Protecting the Wealth

Keeping clients' assets out of the clutches of creditors and tax collectors is a primary goal of any estate plan. But lawyers need effective strategies to help clients go the distance.

BY SAMUEL L. BRAUNSTEIN
AND CAROL F. BURGER

The primary theme that pervades most methods of asset protection in estate planning is simple in concept but often difficult to actually achieve.

During a person's lifetime, there should be an accumulation of assets that can be passed on to succeeding generations after the person dies. The natural succession in most instances is from one spouse to the surviving spouse, then to their children and grandchildren (and, where appropriate, to designated charities).

Included in the many considerations that must be addressed in planning to accomplish that goal are:

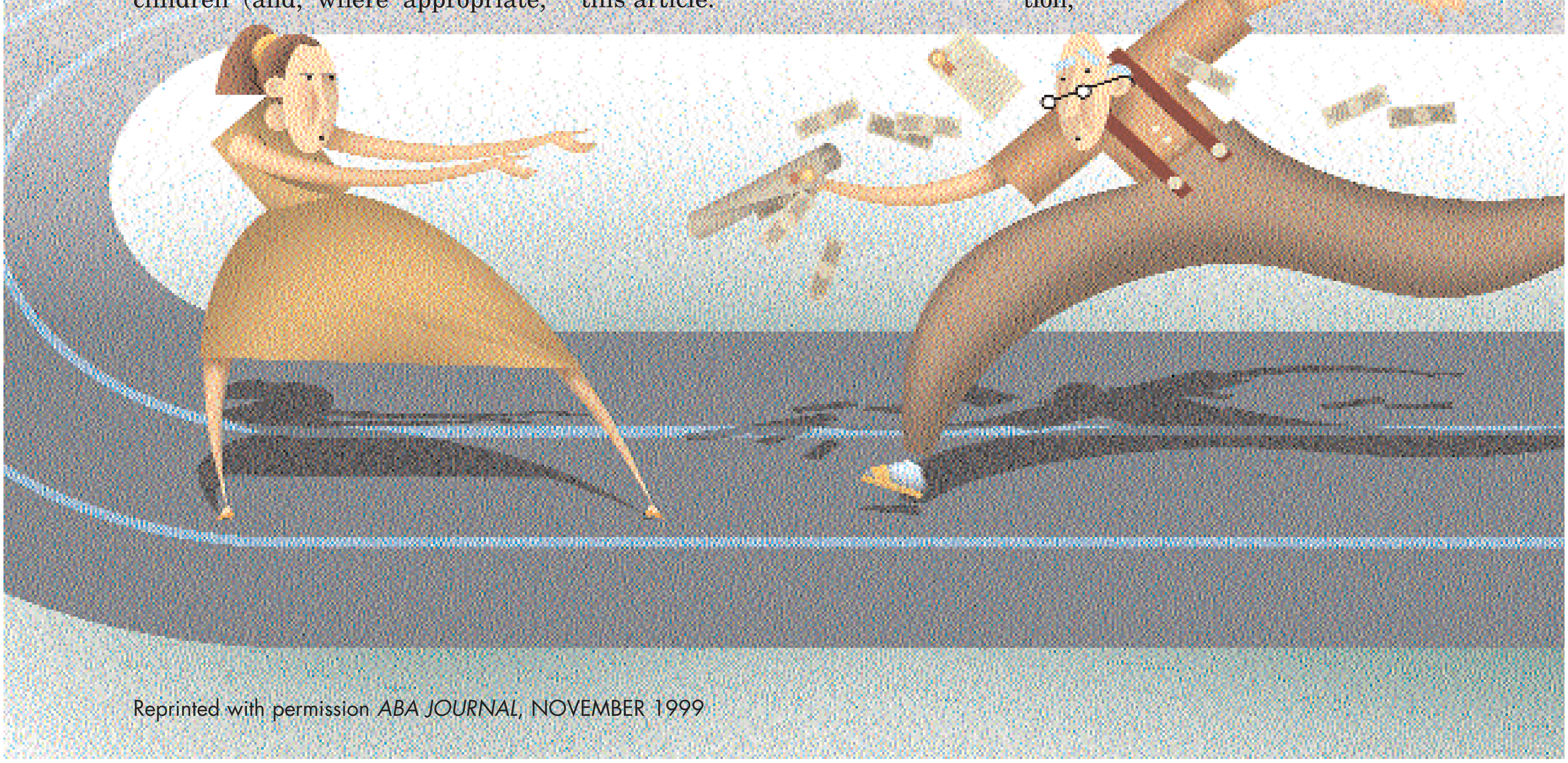
- How does one obtain assets, or "wealth"?
- How does one retain wealth?
- How does one pass the wealth one has retained on to succeeding generations?

