WEALTH TRANSFER AND FAMILY PLANNING FOR THE REALLY WEALTHY IN LIGHT OF THE 2010 TAX ACT

PRESENTED TO THE

THE PALM BEACH ESTATE PLANNING COUNCIL

ROUNDTABLE
COMERICA BANK
PALM BEACH GARDENS, FLORIDA

MARCH 3, 2011

BY:

RICHARD B. COMITER, ESQ.
KEITH B. BRAUN, ESQ.

TABLE OF CONTENTS

WEALTH TRANSFER AND FAMILY PLANNING FOR THE REALLY WEALTHY IN LIGHT OF THE 2010 TAX ACT

I. The Tax Relief, Unemployment Insurance Authorization, and Job Creation Act of 2010.

- **A.** Estate and Gift Tax Exemption unified at $5,000,000.
- **B.** “Portability” between Spouses.
- **C.** Generation-Skipping Transfer ("GST") Tax Exemption is also $5,000,000.
- **D.** Transfer Tax Rate is 35%.
- **E.** Full "Step-up" in Basis for Income Tax Purposes upon Death.
- **F.** Sunsets at the end of 2012 with return to pre-2001 Law.
- **G.** Provisions not included.
  - **1.** No provisions addressing Section 2704(b) or discounts for interests in FLPs holding marketable securities.
  - **2.** No requirement of a 10 year minimum term for GRATs.
- **H.** Planning Opportunities
  - **1.** Increased Gift Exemption.
  - **2.** Increased Lifetime GST Exemption.
  - **3.** Review Existing Estate Planning Documents.
  - **4.** Portability of Estate Tax Exemption.
  - **5.** Use of Increased Lifetime Exemptions to Fix Problems.
  - **6.** Insurance Planning.
- **I.** Concerns
  - **1.** Possibility of Clawback on the Estate Tax Return.
  - **2.** Instability and Unpredictability.
- **J.** Obama 2012 Budget Proposal
  - 1. Restores the 2009 estate, gift and GST tax rules on January 1, 2013.
  - 2. Makes portability permanent.
  - 3. Requires consistency in valuation for income and estate tax purposes.
  - 4. Permits the Treasury Department to issue regulations that expand Section 2704(b) to ignore a new category of "disregarded restrictions," so as to reduce the use of valuation discounts in family business entities.

5. Requires a minimum 10-year term for GRATs, requires the remainder interest in a GRAT to have a positive value, and prevents the use of decreasing payments in a GRAT.

6. Provides that the allocation of GST exemption to a transfer protects that transfer from GST tax for no longer than 90 years.

II. Who are the "Really Wealthy" and Why are They Different?

A. Families with net worths above $50, $100 or $500 million.

B. Perpetuating Family Values and Preserving Synergistic Relationships.

1. Family Size and Meetings. Encourage Meetings and Retreats on a Regular Basis to Mentor and Educate.

2. Family Dynamics ... Blended Families, etc. Sixty percent of third generations family businesses fail due to lack of buy-in by parents.

3. Ongoing Businesses.

C. Overview of Family Office - Goals, Models and Structures.

D. Use of Private Trust Companies.

E. Recognizing Both the Left Brain as Well as the Right Brain Elements - Lead With Your Left and Close With Your Right.

1. The left side is logical issues, numbers, financial items, asset protection and business succession. Remember everything is relative and no matter how rich they are, they always feel they are not really rich.

2. The right side is to perpetuate family values, preserve relationships, cohesion among siblings and personal responsibility versus entitlement issues.

3. Good planning won't cause functional families to become dysfunctional, but could cause dysfunctional families to become functional.

F. Understand What Makes Your Client Tick. What You Think is Important is Not Always What Your Client Thinks is Important. Remember, the Wealthy Client is Always Right and Visionaries Do Not Think Like We Do.

