Going Once, Going Twice... Act Now Before the Window for Estate Tax Savings Closes

Andrew M. Berger, J.D., LL.M., Corporate, Tax and Estate Planning Practice Groups
3111 Stirling Road
Ft. Lauderdale, Florida 33312-6525
Tel: 954.364.6074
Fax: 954.985.4176
aberger@becker-poliakoff.com

The estate, gift and generation skipping transfer (GST) tax exemptions currently stand at $5,120,000 per person, far and away the highest in history. The combination of these historic exemptions, the current low interest rate environment and depressed asset values has resulted in unprecedented estate planning opportunities the likes of which many commentators believe we may never see again.

As this article will discuss, the window for such estate planning opportunities may be closing – fast. Unless Congress acts before the end of the year, the current favorite wealth transfer tax laws will expire on December 31, 2012. Moreover, President Obama has introduced legislation that would significantly curtail many of the most effective estate planning strategies currently being utilized. We are urging our clients to contact us by September 1, 2012 to allow sufficient time to engage in immediate planning based on the current favorable laws.

This article focuses on some of the short-term opportunities available under current law and the drastic provisions of President Obama's 2013 Revenue Proposals.

The Deadline for Estate Tax Savings and President Obama's Proposed Legislation.

As mentioned above, the current favorable laws are scheduled to expire on December 31, 2012. Without interim congressional action – and given that it is an election year, any new legislation would likely have to be passed in the last month and a half of the year – the gift, estate and GST tax exemptions will drop to $1,000,000, while the tax rates will surge to 55% .

Below is a chart setting forth the current estate tax rates and exemption amount, the projected rate and exemption amount for 2013 and the rate and exemption amount under President Obama's recently proposed legislation.

	2012 (Exemption Amount / Tax Rate)	2013* (Exemption Amount / Tax Rate	Obama Proposal (Exemption Amount / Tax Rate
Gift Tax	$5,125,000 /35%	$1,000,000/55%	$1,000,000/45%
Estate Tax	$5,125,000 /35%	$1,000,000/55%	$3,500,000/45%
GST Tax	$5,125,000 /35%	$1,000,000/55%	$3,500,000/45%

The Obama Proposal

The White House recently released President Obama's 2013 Revenue Proposal (the "Obama Proposal"), which proposes to restore the 2009 gift, estate and GST tax regime. This would increase the tax rate for the estate, gift and GST tax to 45% and lower the gift tax exemption to $1,000,000 per person. The estate and GST tax exemptions would be lowered to $3,500,000 per person.

While this may seem like a reasonable compromise between the low rates and exemptions many Democratic legislators are clamoring for and the higher rights and exemptions favored by Republicans, the Obama Proposal contains a number of surprisingly disadvantageous additional provisions, including the following:

1. **Elimination of the Estate Planning Benefits of Grantor Trusts:** Under current law, transactions between an individual (the "grantor") and a "grantor trust" are ignored for income tax purposes, but a grantor trust is still a separate legal entity for estate and gift tax purposes. Thus, a grantor trust provides an estate planning benefit because the income tax consequences are similar to the grantor making a gift tax-free transfer of the income

taxes to the grantor trust each year – thus allowing the assets in the grantor trust to grow income tax free.

The Obama Proposal dealing with grantor trusts would (1) include the assets of a grantor trust in the gross estate of the grantor for estate tax purposes, (2) subject to gift tax any distribution from a grantor trust to one or more beneficiaries during the grantor's life, and (3) subject to gift tax the remaining trust assets at any time during the grantor's life if the grantor ceases to be treated as an owner of the grantor trust for income tax purposes. The proposal would be effective with regard to grantor trusts created on or after the date of enactment and with regard to any post-enactment contributions to a pre-enactment trust.

2. **Requirement of a Minimum Term for a Grantor Retained Annuity Trust (GRAT).** Generally, a GRAT is an irrevocable trust funded with assets expected to appreciate in value, in which the grantor retains an annuity interest for a term of years that the grantor expects to survive. At the end of that term, the assets remaining in the trust are transferred to (or held in further trust for) the beneficiaries. If the grantor dies during the GRAT term, however, the trust assets (at least the portion needed to produce the retained annuity) are included in the grantor's gross estate for estate tax purposes. To this extent, although the beneficiaries will own the remaining trust assets, the estate tax benefit of creating the GRAT (specifically, the tax-free transfer of the appreciation during the GRAT term in excess of the annuity payments) is not realized.

