CHICAGOLAWBULLETIN.COM
Serving Chicago's legal community for 157 years
MONDAY, AUGUST 27, 2012

Chicago Daily Law Bulletin

Volume 158, No. 168

Creative transfers of wealth may disappear by end of calendar year

Ticktock. Ticktock. A window of opportunity in the world of estate planning may be coming to a close. Summer is almost over and the end of the year will be here in a flash. As the calendar year ends, so too may incredible estate planning opportunities. This is no time to procrastinate! After years of planting seeds with several high net-worth clients to engage in more aggressive wealth transfer planning, some are finally starting to act, as they are fearful they may miss this extraordinary opportunity to transfer wealth across generations.

Pursuant to the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010, the estate tax legislation at the federal level provided for a unification of the estate tax exemption, the lifetime gift exemption and the generation-skipping transfer (GST) exemption. All were set at $5 million. The $5 million value was adjusted for inflation this year and, as adjusted, is $5.12 million. The $5.12 million value reflects an increase of the lifetime gift exemption and GST exemption from just $1 million in 2009. What does this mean for succession planning? In essence, clients have the unique opportunity to make lifetime gifts of $5.12 million per person in 2012. Similarly, the exemption applies to GSTs (gifts to a grandchild or a "skipped person").

Unfortunately, the provisions of the act are scheduled to expire on Dec. 31. Without further congressional action, under the current tax code the lifetime gift tax exemption, estate tax exemption, and GST exemption are scheduled to revert to $1 million. For this reason, individuals contemplating making gifts are encouraged to take advantage of the increased thresholds before they potentially disappear. It is always possible that new legislation will be passed prior to Jan. 1. With so many other critical issues on the table, however, it appears unlikely that an agreement will be reached before year-end.

The benefits of gifting under the $5.12 million lifetime gift exemption increase exponentially with depressed asset values. When a client makes a gift during her lifetime, she moves the present value of the asset outside of her estate and also future appreciation. For example, suppose Diane has a commercial piece of real estate valued in today's market at $1 million. When the real estate market rebounds (hopefully soon), the property could return to a higher value of $2.5 million. Therefore, if Diane "gifts" the property today, she would transfer the current value of $1 million outside of her estate and, when the property value rebounds, the appreciation would also fall outside of Diane's estate.

In the above example, a traditional estate planning technique would be to form a limited liability company (LLC) or a limited partnership (LP) to hold title to Diane's commercial real estate. When properly structured, ownership of real estate through an LLC or an LP allows for a discount for valuation purposes of 15 to 40 percent. If the property were gifted directly to Diane's children (through recording a quit claim deed), the value of the gift would be $1 million. In contrast, if the gift was in the form of membership interests in an LLC or limited partnership interests in an LP where the recipient has no ability to control the asset or to sell the asset on the open market, the IRS allows for a discount for lack of marketability or lack of control. Assume, for our example, that the valuation discount is 25 percent. Through this mechanism, Diane could transfer her interest in the asset to her children and only use $750,000 of her lifetime exemption (instead of $1 million).

Many clients are interested in making gifts but are reluctant to part with the cash flow associated with the asset. Fortunately, there are a host of creative estate planning vehicles available to help effectuate the client's wishes. Going back to our example, one popular tool to provide cash flow would be for Diane to transfer the property to a Grantor Retained Annuity Trust (GRAT). The GRAT is an irrevocable trust whereby Diane, as the grantor, would retain the right to an annuity over the term of the trust. The trust could be structured so the annual cash flow mirrors the annuity payments. If the trust adheres to the IRS requirements, the code assumes that the trust assets will produce a return equal to the Section 7520 rate, which is at historically low levels. The value of the taxable gift is the fair market value of the property transferred minus the value of the grantor's retained annuity interest. With proper planning, a "zeroed out" GRAT can be created where there is a matching of values. Any property remaining in the trust at the end of the term passes to the beneficiaries without further gift tax consequences.

THE BUZZ

LINDSEY PAIGE MARKUS

Lindsey Paige Markus, a principal at Chuhak & Tecson P.C., draws on her early career in business, finance and clinically applied neuroscience to communicate with clients and develop creative solutions to fit their estate planning and asset protection needs. Lindsey was named an Illinois Super Lawyers Rising Star in 2010, 2011 and 2012. She is licensed in Illinois and Florida.

One disadvantage of the GRAT is that if the grantor dies during the term, the value of the remainder interest is included in the grantor's taxable estate. This can be overcome by purchasing a life insurance policy as an estate tax replacement. Another common issue for many clients is the desire for the annuities to continue in perpetuity.

For clients who desire the cash flow in perpetuity, and not simply for a fixed term, another creative option is to implement a spousal trust. A spousal trust is an irrevocable trust for the benefit of a spouse during the spouse's lifetime and then for the benefit of the grantor's descendants. In our example, assume Diane creates a trust for the benefit of her husband, Jack, and their children. Diane subsequently transfers her membership interest in the LLC to the spousal trust. The cash flow generated by the LLC would be allocated to the spousal trust and discretionary distributions could be made for Jack's health, maintenance and support. Unlike the GRAT, the value of the gift would be the fair market value of the asset on the date of the gift. Assuming the property is held through a properly structured LLC or LP, a valuation discount could be taken for a lack of marketability or lack of control. This transaction would ensure that the value of the asset is excluded from both Diane's gross estate and Jack's gross estate and would allow Jack access to the cash flow generated by the property for his life.

Furthermore, Jack and Diane would be advised that distributions from the spousal trust should be for Jack's benefit — not the marital unit. This can be accomplished through modifying ownership of assets. For example, if Jack and Diane decided to purchase a vacation home in Florida, title to the property could be in the name of Jack's living trust and the cash distributions from the spousal trust could be applied toward the maintenance of the property.

In short, clients are strongly encouraged to explore the myriad options available to take advantage of the current tax code before the opportunity sunsets on Jan. 1. With innovative counsel and a host of creative planning tools available, individuals can meet their goals and needs while maximizing wealth transfer values. This is no time to procrastinate, as 2012 provides a unique opportunity for creative transfers of wealth across multiple generations.