The answers to the first question are limited only by one's imagination, skill, timing, hard work, luck and family connections. In any case, they are beyond the scope of this article.

The answers to the last two questions, however, are pertinent here in the context of certain practical asset-protection tools that are available today.

In one form or another, today's tools are merely hybrids of the ones that have been used to protect assets for years: trusts, corporations, partnerships and situs selection, to name a few.

Likewise, the factors that can inhibit an individual's ability to accumulate, retain and pass on assets to survivors are familiar: taxation,



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creditors, disagreements among business associates, soon-to-be-former spouses and health considerations. Another variable is clients' expectations about how asset protection mechanisms can be incorporated into estate plans that also suit their priorities while they are alive. The plan must accommodate what clients are trying to protect and from whom.

Understanding how to use these tools is critical to developing estate plans that effectively maximize what is left when the grantor is gone.

Family Limited Partnerships

Although they have drawn widespread attention from practitioners over the past few years, family limited partnerships have been used for management of family property and businesses for many years.

While the "discounts" attributed to interests in FLPs for tax purposes are important when considering the appropriate vehicle to own and manage assets, protection of assets from outside influence is usually the primary reason estate planners use them. Among the reasons practitioners view the FLP as a viable, practical vehicle for asset protection are flexibility of operations; continuity of management and family training; asset protection, both inside and outside the FLP; consolidation of assets and long-term accumulation of wealth; and a positive method of control.

Unlike owning a share of stock in a corporation (or having money in a bank account), holding a partner's interest in an FLP does not by itself create a type of personal property ownership that ordinarily is subject to divestiture by an outside influence. Being a "partner" confers more than merely a property right in the assets of the partnership. It actually changes the nature of the property rights.

This program
Begins at 1 p.m. (EST) on Nov. 17 and discusses asset protection techniques in estate planning.

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Specifically, each partner is a co-owner of specific partnership property, holding as a tenant in partnership so that the partner's right in specific partnership property is not subject to attachment or execution, except on a claim against the partnership itself. Accordingly, assets owned by the partnership in its own name are not subject to satisfying the obligations of its individual partners.

Moreover, a partner cannot normally be divested of that particular interest by an outside influence in contravention of the partnership agreement.