1. Family and social matters are what keeps them up at night.

2. You have to make it happen or your idea will create serious frustration.

3. If the client likes a strategy, run with it while the iron is hot.

4. The client will pay for value, but do it once and make it painless.

5. No one ever says no to them.

G. How much is too much to give to the Beneficiaries?

H. When Should the Beneficiaries Know? During Lifetime or at Death? What Should the Advisor Tell Them?

III. Special Non-Tax Concerns of the Really Wealthy.

A. Asset Protection for Lineal Descendants from Predators, Creditors, Ex-Spouses, Government and Themselves. Clients Need to Understand That Not Being Asset Protected Means They Don't Have What They Think They Have.

1. Dynasty Trusts vs. Vesting Trusts. (Very Important Topic).

2. Self-Settled Trusts vs. Foreign Trusts. No Self-Settled Trust Legislation in Florida.

3. Prenuptial Agreements vs. Stealth Prenuptial Agreements.

a. Can a prenuptial agreement be required to inherit?

b. Is deferral of vesting the answer?

4. Family Limited Partnerships - Charging Order as the Sole Remedy.

B. Distribution Standards

1. HEMS – Limited Access with Ascertainable Standard.

2. Best Interests –Broad Access with Asset Protection.

3. Discretionary – Uncertain Access with Asset Protection.

4. Incentive Trusts – Grantor seeks to encourage ceratin Behaviors and Approaches.

5. Financial Skills Trust Approach – Grantor seeks to focus on Beneficiaries Obtaining Financial Skills.

a. New approach.

b. Result Oriented.

c. Mission Statement.

6. Grantor's Philosophy - Tailor the Standard to Meet Grantor's Expectations.

a. Give beneficiary enough to do something, but not enough to do nothing.

b. Build philosophy into the document as to when and how distributions should be made.

c. Sudden money can be a nightmare. Lottery winners often go bankrupt.

C. Selection and Removal of Trustees.

1. Family Members - Responsibility, Time Commitment and Personal Liability.

2. Independent Trustees.

a. Why? Asset Protection!

b. When Should They Become Involved in the Process?

c. Who Should Have the Right to Remove and Replace, and How Often?

d. Are They Worth It?

3. Co-Trustees.

a. Who Should They Be?

b. Should Roles and Responsibilities Be Separate?

4. Roles of Trustees.

a. Administrative Trustee - Do You Want Them to Monitor Investments? Remember, the most important thing is return of investment and not return on investment.

b. Investment Trustee or Committee.

c. Distribution Trustee.

d. Trust Protector - Your Ace in the Hole.

5. Directed Trusts vs. Delegation of Trustee Responsibilities.

a. The Florida Trust Code authorizes directed trusts and delegation of trustee responsibilities.

b. Directed Trusts. The terms of the trust must expressly authorize a person with the power to direct certain actions of the trustee. The trustee will generally not be liable for the acts of the powerholder, unless the attempted exercise violates the terms of the trust agreement or the fiduciary duty owed to the beneficiaries. The power holder is subject to the same fiduciary standards as the trustee.

c. Trustee Delegation of Authority. A trustee may delegate any duty and/or power provided that the delegation would be proper for a trustee of comparable skill under the circumstances. A trustee will not be liable for acts of the agent, if the trustee exercised "reasonable care, skill, and caution" when selecting the agent, defining the scope of the delegation and monitoring the agent's actions. The agent is subject to the jurisdiction of the Florida courts and owes a duty to exercise reasonable care. Unlike the directed trustee, a delegated trustee has selection and monitoring duties and the agent is held to a lesser standard of care, *i.e.*, reasonable care standard rather than a fiduciary standard.

D. Reformation/Modification and Decanting of Trusts.

E. Letter of Wishes - When and Why? Provides an Opportunity to Understand What Clients Are Really Thinking and Want to Happen. Perhaps , a Charitable Mission Statement Might be Included in a Letter of Wishes or in a Video.