   GRATs have proven to be a popular and efficient technique for transferring wealth while minimizing the gift tax cost of transfers, provided that the grantor survives the GRAT term and the trust assets do not depreciate in value. The greater the appreciation, the greater the transfer tax benefit achieved. The Obama administration has realized that taxpayers have become adept at maximizing the benefit of this technique, often by minimizing the term of the GRAT (thus reducing the risk of the grantor's death during the term), in many cases to two years, and by retaining annuity interests significant enough to reduce the gift tax value of the remainder interest to zero or to a number small enough to generate only a minimal gift tax liability.

   The proposal would impose a requirement that a GRAT have a minimum term of ten (10) years and a maximum term of the life expectancy of the annuitant plus ten years. The proposal also would include a requirement that the remainder interest have a value greater than zero at the time the interest is created and would prohibit any decrease in the annuity during the GRAT term. Although a minimum term would not prevent "zeroing-out" the gift tax value of the remainder interest, it would increase the risk that the grantor will fail to outlive the GRAT term and the resulting loss of any anticipated transfer tax benefit.

3. **Elimination of Lack of Control Discount Afforded to Family Limited Partnerships and LLCs:** a family limited partnership or family limited liability company ("FLLC") is commonly used to transfer wealth for gift, estate and GST tax purposes. Typically, a FLLC is formed and funded with the family's business interests, hard-to-value assets or assets subject to liability risk. Over time, parents make gifts of a percentage of their ownership interest in the FLLC to grantor trusts for their children or grandchildren. Due to the closely held business nature of the FLLC, the ownership interests transferred are often subject to significant valuation discounts, such as lack of control and lack of marketability discounts, for gift and estate tax purposes. The Obama Proposal, effective on the date of enactment, would eliminate the significant valuation discounts afforded to FLLCs.

Estate Planning/Business Succession Planning Strategies
The above described strategies, which are the target of the Obama Proposal, are some of the most effective estate planning tools available.

Due to the expiring of the current favorable gift, estate and GST tax laws and the drastic provisions of the Obama Proposal, we are urging clients to consider advanced estate planning before September 1, 2012. The remainder of this letter discusses some of the strategies that are particularly useful in the current climate.

Family Limited Liability Company Planning.
The cornerstone of many estate plans for high net worth individuals is a family limited partnership or family limited liability company. The FLLC owns assets you transfer into

it, such as business interests, art work, brokerage accounts, bonds, and/or bank accounts. It is important that the FLLC not own assets used to pay current living expenses, interests in a primary residence, or shares in a Subchapter S corporation.

1. **Tax and Non-Tax Benefits.** As mentioned above, the primary benefit of a FLLC is the reduction of wealth transfer taxes through the application of valuation discounts on the transfer of FLLC interests. However, FLLC's also offer the following non-tax benefits:

    a. **Control over FLLC Assets and Distributable Cash Flows.** Parents often fear that their children will not spend their gifted wealth wisely or that they may become less productive citizens. By transferring limited partnership interest, children only receive a share of the partnership's distributable cash flows. Thus, parents can transfer substantial wealth to their children while maintaining control over how that wealth is used.

    b. **Protection of FLLC Assets from Creditors.** A creditor has no right to levy property titled in the name of a FLLC to satisfy the debt of a partner. Moreover, in a properly drafted FLLC agreement, a judgment creditor of a partner has no right to vote or even inspect the books and records of the partnership or LLC. Instead, the sole remedy of a creditor is to obtain a "charging lien," which essentially garnishes any distributions of cash or other property made from the FLLC to the debtor partner. If you, as the general partner, do not order distributions of cash or property, the creditor gets nothing. With little or no hope of receiving distributions until some time in the distant future when the FLLC terminates, the creditor is often willing to settle the liability at a significantly reduced amount.

