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Case Study –

Reducing/Eliminating Federal Estate and Generation Skipping Transfer Tax

The following case study will illustrate the methods which can be employed in designing an estate plan to reduce, or even eliminate, the federal estate and generation skipping transfer tax at death. The subject of this Case Study attended one of my seminars on Advance Estate Planning, saw the application of the strategies to her situation, retained our law firm to analyze her specific factors, and elected to modify her estate plan to achieve the desired tax savings.

Existing Estate Plan Design: Several years before the death of Mr. B, he and Mrs. B had their estates planned by a very competent estate planning lawyer in their home town. The attorney had formed a living trust and funded it with their joint assets, formed an irrevocable life insurance trust which purchased substantial amounts of life insurance to pay the estate taxes upon the death of the survivor, and transferred their home to a QPRT, a device to reduce the estate taxation on their personal residence. Most of the conventional estate planning strategies were in place when we met.

When I met Mrs. B, she was in her early 70's and in very good health. When Mr. B died, the estate was valued in the area of $60M. The living trust was established to take advantage of the full marital deduction, so that the estate tax would be deferred until Mrs. B died. When we projected the value of the estate at Mrs. B's death, we concluded that her estate taxes would far exceed the amount of life insurance payable at her

Mrs. B was also making gifts of almost $1M per year to the life insurance trust in order to keep the life insurance policies in force. Mrs. B had consumed her available unified credit, resulting in the gifts being taxed to the tune of $550,000 per year.

Finally, Mrs. B has adult children to whom the estate is to pass at her death. She wanted to examine the ability to reduce the taxes at death, but during her lifetime she wanted to retain full control of her holdings without any interference from the children.

Objectives: Our objectives in planning this estate were as follows:

1. Freeze the value of the estate at current values and transfer the current assets out of her estate to shift the future growth to Mrs. B's descendents;

2. Accomplish #1 without Mrs. B having to incur any immediate gift or capital gains tax;

3. Reduce the value of the current estate by using available discounting techniques;

4. Eliminate the annual gift tax on the funds used to maintain the life insurance policies in the insurance trust; and

5. Arrange for Mrs. B to remain in full control of her holdings, without such control resulting in the assets being included in her estate.

Planning Recommendations

Formation of Family LLC and Sale to Tax Defective Grantor Trust: The threshold objective for Mrs. B's estate plan was to transfer the appreciating assets out of her taxable estate, such that the future growth would not be included in her estate and taxed at her death. Due to the size of the estate, it was imperative this be done without incurring any transfer tax, e.g., gift tax or capital gains tax.

The foregoing was accomplished for Mrs. B. by forming a limited liability company (LLC) in a state which allows a single member LLC. Once the LLC was formed, Mrs. B, as trustee of her living trust, arranged for the assets of her living trust to be transferred to the LLC. This was accomplished by simply contacting the broker and changing the name on the accounts to the LLC.

Next, we created an income tax defective trust, or Superfreeze Trust (SFT). This is a special kind of irrevocable trust that, for income tax purposes, is treated by the IRS as a grantor trust, while for estate tax purposes, the assets in the SFT are excluded from the estate at the death of the grantors. Mrs. B then funded the SFT by making a cash gift. The dispositive provisions of the SFT provided that at Mrs. B's death, the children would receive income for their lifetimes and principle for their welfare and benefit only. At their death, the SFT would continue to provide a similar benefit for her future descendents. By utilizing this dynasty trust type scheme, estate taxes would be deferred as long as the assets remained in trust.

South Dakota: Most states have a law called the Rule Against Perpetuities. This means that a trust may only remain in existence for a predetermined period of time. At the time of its forced termination, the assets which are distributed must be taxed. Generally, a trust may only remain in existence for 2 to 3 generations.

South Dakota changed their law and abolished the Rule Against Perpetuities, permitting trusts established there to remain in existence in perpetuity. Therefore, by domiciling the SFT in South Dakota, Mrs. B is now able to maintain the SFT in existence in perpetuity and defer the estate taxation of the corpus of the trust indefinitely.

With the SFT in place and holding the cash gift, the next step is to freeze the value of the estate by transferring the LLC interest held by Mrs. B's living trust. If Mrs. B were to make a gift of the LLC interest, she would incur a gift tax liability of over $33M. Therefore, instead of a gift, we arranged for the living trust to sell the LLC interest to the SFT at its fair market value (FMV). FMV is critical, as the price at which the LLC interest is sold is essential to the integrity of the transaction.

When valuing an interest in a closely held business like the LLC, certain factors are taken into account to determine FMV. These factors result in an adjustment to the value of the underlying assets, which can vary between 25% and 50% or more. In Mrs. B's case, we retained the services of a nationally recognized valuation firm to issue an opinion of the value at which the LLC interest should be sold and had the firm provide us their written opinion of FMV. The firm determined the FMV should be the value of the underlying holdings ($60M) reduced by a discount of 30% ($18M), for a purchase price of $42M.