F. Economic Risk Spreading.

1. Off-shore Investments.

2. Hedge Funds.

IV. Life Insurance Planning.

A. Alternate Ownership Structures for Funding Life Insurance - First vs. Second to Die.

1. GST Exempt Dynasty Trust - Funding With Gifts vs. Loans and Impact of 2010 Tax Act.

2. Family Limited Partnerships.

3. Children Owning Life Insurance on Parents.

4. Beneficiary Trust of a GRAT.

B. Second to Die Insurance in Lieu Of or In Conjunction with Estate Planning.

C. Premium Financing - Pros and Cons.

D. Private Placement Insurance - Off-Shore vs. On-Shore - Income Tax Planning for Tax-Sensitive Assets.

E. Senior Life Settlement Market.

V. Zero Estate Tax Planning - Where Are You Now and Where Do You Want to Go?

A. Traditional Basic Transfer Tax Planning Tools Have only Minimal Impact.

1. Annual Exclusion Gifts.

2. Early Utilization of Unified Credit Equivalent Gifts.

3. Rebalancing Asset Ownership to Assure Full Use of Exemptions.

B. Lifetime Taxable Gifts – Why and Why Not?

1. Tax-Exclusive vs. Tax-Inclusive.

2. Benefit of Exclusion of Gift Taxes Paid.

3. Leveraging and Appreciation Shifting.

4. Non-financial Issues.

C. Tax-Free Gifting - Structures, Techniques and Strategies. The keys to successfully implementing techniques and strategies are: (i) to compute the taxes without gifting, (ii) utilize charts, examples and cash flow modeling and projections of the tax benefits to be derived by adapting the applicable strategy, (iii) never be too complicated and don't get lost in the trees, (iv) use bullet point summaries for key points in documents with a risk and reward bottom line type of analyses that this type of client is used to, (v) provide alternatives with your recommendations, (vi) have other members of the team on board to support your recommendations, (vii) stay inside the box on discounting percentages to avoid an IRS audit, and (viii) stay on top of the implementation of the strategy to keep the momentum going. We cannot overemphasize the importance of crunching the numbers to provide assurances to the reluctant client that implementing this strategy will not impact their lifestyle.

1. Use of AFR Loans to Leverage and Shift Appreciation.

2. Shifting of Business Opportunity as a Vehicle to Avoid the Need for Wealth Transfer Planning.

3. Grantor Retained Annuity Trusts ("GRATs") are often a favorite of a client, because they are simple and do not involve a lot of documents. Under this strategy, appreciation and net cash flow in excess of the discounted value of the equity interest plus a rate of return equal to the applicable federal rate are transferred to the beneficiaries of the GRAT. RBC's top 10 structuring rules for this Zero Based Statutory Estate Tax Strategy where the only downside risk is the transaction costs are set forth below:

   a. Use two year rolling GRATS to avoid the negative impact of stock volatility. Thus, bad performance will not drag down good performance in the next short period. Losses in early years can seriously reduce the positive economics of this technique.

   b. Use long term GRATS if you believe the applicable federal rate will be going up and/or anticipate significant appreciation in order to lock in a lower annuity amount at a lower interest rate; moreover, the IRS's proposed treasury regulations under section 2036 provide that the gross estate inclusion for a failed GRAT will be the amount of the trust corpus necessary to yield the annuity payment utilizing the AFR in the year of death rather than the entire value of the trust corpus at the date of death. Does this mean the use of a 20% increase in annuity rate each year creates the potential for more inclusion in the gross estate than the value of the trust corpus transferred into the GRAT?

   c. Transfer a discounted equity interest to leverage benefit of a GRAT, and use a well respected appraisal company to prepare the valuation report. The IRS has a disincentive to challenge such a valuation report, because they know they will have to spend dollars to hire their own appraiser; moreover, any increase in the value of the assets transferred to the GRAT does not trigger additional gift taxes; rather, a higher annuity payment to the grantor is triggered.

   d. Annuity payment should continue to be paid to the grantor's estate in order to defer estate tax until the surviving spouse's death.

