to a non-family member or a loan from a bank. A pledge or security agreement should be signed, required taxes should be paid, required filings should be made, etc. A fully documented paper trail should exist for the transaction and the payments made on the note.

Why Reorganize the Corporation to an LLC?

Corporate stock is freely transferable, making it very easy for a judgment creditor to foreclose on corporate stock and become a shareholder. In most states, the percentage required for shareholder voting to liquidate a corporation is less than 100%, generally ranging from 51% to 80%. If a judgment creditor forecloses on enough shares of stock to allow the creditor to liquidate the corporation, the creditor would be able to seize the assets of the corporation to satisfy the claim.

Alternatively, LLC interests are usually not transferable without the consent of all members. Due to this limitation on transferability, an LLC offers much greater asset protection from creditors. Many states limit a creditor's remedy to a "charging order" on distributions to LLC members. (Only when a distribution is made will it go to the creditor; when the claim has been repaid, the charging order is stopped.) The creditor can never become a substitute member, and will only become an assignee with no ability to vote on admission of new members or the liquidation of the LLC. In most states, it takes a 100% vote of all members to liquidate an LLC. Because a creditor can never become a member, it can never vote on liquidation of the LLC.

Outcome of the Planning

Frank owns the 10 voting units, giving him 100% control of the business and 1% of the equity. Tom's dynasty trust owns 990 non-voting units, giving Tom no control over the business and 99% of the equity. Tom's trust also has $600,000 in cash that Frank gifted to it as seed capital. This cash is invested, and the income tax attributes of income, gains and losses are passed through to Frank to be reported on his tax return, as is the income, gains and losses attributable to Tom's trust's 99% ownership in the business.

Income Tax Reporting

As long as Frank is deemed the owner of Tom's dynasty trust for purposes of reporting trust income, the dynasty trust does not have to file a Form 1041 fiduciary income tax return. A corporate income tax return (1120S and K-1) is filed for the business and Frank reports the trust's income on his tax return.

Income Tax Effect of Sale of Units

Because Frank is the deemed owner of the trust for income tax purposes, the sale of the LLC units to Tom's trust is a non-recognition event; i.e., a sale by Frank to himself. No gain or loss is recognized on the sale. No interest income is recognized on the installment note payments and no interest deduction is allowed to the trust.

Planning Tip: Include a "toggle" provision to turn each dynasty trust's grantor status off or on as needed, so that the income being taxed to Frank can be stopped if that should become undesirable later. Consider giving this power to a trust protector.

Pass Through Dynasty Trust Income

Income from the LLC will be allocated to the unit holders based on their ownership percentages. Let's assume the business has $500,000 in net income. Frank owns 10 voting units, equal to 1% of the equity, so he will be allocated $5,000 on the 1120S as K-1 income. Tom's dynasty trust owns 990 non-voting units, which is equal to 99% of the equity. So Frank, on behalf of the trust, will also be allocated $495,000 on the 1120S as K-1 income.

Because the dynasty trusts are grantor trusts for income tax purposes, Frank must pay the income tax on all their income, including the S-corporation income that is allocated to Tom's trust. But that is what he was doing before the sale, so he is paying the same income tax before and after.

Planning Tip: Frank's payment of income taxes in dynasty trust income is not an additional gift to the trusts, so every year he is effectively transferring additional estate assets to the trusts for the children without additional transfer tax.

How the Dynasty Trust Makes the Required Note Payments

In this case study, we assume that the LLC will have $500,000 per year of cash flow to distribute to the unit holders. Tom's dynasty trust will receive a cash distribution of $495,000 ($500,000 times 99% = $495,000). At the end of the first year, it will have $1,095,000 in cash ($495,000 from the LLC plus $600,000 that Frank gifted to it as seed capital). The trustee uses this money to pay the $447,197 note payment to Frank.

Planning Tip: If the business does not make enough income to pay the note, the payment can be deferred until the business recovers or the term or interest rate of the note can be adjusted.

Results after One Year: At the end of the first year, the note has been reduced to $5,745,847 and Tom's trust has a cash balance of $647,803. This cash can be invested and saved, distributed to Tom (gift tax-free), or used to buy and pay for a life insurance policy on Frank's life.

Frank has received $5,000 from the LLC and $447,197 from the note payment for a total of $452,197 in income. He pays income taxes on the full $500,000 of S-corporation income. If, after all deductions, he has a 25% effective income tax rate, he would pay $125,000 in income taxes, leaving him with $327,197 in income to support his and Betty's lifestyle.

Planning Tip: A higher income tax rate means less net income, but the client can also receive additional (reasonable) compensation as an LLC manager or as a Director. If he needs less income, his salary can be reduced, but ensure that it is not so much that he loses benefits.

When Frank Dies: Frank and Betty also establish estate plans, so the assets in Frank's estate will pass as planned, not according to the state's default rules.

If Frank and Betty have consumed or gifted the net after-tax proceeds of each note payment from Tom's dynasty trust, only the unpaid balance of the note will be included in the value of his taxable estate. Tom's dynasty trust is GSTT exempt, so its assets will never be subject to estate, gift or GST taxes. Frank's estate plan leaves the 10 voting units to Tom's dynasty trust, giving Tom 100% ownership of the business. The dynasty trusts for Susan and Charlie are also GSTT exempt, and the life insurance proceeds will be exempt from probate and income, estate and GST taxes. Betty will continue to receive the remaining note payments for her support.

Estate Tax Results: Frank has removed 0.99 x $10,000,000 + 3 x $600,000 = $11,700,000 of appreciating assets from the value of his gross estate that, at his death, would have been subject to estate taxes. He and Betty have used $1,800,000 of their lifetime gift/estate/GST exemptions. (Remember, unless Congress acts before the end of 2012, the top estate tax rate in 2013 is scheduled to go back to 55% with a $1 million exemption.)

Frank has received an asset (the $5,940,000 note) that, in his estate, may have a discounted value due to lack of marketability, etc., and that will not appreciate; in fact, the note is depreciating because the principal will decrease over the 20-year term.

If Frank does not accumulate the note payments, at the end of the note term he will have completely removed the $10,600,000 and all future appreciation from his gross estate without making a taxable gift other than the initial $600,000 seed capital gifts to the dynasty trusts.

The trust assets are not subject to generation-skipping transfer tax, will be protected from creditors, and will not be included in the children's or grandchildren's or great-grandchildren's gross estates at their deaths.

Objectives Met: All of Frank's objectives have been met. His son Tom will receive the business without having to buy it, and Frank can control the timing of the business transfer. He was able to provide for his other children and his wife, and he saved substantial estate taxes.

Conclusion: While this kind of planning can be complicated, the above example demonstrates that the rewards are many. We have the opportunity to help our clients solve their problems, strengthen family relationships, save money and have peace of mind. At the same time, we have the opportunity to strengthen our relationships with clients, their children and the other planning professionals with whom we collaborate. This type of planning is truly a win-win opportunity.

To comply with the U.S. Treasury regulations, we must inform you that (i) any U.S. federal tax advice contained in this newsletter was not intended or written to be used, and cannot be used, by any person for the purpose of avoiding U.S. federal tax penalties that may be imposed on such person and (ii) each taxpayer should seek advice from their tax advisor based on the taxpayer's particular circumstances.

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