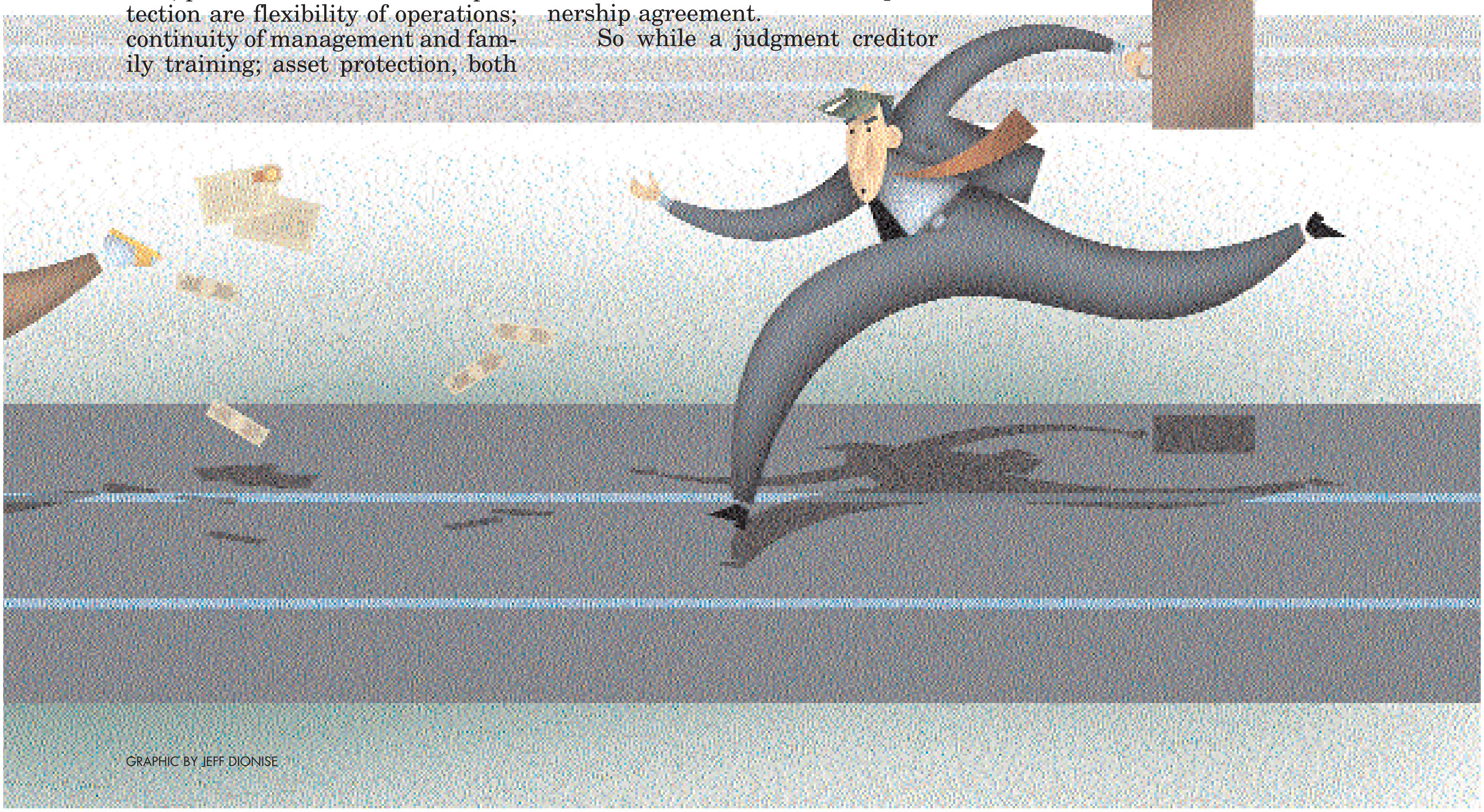
So while a judgment creditor might be able to divest a person of ownership in a share of stock in a corporation (or a bank account), a partnership interest is not subject to such divestiture.

A partnership interest may, however, be subject to a "charging order." A charging order against a partnership interest is essentially an order by a court that awards a judgment creditor (or other appropriate party) whatever the partner/debtor is entitled to receive from the partnership in the capacity as a partner.

Under a charging order, if the partner is entitled to a cash or other asset distribution from the partnership in the capacity of being a partner, it must be made to the judgment creditor. If there are no such entitlements, nothing needs to be distributed to the creditor from the partnership, and its assets remain intact in spite of the judgment against one of its partners.

By contrast the same type of judgment against, for example, the owner of a majority interest in a closely held corporation could result in divestiture of the stock ownership (and control of the corporation) to the creditor. And the corporation itself could be used as a method of paying the debt through sale of the stock, liquidation or other means.

In most plans using FLPs, mom and/or dad are designated as the general part-



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ner(s) of the FLP, either concurrently or successively, depending on the circumstances. That way, they maintain control over the family business during their tenure. The children normally are designated limited partners (mom and dad can be limited partners, as well), and interests in the FLP are transferred to the children over a period of time (usually several years and possibly at a savings of income taxes) through gifts and other means. In that way, mom and dad can pass the torch without giving up the controls until it is appropriate, at the same time reducing their taxable estates.