- **e.** An intentionally defective grantor trust ("IDGT") should be the beneficiary of a GRAT in order for the grantor to continue to make tax-free gifts of the income taxes with respect to income allocable to the IDGT.
- **f.** Do not "zero out" a GRAT in order to trigger the statute of limitations.
- **g.** Do not utilize transferred property to fund the annuity payment in order to avoid highlighting valuation issues. Use interim loans from entities and trusts in which the beneficiaries and not the grantor are the owners and beneficiaries.
- **h.** Consider delaying payment of GRAT annuity for 105 days to increase funds distributable to GRAT.
- **i.** Avoid using grantor as trustee of GRAT and beneficiary trust.
- **j.** Always utilize a chart and examples to explain the tax benefits and economics of a GRAT.
- **k.** Consider increasing GRAT annuity amount by up to 20% a year in order to reduce cash flow requirements in earlier years.

4. Use Intentionally Defective Grantor Trusts ("IDGTs") as a vehicle for the grantor to pay the income taxes of the beneficiaries of the IDGTs for the term of the IDGT.

- **a.** The use of spendthrift provisions should protect IDGT assets from the beneficiaries' creditors, helping to protect family wealth from creditors, predators and divorcing spouses.
- **b.** The grantor may retain the power to release those powers that cause the trust to be a grantor trust, enabling the parent to decide when to turn off the nozzle which shifts the income tax burden to the next generation.
- **c.** The IDGT can be structured as a GST exempt dynasty trust.
- **d.** With the March mid-term AFR at 2.44% and 120% of the mid-term AFR being 3%, a sale to an IDGT has a 0.56% interest rate advantage

over a GRAT on the present value of what has to be returned to the grantor.

e. Fund with discounted equity interests for best results.

5. Sale to IDGTs as a vehicle for a GST Exempt Dynasty Trust to Pay for a discounted equity interest with pre-tax dollars without generating any income tax on the sale.

a. Consider use of a purchase price adjustment clause to discourage the IRS from contesting the face amount of the note (the discounted sales price for the equity interest); perhaps, a formula could be inserted into the trust to pay the excess purchase price to an inter-vivos marital trust or charity as the contingent beneficiary. Taxpayers have had recent success against the IRS in the *McCord* (5th Circuit)*, Petter* (Tax Court) and *Christensen* (8th Circuit) decisions.

b. The failure of the sale of a discounted equity interest to result in the recognition of any income or gain from a federal income tax perspective combined with the continual use of pre-tax dollars to pay the deferred purchase price (grantor pays tax on income allocable to the IDGT) makes this strategy attractive even if the asset does not appreciate as significantly as anticipated.

c. Flexibility to prepay or change the interest rate on the promissory note evidencing the deferred portion of the purchase price.

d. Consider paying a fee to the guarantor of the deferred note to avoid a gift argument.

e. Income tax risk if the grantor dies before payment of the note.

6. Qualified Personal Residence Trusts.

a. The last remaining tax shelter sanctioned by the Internal Revenue Service.

b. Alternative structures for end of QPRT term.

(i) The beneficiaries of an original QPRT can create a new QPRT at the end of the original QPRT's term and permit the

Grantor to reside in the QPRT for the new term. This structure permits the Grantor of the original QPRT to continue to live in the residence without paying rent, although it requires the remainder beneficiaries to make a taxable gift. PLR 200935004 and 200920033.

(ii) A transfer of a residence to a QPRT followed by the sale of remainder interest to a "Purchasing Trust" in exchange for cash or marketable securities would not constitute a gift for Federal gift tax purposes. PLR 200840038.

c. At end of term, if Grantor continues to use the residence, then Grantor must enter into a lease prior to the end of the QPRT term and must pay fair market value rent.

d. Homestead issues.

e. Low interest rates increase the value of the remainder; however, real estate values continue to be depressed.

