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Estate Planning Essentials for Physicians

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The physician who plans well and plans ahead can build an estate plan that reaps many benefits and serves several purposes: shield assets from creditors, litigants, and ex-spouses; eliminate uncertainties over the administration and probate of the estate; maximize the estate's value by reducing taxes and expenses; and, ultimately, pass the estate's assets to heirs during (and after) the grantor's lifetime. The best plans act as a roadmap across an investor's portfolio and an indicator of what will occur with all assets.

Planning can dramatically reduce—or avoid altogether—some common tax hits, including: capital gains, state, inheritance, and estate and gift *taxes*. There are several options to consider when building an estate plan. Here are three options that might serve to protect assets:

1. Freeze them in an Intentionally Defective Grantor Trust
2. Freeze them using a Grantor Retained Annuity Trust
3. Create a Family Limited Partnership

The phrase "frozen assets" often evokes fear about not being able to access one's property. However, when one chooses to freeze the value of an asset, it can be an effective way to pass on a business or other growth-assets to family members.

Intentionally Defective Grantor Trust

One intelligent freeze technique is to employ the Intentionally Defective Grantor Trust (IDGT). The IDGT is structured as a grantor trust that is purposely "defective" regarding specific income tax rules. By retaining certain powers, including the right to borrow funds, the grantor ensures he or she will be responsible for paying income tax on the trust's income.

This is not as bad as it sounds. Because the trust is considered an “alter-ego” of the grantor, there will be no taxable gain when assets are “sold” to the trust or when the grantor receives interest payments from the trust.

Example

Suppose a father transfers $1 million worth of cash or an asset to an IDGT with a rate of return of 10%. The income generated would be $100,000 per year. If the trust paid its own tax (assuming no distributions were made from the trust) $1,055,000 would remain in the trust. At the end of the year (assuming a 45% combined state and federal income tax bracket), the original principal of $1 million plus $100,000 of income (less $45,000 in taxes) would remain.

However, if the trust income is taxed to the grantor and the grantor uses **other** non-trust funds to pay the tax, then there would be $1.1 million in the trust at the end of the year instead of $1,055,000. The grantor reduces the “value” of his estate without any transfer tax consequences by using **other** funds to pay the income tax on behalf of the IDGT. And the money the grantor uses to pay the tax is also removed from his estate, creating a double benefit.

If the grantor uses other funds to pay the income tax and no distributions are made from the trust, after 20 years there would be **$6.7 million** in the IDGT instead of $2.9 million—provided it’s a non-grantor trust. The difference of $3.8 million is, in effect, a tax-free gift.

Grantor Retained Annuity Trust

Another efficient option for an investor to freeze the value of his or her estate is a Grantor Retained Annuity Trust (GRAT). This is an irrevocable trust into which the grantor, who creates the trust, transfers assets and retains the right to receive an annuity for a specified term.

At the end of the GRAT term, the trust’s remaining assets pass to designated beneficiaries—generally, family members—tax free. The IRS assumes a GRAT will grow at a rate (commonly referred to as the “7520 rate”) that is set at the time the trust is established. Since the IRS does not look at the actual growth of the assets, growth surpassing the assumed rate can be passed *estate and gift tax free* to trust beneficiaries.

For the trust vehicle to be compelling, the grantor presupposes the actual return earned will be higher than the hurdle rate. A GRAT is a great wealth transfer option in a low-interest-rate environment since it’s easier to outperform the hurdle rate than in a high-interest-rate environment.

To avoid triggering a taxable gift, as well as minimize gift tax costs, the annuity amount is generally set so that the present value of the annuity payments over the GRAT term will equal or almost equal the value of the property contributed to the GRAT plus the 7520 rate. As a result there is little or no taxable gift (called “zeroing out”). The lower the 7520 rate, the lower the annuity amount needed to effect a zeroing out.

There are risks, though. For instance, **if a grantor** pre-deceases the full term of the GRAT, the trust property might be included in the estate for estate tax purposes. This would negate transfer tax savings and it would be as if the GRAT never existed. To mitigate this risk, a series of shorter term GRATs could be established. There will be an added benefit as some GRATs might fail (with no downside other than lost setup costs) and some might succeed. This is analogous to placing a series of bets. It will enable the grantor to take advantage of potential market volatility by locking in the GRAT’s tax-free transfers and (possibly) outperform the hurdle rate.

The longer-term GRAT has 3 main benefits:

1. Locking in a low interest rate for the entire term of the GRAT.
2. Little or no gift tax consequence (though, under current law this may change).
3. The grantor trust structure where payment of income taxes by the grantor is, in effect, a further tax-free gift to beneficiaries since the trust assets can grow without reduction for income tax payments.

One thing to keep in mind is that for a longer term GRAT, positive and poor investment performance may also offset each other. This reduces the likelihood of beating the hurdle rate and successfully passing assets tax free to trust beneficiaries.

Family Limited Partnerships

Our final example, Family Limited Partnership (FLP), has 2 types of partners: general partners, who hold control over the assets, decision-making, and how the assets are distributed; and limited partners, who hold an economic interest.

It’s important to note that even if a general partner holds a substantially smaller percentage of the assets, he or she retains control. FLPs allow for up to a 40% discount on the market value of assets placed into trusts, which means the intelligent physician can effectively pass along up to $8.9 million (individuals) and $17.8 million (married couples). The math is simply $5.34 million divided by 60% and $10.68 million divided 60%. For 2014, over an investor’s lifetime, he or she can gift $5.34 million—$10.68 million for a couple—exempt from gift and estate taxes.

While those amounts may sound substantial, a physician nearing retirement who has invested wisely may wish to employ these techniques for 2 reasons: gifts of this magnitude can substantially reduce the amount of the estate, thereby, reducing the taxable amount of the estate; and gift, inheritance, and estate taxes are avoided.

What investors put into an FLP, or multiple FLPs, can include a range of assets. If, for example, a $2 million home is put into the FLP and the market value of the home rises to $3 million, it is still only “worth” $2 million since it “resides” within the FLP.

Choosing right

The good news is that today’s physician can choose from a myriad of estate planning techniques that offer not only tax advantages, but also various levels of control over the assets. When the instruments employed are structured properly, wealth transfer goals can occur with maximum precision and efficiency with minimal risk. Choosing the right estate planning techniques today could mean millions of dollars in tax savings years down the road.

Estate planning is an aspect of wealth management that may be neglected—as it means planning for an inevitable reality few wish to confront. Thinking about the fine details and nuances of what will outlive us and be passed on to heirs can prove daunting even for the most pragmatic of physicians—yet, ignoring it is a mistake.

Have questions? We want to hear them! Contact us at sabernathy@abbygroup.com or bluster@abbygroup.com.

Steven Abernathy and Brian Luster co-founded The Abernathy Group II Family Office, which counsels affluent families on multi-generational asset protection, wealth management, and estate and tax planning strategies. It is independent, employee-owned, and governed by an Advisory Board comprised of thought-leading business and medical professionals. Abernathy and Luster are regular contributors to several publications and blogs. To learn more visit: http://www.abernathygroupfamilyoffice.com.

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