    To make matters worse for the creditor, the IRS has held that when a creditor has a charging lien on a FLLC interest and the general partner does not distribute partnership income, the creditor, not the debtor partner, is liable for the debtor partner's allocable share of partnership income. The charging lien may thus become a "poison pill" for the creditor to the extent the creditor receives nothing but a tax bill in connection with his/her collection efforts.

    c. **Simplification of Gift-giving.** Consolidating family assets into a FLLC facilitates the transfer of assets that are not easily valued and/or difficult to divide among beneficiaries. Rather than making gifts of such assets, you would simply gift interests in the FLLC. It is important to obtain a qualified appraisal of the transferred interests to substantiate the discounted transfer tax value should the IRS challenge the amount at some future date.

    d. **Operational and Investment Flexibility.** A FLLC is essentially a contract between the partners, one that is drafted at the direction of you. Provided that the partners agree, a FLLC agreement can be amended or terminated, usually without adverse tax consequences. Further, the general partner is authorized to invest the family assets in a fashion which produces the highest rate of return consistent with his or her risk tolerance.

2. **How the FLLC Works.** The equity of the FLLC would be divided into two classes: the general partnership interest (typically 1%) and the limited partnership interest (the remaining 99%). Because all management authority is vested in the general partnership interest, so long as you retain this 1% interest, you will control the investment and management of the assets held by the FLLC regardless of what percentage of the limited partnership interests you retain or transfer by gift. You, as the general partner, determine how much, if any, cash will be distributed to the partners, though all partners receive proportionate distributions of cash to the extent distributions are made.

    In general, the Tax Code provides that the value of a FLLC interest is determined under a "willing buyer-willing seller" test. Under this test, the fair market value of the FLLC interest would be equal to the price at which the interest would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of all relevant facts.

Due to the restrictive terms of a typical FLLC partnership agreement, the amount a willing buyer would pay for a Limited Partnership interest is far less than the fair market value of the assets underlying that Limited Partnership Interest. To give effect to this reality, appraisers typically discount the value of limited partnership interests by 30-60%, depending on the nature of the underlying assets. Though the IRS has mounted a few successful challenges against FLLC's in certain "bad facts" cases, substantial discounts for lack of control and lack of marketability have been almost uniformly approved by the courts where the partnership agreement is properly drafted and FLLC is properly structured. These discounts are in addition to discounts to any non-managerial interests you may have in any underlying business interests.

Limited partnership interests are transferred in either of three primary ways: (1) direct gifts to a grantor trust; (2) transfer to a grantor retained annuity trust ("GRAT"); and (3) a sale of the limited partnership interest to an intentionally defective grantor trust. ("IDGT"). Each of these three approaches will be discussed, in turn, below.

Direct Gifts to a Grantor Trust

The simplest way to take advantage of the current high gift and estate tax exemptions is to make a significant gift of FLLC interests. As mentioned above, until the end of the year, the estate, gift and generation skipping transfer (GST) tax exemptions are each $5,120,000 per person. By transferring limited partnership interests in a FLLLC, the value of the gift will be significantly reduced, that allowing you to leverage your gift tax exemption.

We generally recommend that gifts be made in trust as opposed to outright. The downsides to an outright transfer, as opposed to a transfer into a trust, include the risk of the assets being treated as marital property in the event of divorce, the property being reachable by the recipient's creditors (or in the case of a FLLC interest, potentially subject to a charging lien), and the inability to ensure that the assets remain in your family for future generations. The use of a trust avoids each of these concerns and, as discussed below, is more tax-efficient than gifting assets outright.

A grantor trust is set up so that the assets of the trust are excluded from your estate for federal estate tax purposes, but considered owned by you for income tax purposes. It is an incredibly powerful estate planning tool because it allows you, as the grantor, to pay the income tax on any income earned by the trust, without such payments being subject to gift tax. By shifting the tax burden to you, the trust assets grow tax free, and you essentially make gift tax-free gifts each year in the amount of the tax payments.

In your case, even the full use of your exemption may not be sufficient to adequately reduce your estate. The two most common advanced strategies used to further reduce your estate are GRATs and sales to an IDGT.

Gifts to a Grantor Retained Annuity Trust

A GRAT is an irrevocable trust to which a grantor transfers property while retaining the right to receive annual annuity payments for a specified term of years. If the grantor survives the trust term, the trust property remaining at the end of the trust term passes to designated beneficiaries (or to trusts for their benefit).