7. Pay tuition or medical expenses of non-immediate family members directly to educational institution or medical service provider. Consider using a HEET Trust, which provides education planning for children, grandchildren and other descendants in perpetuity without using the generation skipping tax exemption.

D. Voluntary and Involuntary Philanthropy. (After You Have Provided Income Assurance of Surplus Funds if They Live for Their Life Expectancy and Explain How Charitable Techniques Permit Them to Direct Taxes to Charities.) Remember, Charitable giving does not have to be hazardous to your wealth.

1. Charitable Lead Trusts – Attractive in a low interest rate environment.

2. Charitable Remainder Trusts.

3. Private Foundations.

E. Combining Disparate Planning Techniques.

1. CLTs/Dynasty Trusts/Family Partnerships.

2. Private Annuities vs. Sales vs. GRATs.

VI. Planning for Entrepreneur with Rapidly Declining Health After You Have Made Sure the Documents are in Order and Assets are Transferred into the Revocable Trust.

A. Importance of a Durable Power of Attorney that Authorizes Gifts.

B. Make Lifetime Bequest to Charity in Order to Obtain a Gift Tax Charitable Deduction on the Decedent's Final Income Tax Return.

C. Gift a fractional interest in a Vacation Home.

D. Prepay tuition directly to educational institutions.

E. Gifts to put client in minority ownership status.

F. Sale of a remainder interest in a GRAT if the beneficiary is not a member of the grantor's immediate family.

G. Make sure the documents are in order and the client's revocable trust is funded to the extent possible.

VII. Planning for Parents of the Rich and Famous. Encourage Inter-Generational Planning to Avoid Taxing the Baby Boomers.

VIII. Planning for the Estate of the Non-Propertied Spouse. Consider an Inter Vivos QTIP.

A. IRS Regulations recognize that on death of non-propertied spouse, remaining assets may be held in trust for donor spouse. Treasury Regulation §25.2523(f)-1(d)(1).

B. Asset Protection. Amendment of Section 736.0505 of the Florida Statutes.

IX. Recent Developments.

A. Unbundling of Investment Advisory Fees.

1. Corporate trustee fees are required to be unbundled between fully deductible services, *i.e.,* unique expenses, and services subject to the 2% floor, *i.e.,* non-unique expenses. *See* Knight v. Commissioner, 128 S. Ct. 782 (2008) and the proposed regulations under IRC Section 67(e). Unique expenses include trustee accountings and fiduciary tax returns. Non-unique expenses include investment advisory fees.

2. IRS has not issued Final Regulations for IRC §67(e).

B. IRS Estate and Gift Tax Audits.

1. The number of Federal estate tax filings has been declining since 2001.

2. Since 2001, however, the Internal Revenue Service's audit coverage rate of Federal estate tax returns has been increasing. Practitioners should change their assumptions from Federal estate tax returns "may be audited" to "will be audited".

3. The IRS has hired additional estate tax attorneys. Thus, the audit rate will be increasing.

4. Audits are being conducted under a national program making face to face meetings with an IRS attorney less likely.

5. 95% of audits are resolved at the audit level and 95% of cases that go to appeals are also resolved without the need for a court proceeding.

6. Artwork with a value in excess of $20,000 is submitted to an Art Advisory Panel that meets twice a year. Must go to court to challenge their valuations.

C. Current Structuring of Family Partnerships in Light of Increased Court and IRS Sophistication - Use Common Sense, Follow the Rules and Be Within the Norm on Valuation Issues to Avoid IRS Audit.

1. Documentation of Nontax Purposes. Saving taxes should not be the overriding primary purpose. Establish significant non-tax purposes.

2. Avoid Non Pro Rata Distributions for Paying Personal Expenses.

3. Keeping Sufficient Assets to Pay Living Expense is not a Safe Harbor around 2036(a)(1). Client should retain sufficient assets to maintain standard of living to life expectancy, and perhaps beyond, without regard to entity distributions; however, this alone will not shield the client from 2036(a)(1) exposure.