If there is an action against the partnership entity rather than the individuals who happen to be partners, the assets of the partnership, as well as those of the general partner, are at risk in the event of an adverse judgment. The question then presents itself: How does the FLP actually conduct active business operations without unduly exposing the partnership's underlying assets?

SAMUEL BRAUNSTEIN
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Multiple Tiers

Use of multiple tiers of formal entities has long been a common practice to protect the operations and assets of one entity from another in a related group of enterprises. Under this practice holding entities—such as corporations, trusts and partnerships—own subsidiary entities that in turn can own subsidiaries.

By placing various business enterprises in separate entities and observing the formalities associated with them, the overall enterprise is thereby able to shield its individual segments from each other.

The longstanding problem with having multiple layers of entities is the complexity of state legal requirements, as well as tax compliance and reporting issues. At least until recently, unless an enterprise had the financial clout to address the continuing compliance issues that would ensue, such a structure usually was disregarded as either unnecessary or too complicated.

All too often, though, the result was disaster when there were no effective shields to protect the viable business entities from the failures.

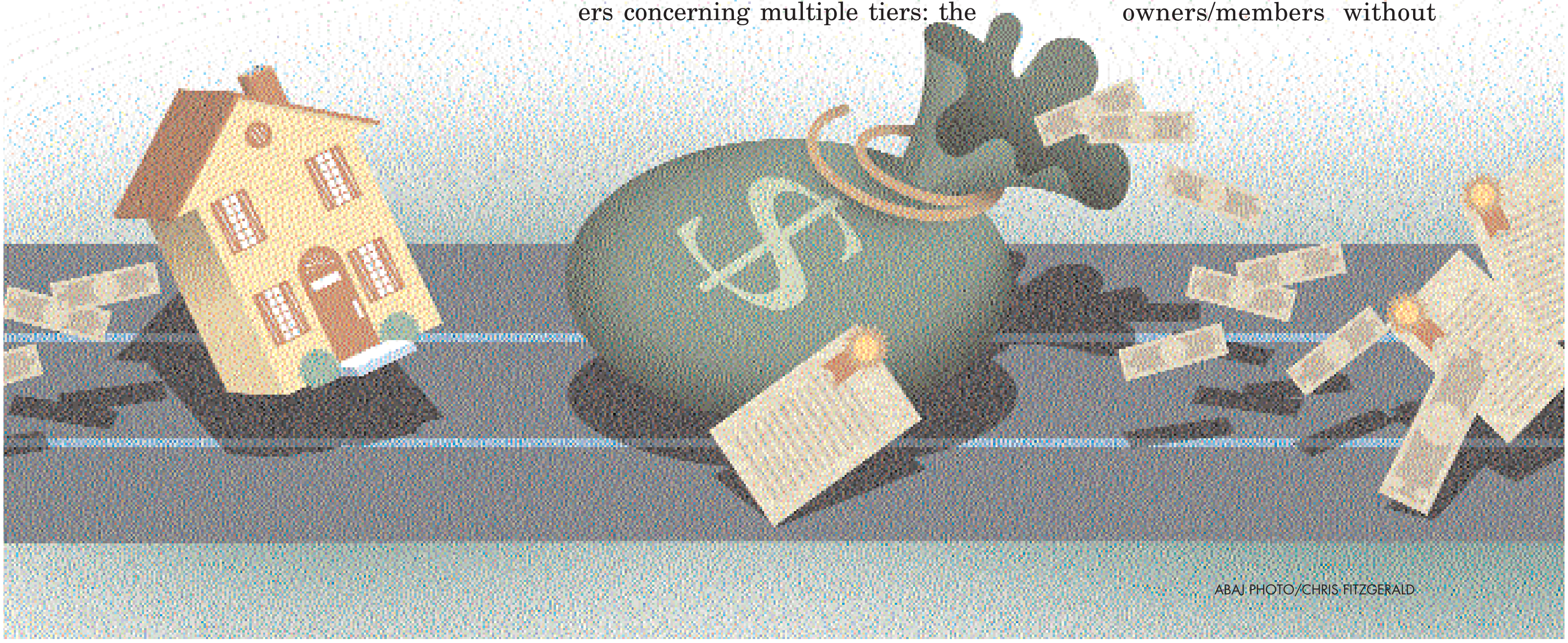
Limited Liability Companies

Over the past few years, a new entity has emerged that appears to answer many practitioners' prayers concerning multiple tiers: the limited liability company.