When a GRAT is created, the grantor is treated as having made a taxable gift equal to the present value of the remainder interest. In general, the amount of this gift is determined by calculating the present value of the grantor's retained annuity and subtracting that value from the total value of the property transferred to the GRAT. The longer the term of the GRAT and the larger the annuity payment, the higher the present value of the retained annuity and the less the value of the gift.

The annuity can actually be calculated so that the GRAT that will not have any gift tax consequences to the grantor. By calculating an annuity rate that will result in annuity payments to the grantor over the GRAT's term having a present value equal to the value of the property transferred by the grantor, the present value of the remainder interest will be zero (a "zeroed-out GRAT") for gift tax purposes.

The principal benefit of transferring of property to a GRAT is that if the assets appreciate at a higher rate than the annuity payment rate, the difference will be effectively removed from your estate at potentially little or no gift tax cost. This benefit is multiplied when transferring limited partnership interests in an FLLC because the annuity payments are calculated based on the discounted value of the limited partnership interests, rather than on the value of the underlying assets owned by the FLLC.

The primary downsides to a GRAT are that (1) you have to survive the term of the GRAT to capture the benefit (if you die before the term, the assets become part of your estate as though the transfer never took place); and (2) the assets of the GRAT need to appreciate at a higher rate than the annuity payment rate. Given the lack of any tax disadvantage to these worst case scenarios, however, GRATs can be fairly characterized as "heads I win, tails I tie" proposition.

Sale to an Intentionally Defective Grantor Trust

A sale of an asset by a grantor to an intentionally defective grantor trust (an "IDGT") in exchange for an installment note is another estate planning tool that can transfer future appreciation of the asset to beneficiaries at a relatively minimal gift tax cost. Such an installment sale takes advantage of the current low interest rates required by the IRS to be charged on the note to avoid imputed interest and gift consequences.

Using this technique, a grantor sells assets for their current fair market value to an IDGT. The IDGT gives the grantor a promissory note in exchange for the property. In order to avoid adverse gift tax consequences to the grantor, the promissory note must require that the grantor receive interest at the minimum rate required under the current tax laws. This rate is the hurdle rate above which the property sold to the IDGT must appreciate in order for the technique to be successful.

The assets sold to the IDGT are not included in your estate upon your death, though the outstanding balance of the note will be included. As with a GRAT, if the assets appreciate at a higher rate than the hurdle rate, the difference in appreciation will be effectively removed from your estate. Also as with the GRAT, the benefits are multiplied when you sell limited partnership interests because the value of the note (and the payments therefrom) are based upon the discounted value of the limited partnership interests rather than underlying value of the FLLC's assets.

It is recommended that when structuring the sale transaction that you fund the IDGT (before you sell the FLLC interests to it) with an amount equal to at least 10% of the value of the property sold. This allows the trust to begin paying down the note from its own assets rather than from the assets it purchases, thereby making the transaction more commercially reasonable. If this funding is not possible, the transaction will likely still be respected if the note is guaranteed by the beneficiaries.

The note can provide for interest-only payments during the term, with a balloon payment of principal at the end of the term. The principal payment can be made by transferring property back to the grantor, or, if the property has been sold by the IDGT, the note may be paid with cash. The property remaining in the IDGT, after the interest and the balloon payment, is distributed to the beneficiaries of the trust.

Because the IDGT is a grantor trust, no taxable event occurs when property is sold to the IDGT or when interest payments are made to the grantor. You are taxed the property sold to the IDGT as though you continued to own the property directly.

Conclusion

We strongly recommend that your review your existing estate plans and contact your attorney before September 1, 2012 to discuss the impact of the current transfer tax laws on your planning and the significant wealth transfer opportunities for you and your family in 2012. ■

For additional information or advice, please contact Andrew Berger at 954-364-6074 or ***aberger@becker-poliakoff.com***.

Andrew Berger *is a tax and estate planning attorney with Becker & Poliakoff, P.A. He received his LL.M. in Taxation from New York University School of Law, his J.D. from Fordham University School of Law, and his B.A. from Emory University. He is admitted to practice law in Florida, New York and New Jersey.*