The living trust then enters into a purchase and sale transaction by which it sells the LLC interest to the SFT for $42M (the FMV of the LLC interest). The terms of the transaction are generally 5% cash down payment and an interest-only promissory note due and payable in 20 years. Interest is charged at the rate determined by special tables published by the IRS, called the AFR rate. While the rate changes monthly, the rate in this case was about 6.0%. The SFT will pay cash down of $2.1M and execute a note for the balance. The funds for the cash down payment came from the gift Mrs. B made to the SFT when it was formed. The cash gift sum comes back in the form of the down payment so the living trust is made whole.

Mrs. B's living trust receives interest only payments from the SFT, quarterly, as payments on the promissory note. In 20 years, or sooner, as the case may be, the SFT will repay the note from the assets of the SFT. In 20 years it may not be a propitious time for the SFT to retire the note because of circumstances involving the assets held in the LLC (from which the funds will come to retire the note). However, it is critical that the SFT repay the note when it comes due, otherwise the IRS could disqualify the transaction as being a sham. To that end, we recommended that Mrs. B establish a sinking fund to retire the note, setting aside the funds each year to do so.

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At the conclusion of the sale transaction, the SFT owns 100% of the LLC interest and all future appreciation of the assets in the LLC belong to the SFT. Mrs. B is the managing member and controls all operations of the LLC. The living trust holds a $42M note, an asset that will be included in Mrs. B's estate at her death. The sale of the LLC interest was to a tax defective trust. That means, for income tax purposes, the sale is disregarded and results in no capital gains tax. Because it was a "sale" and not a "gift" there will be no transfer tax incurred in removing the asset from Mrs. B's estate.

Estate Tax Benefits:

1. The transfer of the holdings to the LLC was not a taxable event;

2. The funding of the SFT with cash in excess of the unified credit is a taxable event;

3. The sale of the LLC interest to the SFT was not a taxable event;

4. The interest received on the note each quarter is not taxable interest because the installment sale to the SFT is disregarded. The K-1 income from the LLC is reported on Mrs. B's tax return even though owned by the SFT;

5. The $18M discount received in connection with determining FMV is eliminated from the taxable estate because it is not included in determining the purchase price of the sale to the SFT. The estate tax savings are $9.9M ($18M x 55% tax rate) as soon as the sale transaction is concluded.

Elimination of Gift Tax on the Life Insurance Premiums: To maintain the life insurance policies in the irrevocable life insurance trust, Mrs. B was required to make annual gifts to the trust of almost $1M. Since she used her entire unified credit, she could only use the $10,000 per donee exclusion to reduce the amount of her annual taxable gifts. As a result, the actual cost to maintain the insurance policies was increased by the annual gift tax of $550,000. Mrs. B desired to keep the insurance in force, as the proceeds were earmarked to pay part of the projected estate taxes that would be due at her death.

To solve this problem, we advised Mrs. B to have the SFT purchase the existing life insurance policies in the trust. We obtained the FMV of the policies from the insurance carrier, and arranged for the trustee of the insurance trust to sell the policies to the SFT. The SFT owns an LLC interest with a capital account of at least $60M, the value of the underlying securities of the LLC. The trustee of the SFT arranged to have Mrs. B, managing member of the LLC, make annual capital distributions to the SFT, the funds of which will be used to make the payments on the life insurance policies it purchased from the old life insurance trust.

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Now that the life insurance is owned by the SFT, Mrs. B no longer needs to make the annual gifts to the life insurance trust. The SFT has its own source of funds (the LLC capital account) from which it can draw to make the annual premium payments. This does not result in a taxable gift, so Mrs. B will save over $500,000 per year in gift tax.

RESULTS OF REVISED PLANNING

Most of our higher net worth clients come to our firm with many of the conventional tax planning strategies already in place. However, the conventional estate planning strategies are designed to deal with a much smaller estate tax problem than we often find.

As you saw from the Case Study illustrated above, by looking at the same problem from a different prospective, and by utilizing legal principles currently available to everyone, substantial tax savings can be achieved. In Mrs. B's case, the following was accomplished:

- Removal of appreciating assets from her estate without any transfer tax cost;
- Reduction of her estate by 30% ($18M) by using the valuation discounting currently available to everyone;
- Estate value frozen at $42M (not $60M) and all future growth to occur outside Mrs. B's taxable estate;
- The $18M discount equals an immediate estate tax savings of almost $10M;
- Using the SFT to purchase the life insurance policies on which Mrs. B had been making annual gifts of $1M, she will save over $500,000 annually; and
- By using South Dakota for the domicile of the SFT, the estate and generation skipping transfer tax will be avoided in perpetuity.

Careful tax planning is essential and there are numerous traps for the unwary. You are advised to consult with competent tax, accounting and legal professionals.

Please contact Jeffrey M. Verdon Law Group, LLP* at (949) 263-1133 or jeff@jmvlaw.com for further information.

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