Under the various state statutes that enable their creation, LLCs are formal entities providing the same basic protection against an owner's potential liability to creditors as a corporation. LLCs generally have the ability to choose how they will be taxed—as, for example, proprietorship, partnership, or S or C corporation.

In addition, there are at least two other significant characteristics of LLCs that affect their federal income tax treatment:

First, when taxed as a partnership, an LLC passes through treatment of tax attributes to its owners/members without



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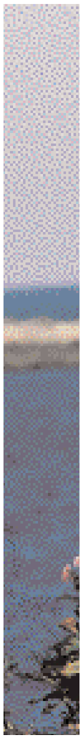


the limitations attendant to Subchapter S corporations. Second, there is no requirement of having a general partner, as there is in a regular partnership.

When an FLP is used in the multitiered concept of enterprise protection, it is easy to visualize a structure in which it would function as the central asset-holding entity, while also serving as the owner/member of various LLCs as needed to conduct actual business operations. This structure provides a layer of protection to the FLP's assets, and between the various operational LLCs owned by the FLP.

The rules for dealing with FLPs and LLCs, whether or not employing multilayered enterprise formulations, remain the same as for other entities: The formalities must be observed to obtain the benefits.

Grantor Retained Annuity Trust

A grantor retained annuity trust is a vehicle that allows future appreciation to be transferred at little or no tax cost. With a GRAT, the grantor transfers property to an irrevocable trust, retaining the right to a fixed annuity payment for a specified number of years. At the end of the trust term, the property passes to the grantor's children or other beneficiaries, either outright or in further trust.

For gift tax purposes, the grantor is considered to have made a gift on the date of the property transfer to the trust for an amount equal to the difference between the value of the property transferred (taking into account any applicable discounts) and the value of the retained annuity payments (valued as though the payments would cease as of the earlier of the expiration of the annuity term or the grantor's death).

If the term of the trust is long enough, the annuity is set high enough and the grantor is young enough, the value of the gift can be reduced to a nominal percentage of the value of the property transferred.

The interest rate used for purposes of valuing the annuity payments is established under Internal Revenue Code § 7520 as 120 percent of the federal mid-term rate, as published monthly by the IRS, for the month in which the property is transferred to the trust.

Example 1: *A grantor age 53 transfers 1,000 shares of stock with a value of $1 million to a GRAT with a nine-year term, retaining a 15 percent ($150,000) annuity for the nine-year period. The section 7520 rate of the month is 7.2 percent. The grantor has made a gift for gift tax purposes equal to 6.22 percent of the value of the shares transferred, or $62,200.*

Under the IRC, a GRAT is considered a grantor trust, sometimes known as a defective trust or defective grantor trust, which means that, for income tax purposes, the property owned by the trust is generally still treated as if it were owned by the grantor. The grantor therefore recognizes no gain on the transfer of appreciated property to the trust, and no income on the receipt of the annuity payments. Instead, all the income earned by the trust will be taxed directly to the grantor.

The trust may be structured so that if the income tax payable by the grantor on the trust's income exceeds the annuity amount he receives for the year, the grantor may receive a distribution from the trust equal to the excess.

For estate and gift tax planning purposes, it is more advantageous for the grantor to pay the tax from his own funds, since (despite some Internal Revenue Service rumblings to the contrary) the grantor's payment of the tax should not be considered a gift to the beneficiaries. Since the grantor does not recognize gain on appreciated property transferred to the trust, it is only logical that the trust and ultimately the beneficiaries receive the property with a carryover basis.

