Medical Economics
SMARTER BUSINESS. BETTER PATIENT CARE.

Published on *Medical Economics* (http://medicaleconomics.modernmedicine.com)

3 ways to avoid tax hits in estate planning

Brian Luster and Steven Abernathy
Publish Date: JUN 10,2014

Estate planning is an often-neglected aspect of wealth management, because it involves thinking about 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. Nevertheless, ignoring it is a mistake.

The savvy physician will not shy away from this needed component of wealth management, but instead will plan well, plan ahead, and reap the benefits. A well-prepared estate plan optimally serves several goals: eliminating uncertainties over the administration and probate of the estate itself; maximizing its value by reducing taxes and expenses; shielding assets from creditors, litigants, and ex-spouses; and ultimately passing the estate's assets to heirs during (and after) the grantor's lifetime.

> "The most effective estate plans are a roadmap across an investor's portfolio to what will happen with all assets across many categories. Without a clear plan, an estate may be subject to several taxes right off the bat.

The most effective estate plans are a road map across an investor's portfolio to what will happen with all assets across many categories. Without a clear plan, an estate may be subject to several taxes right off the bat (depending on the state). These may include: capital gains, state, inheritance, and estate and gift taxes. With proper planning and forethought, these tax hits can be reduced—or avoided altogether. This article introduces three instruments that might be used in an estate plan:

- family limited partnerships (FLPs),
- freezing assets in an Intentional Defective Grantor Trust, (IDGT), and finally
- freezing assets using a Grantor Retained Annuity Trust (GRAT).

1. Family limited partnerships

FLPs have two 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 asset(s), she or he retains control. FLPs allow for up to a 40% discount on the market value of assets placed into trusts, which means the 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 by 60%. (For 2014, over an investor's lifetime, he or she can gift $5.34 million, or $10.68 million per couple, exempt from gift and estate taxes.)
While those amounts may sound substantial, a doctor who is nearing retirement and has invested wisely may wish to employ these techniques for two reasons:

Gifts of this magnitude can substantially reduce 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 included in the FLP, and the market value of the home rises to $3 million, it is still "worth" only $2 million because it "resides" in the FLP.

Next: Intentional defective grantor trust

2. Intentional defective grantor trust

Another effective way to pass on a business or other assets to family members as part of an estate plan is by employing a "freeze" technique in an IDGT.

The IDGT is structured as a Grantor trust that purposefully runs afoul of specific income tax rules. By retaining certain powers, including the right to borrow funds, the grantor ensures that he or she will be responsible for paying 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.

Here is an example. Suppose dad transfers $1 million worth of cash or an asset to an IDGT with, say, a 10% rate of return. The income generated would be $100,000 per year. Assuming a 45% combined state and federal income tax rate, and that no distributions were made from the trust, the original principal of $1 million plus $100,000 of income less $45,000 in taxes—or $1,055,000—would remain at the end of the year.

If the trust income is taxed to the grantor and the grantor uses other non-trust funds to pay the tax, however, then $1.1 million would remain in the trust at the end of the year instead of $1.055 million. The grantor thus 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.

Moreover, if the money the grantor uses to pay the tax is also removed from his estate, it creates 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.

Next: Grantor retained annuity trust

3. Grantor retained annuity trust

A GRAT offers yet another efficient option for an investor to freeze the value of his or her estate. One of the most dramatic examples of effective use of a GRAT is illustrated by the Walton family. Several years ago, Audrey Walton, daughter of one of the cofounders of Wal-Mart Stores, Inc., wanting to give $100 million worth of stock to her daughters, transferred 7.2 million shares to a GRAT. The basic premise was simple; the investor takes advantage of the ability to separately value different interests of a single asset. These interests are typically: 1) the cash flow from the trust's asset (usually in the form of an annuity), such as the rent from an apartment building; and, 2) the trust's asset itself (i.e. the apartment building).

The trick is in the valuation. The asset placed into the trust is valued at less than its fair market value because the annuity cash stream, also called retained interest, is still held by the grantor. This minimizes the gift tax; more importantly, by allowing the retained interest to equal the value of the asset (plus an assumed growth rate provided by the U.S. Treasury Department).

The retained interest value is "frozen" at the time it is placed in the trust. Assuming the asset increases in value faster than the assumed growth rate, any appreciation is passed on tax-free. (Note: the grantor, not the trust, is paying taxes on the growth.)

Audrey Walton's trusts were to terminate in just two years, with the remaining shares to be transferred to her daughters. The trust stipulated that for the first year, Walton was to be paid an annuity equal to 49.35% of the initial trust, and 59.22% for the second year. Payments could be made in-kind with the Wal-Mart stock. Using the voodoo of actuarial tables, the daughters' remainder was valued at only $6,195—not a bad gift tax to pay on 10% of $1 billion.

Why so low? The dollar amount Walton received, in the form of an annuity, equaled the value of the stock at the time it was arranged. What would have happened if the value of the stock increased at the end of the two years?

In what was a surprise at the time, the value of the Wal-Mart stocks declined, thereby exhausting the trust corpus, so the daughters were left with nothing from it. So, what would have happened had the shares appreciated? (Remember that even 15% is certainly possible in a volatile market.) The daughters would have received approximately $15 million for the bargain price of a gift tax on $6,195, plus relatively minimal administrative and legal costs.

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

Steven Abernathy and Brian Luster co-founded The Abernathy Group II Family Oce, basedâ€¨in New York, New York. Theâ€¨ firm counsels affluent families on multi-generational asset protection, wealth management, and estate and tax planning strategies.

Source URL: http://medicaleconomics.modernmedicine.com/medical-economics/news/3-ways-avoid-tax-hits-estate-planning

Links:
[1] http://medicaleconomics.modernmedicine.com/medical-economics/news/investment-strategies-physician-stock-portfolios
[2] http://medicaleconomics.modernmedicine.com/medical-economics/news/strategies-reducing-tax-bite