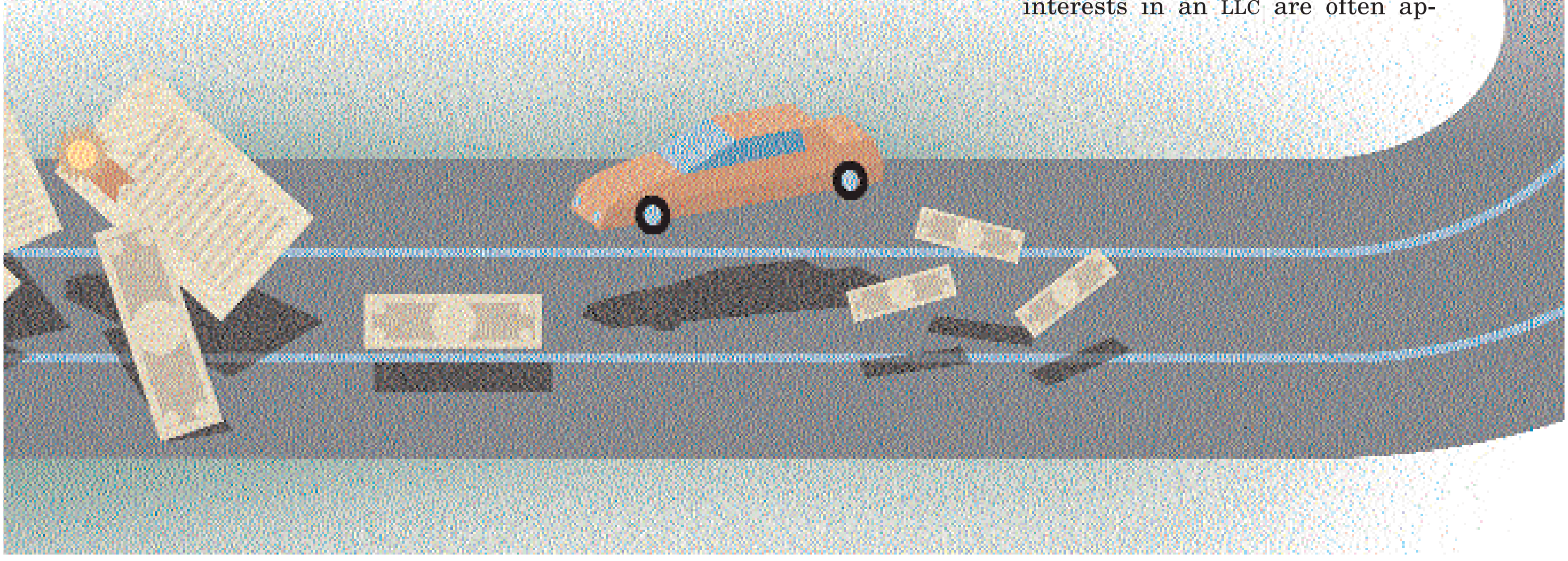
The annuity payments may be made in cash or in kind but cannot be paid with a promissory note. While payment of the annuity in cash or marketable securities avoids the need for annual appraisals, payment of the annuity in kind does not reduce the estate planning advantages of the GRAT.

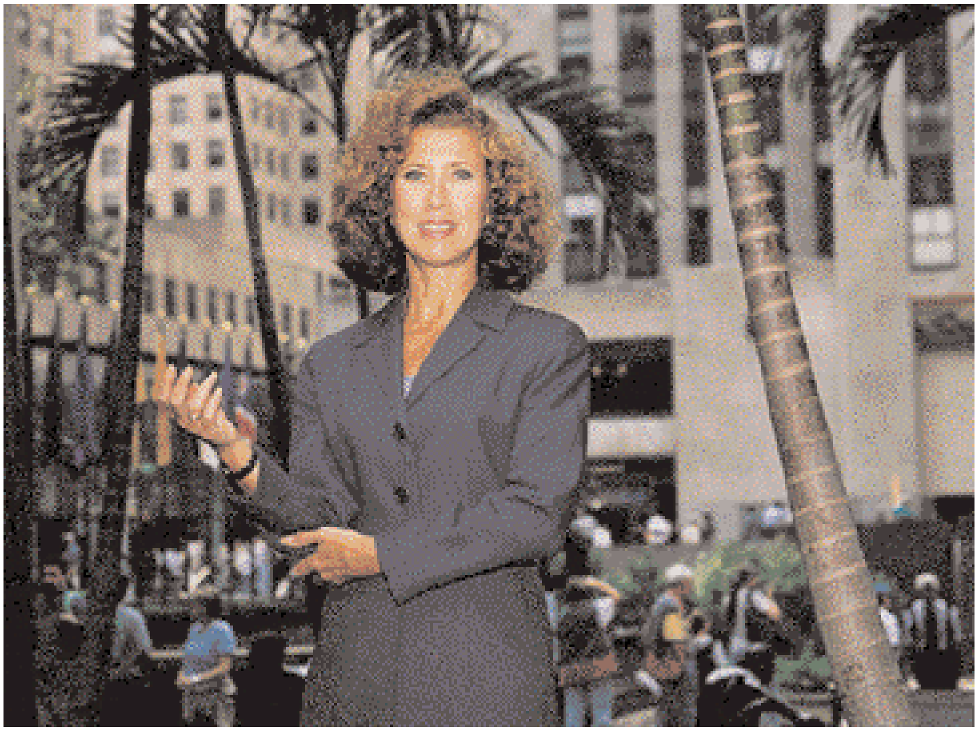
Example 2: *Same facts as Example 1. At the end of year one, the shares have appreciated to $1.5 million. The trust may make its annuity payment by returning 100 shares to the grantor. No gain is recognized on the transfer. The grantor retains his original tax basis in the returned shares.*

The catch to the GRAT is that for the estate planning benefits to be realized, the grantor must outlive the term of the trust. If the grantor dies during the trust term, the property will be included in the estate for estate tax purposes.

For this reason, it may be preferable to create several different GRATs, some with shorter terms, or to use a series of rolling, short-term GRATs. Also, the GRAT generally results in a transfer of value to the next generation only if the income earned on and appreciation of the property exceeds the section 7520 rate.

Stock in an S corporation, partnership interests and membership interests in an LLC are often ap-





CAROL BURGER

By keeping client goals in sight, lawyers can stay on the proper path.

propriate assets for transfer to a GRAT, since only the pretax rate of return must exceed the section 7520 rate.

Installment Sale to Grantor Trust

A GRAT alternative is a property sale to a grantor trust in exchange for an interest-bearing promissory note. Because the trust is ignored for income tax purposes, the grantor does not recognize gain on the sale of appreciated property to the trust, nor is the grantor required to recognize interest income on the note payments he or she receives.

The major advantage of the installment sale over the GRAT is that the transferred property will be outside the grantor's estate regardless of the date of the grantor's death (though any balance remaining due on the promissory note will be includable in the estate). This advantage is reduced somewhat, however, by the fact that the trust will cease qualifying as a grantor trust at the date of the grantor's death.

While there is little authority on what happens next, the most likely result is that the grantor's estate would recognize capital gain and interest income on any remaining payments due on the note. If the note is paid in kind with appreciated assets rather than cash, the trust would also recognize capital gain on its payment.

Another advantage of the installment sale over the GRAT is that interest payable to the grantor on an installment note is required to be calculated at the applicable federal rate (short-term, mid-term or long-term, depending on the term of the note), which generally is lower than the section 7520 rate at which the GRAT annuity is calculated. Since the grantor receives a lower rate of return, assets with a greater value are ultimately passed to the beneficiaries.

There are, however, a number of disadvantages to the installment sale when compared to the GRAT. The most significant is the increased gift tax exposure resulting from an incorrect valuation of the transferred property. With a GRAT, the annuity payable to the grantor is generally expressed as a percentage of the value of the assets transferred to the trust. If the reported value of the transferred property is increased upon audit, a receivable is created in favor of the grantor. While the increase in the reported value of the property reduces the estate planning benefits of the GRAT, the actual gift tax exposure may be minimal.

Example 3: *Same facts as Example 1, but upon audit it is determined that the value of the property transferred to the trust was $2 million. Under the terms of the trust, the annuity payable to the grantor should have been $300,000 rather than $150,000, and the difference for the period preceding the audit must be paid to the grantor. The value of the gift for gift tax purposes, however, has been increased only by $62,200 (the difference between 6.22 percent of $1 million and 6.22 percent of $2 million).*

Another disadvantage is that an installment sale to a trust that pays the entire purchase price with a promissory note and holds no assets other than the property it has just bought may be considered a transfer with a retained interest under IRC § 2036 that is includable in the grantor's estate.

To avoid this risk, the trust should be funded with other assets that would support the note if, for example, the property sold to the trust were to decline in value. This generally requires the grantor to make a gift to the trust in advance of the sale. A gift of about 10 percent to 15 percent of the value of the property sold to the trust probably would be sufficient to support the sale.

Self-Canceling Installment Note

Property can be sold in exchange for a promissory note providing by its terms that no further payments will be due after the seller's death. If the seller dies before the note has been fully paid, the unpaid balance is not includable in the seller's estate for estate tax purposes. But the unpaid balance is recognized by the grantor's estate for income tax purposes as income in respect of a decedent. See *Estate of Frane v. Commr.,* 998 F.2d 567 (8th Cir. 1993).

If the asset sold was a capital asset in the hands of the seller, and the long-term holding period satisfied, the unpaid balance will be taxable at the lower rates applicable to capital gains. The buyer's tax basis for the asset purchased is the full purchase price, regardless of whether the full price is paid. The buyer also is entitled to deduct the interest paid, assuming it is otherwise deductible as business, investment or qualified home mortgage interest.

If the transaction is to be recognized as an arm's-length sale rather than part-sale/part-gift, the seller must be compensated for the risk

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of not receiving the entire purchase price. Thus, either the principal balance of the note or the interest rate payable under the note will have to be greater than would be the case with an ordinary promissory note.

Private Annuity

An alternative to a self-canceling installment note is a private annuity. The difference is that a self-canceling installment note has a fixed maturity date, whereas the private annuity continues until death or to a fixed period extending beyond the seller's life expectancy. If the fixed maturity date on a purported self-canceling installment note exceeds the seller's life expectancy, it is treated as a private annuity.

For a private annuity to be treated as an arm's-length sale, the present value of the annuity payments over the seller's life expectancy must equal the fair market value of the property sold. The present value of the annuity payments is generally calculated under annuity tables published by the IRS. The tables may be used even if the seller is in somewhat poor health but not when there is a greater than 50 percent likelihood that the seller will die within one year after the date of the sale.

For income tax purposes, the seller recovers his or her tax basis over the expected annuity payments, so that each payment received upon a sale of appreciated property is in part a return of basis, in part capital gain and in part ordinary income analogous to interest. Depreciation recapture, however, must be recognized entirely in the year of sale.

Once the seller has reached life expectancy and recovered the basis in full, excess payments are taxable as ordinary income instead of return of capital. Sellers who die prior to their life expectancy may deduct the unrecovered basis on their final income tax returns.

The buyer's tax basis in the property received may change over time. Generally, the buyer's tax basis is equal to the present value of the expected future annuity payments. Payments in excess of this amount may be added to basis as they are made. If the seller dies earlier than expected, basis is reduced to the payments actually made.

There are advantages and disadvantages to using a private annuity rather than a self-canceling installment note. In both cases, the buyer risks paying more for the property than he or she had paid using cash or an ordinary installment note. With a self-canceling installment note, the buyer has overpaid for the property even if the seller lives to life expectancy. With a private annuity, the buyer has overpaid for the property only to the extent the seller passes life expectancy.

The major tax advantage of the private annuity is that no amount is includable in income by the seller's estate after death. If the seller were to die prior to reaching life expectancy, the buyer would have received the property at below fair market value, and there would be no estate tax or income tax inclusion by the seller.

The buyer gives up his or her interest deduction by using a private annuity rather than a self-canceling installment obligation. Although a portion of each payment in a private annuity is includable in ordinary income by the seller, no portion of the payment is considered interest deductible to the buyer.

Sorting through the various asset protection mechanisms may seem like wandering through a maze. But by keeping the goals of the process in sight, the attorney can guide a client on an appropriate path. ■

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