4. Follow the Partnership Formalities. If the client is not a general partner, make sure client is not in control of the partnership checkbook.

5. Involve Others in Negotiations. Meaningful negotiations are important when partnerships are created. Evidence of an arm's length transaction, *e.g.,* consider separate counsel for senior and junior family members.

6. Consider Ceding Control or Having a Third Party With Significant Ownership Interest.

7. Investment Changes. After the partnership is created, consider changes in the investment mix.

8. Insulate Spendthrift From Distribution Decisions. Do not name the person with creditor concerns as the general partner, if a purpose of creating the partnership is creditor protection.

9. File Protective Claims for Refund if Gain Recognized Attributable to Hard to Value Assets in an Estate. If gain is recognized with respect to the sale of partnership assets, file a protective claim in the event an estate tax audit results in an increased value which would result in an increase in the partner's basis.

10. Consider using a state law partnership which is not a partnership for federal income tax purposes.

11. Structuring a family partnership that is a partnership for state law purposes, but a single member LLC for federal income tax purposes - inside or outside the box planning?

D. Consider Structuring Real Estate Entrepreneurs' Business in a Manner to Qualify for Section 6166 Relief In Light of Recent IRS Rulings.

E. Grantor Trust

1. Approval of use of the power of substitution in a non-fiduciary capacity as the grantor trust power. Rev. Rul. 2008-22. Be careful using the substitution power in an ILIT because could cause incidents of ownership in the life insurance policy.

2. Toggling. Can turn off grantor trust status by including language that the grantor can release the grantor trust power. A different party can hold the power to restart the grantor trust status by giving the power back to the grantor. (Person releasing the power should not be same person who can restart the power). Be careful turning the power off and on, begins to look like a retained power under IRC 2036.

X. Ways to Reduce the Possibility of a Beneficiary Challenging the Estate.

A. Delaware Law Governs the Trust Instrument. Delaware law provides that an action to contest a trust cannot be initiated if not made before 120 days after the trustee provides written notice, to the person who is contesting, of the trustee's name and address, of whether such person is a beneficiary, and of the time allowed under this section for initiating an action to contest the trust. An advantage of this strategy is that if the trustee exercises his/her discretion to serve this notice on the trust beneficiaries while the settlor is still alive, the settlor would be able to testify during any judicial proceeding. Additional notice would be required each time a settlor amends his/her trust, which would start the commencement of a new 120 day contest period. To qualify for this strategy a trust company with Delaware offices must be named as a co-trustee.

B. Provide that the Trust Will Be Governed by a State That Enforces *In Torrorem Clauses* Without Reasonable Exceptions. To qualify for ths strategy, a trust company with offices in the state that will govern the trust must be named as co-trustee. A strategy to plan around a state law providing *in terrorem clauses* are unenforceable is including a provision in the trust that if the beneficiary has no valid prenuptial or postnuptial agreement then the vesting rights of the beneficiary are deferred (but not completely eliminated).

C. Videotape the Execution of the Testamentary Instrument.

D. Use Other Attorneys or Professionals as Witnesses to the Execution of the Documents To Provide More Credible Testimony on Questions of Capacity.

E. Have the Witnesses Join a Meeting with the Client Prior to Execution of the Testamentary Instrument.

F. Arrange a Medical or Mental Capacity Examination to be Conducted On or Near the Execution of th Instrument.

G. If a Concern Exists that a Claim of Undue Influence May be Made, or if Certain Beneficiaries are Being More Generously Provided For in the Instrument, Then a Statement May Be Included in Settlor's Trust Setting Forth That a Larger Gift Has

Been Provided After Careful Consideration And That the Beneficiary of the Larger Gift Has Not Influenced Settlor.

H. Have Client Write Letter to Attorney Requesting the Attorney to Include Certain Provisions in the Testamentary Instrument.

I. Have Client Execute a Series of Testamentary Instruments Over a Period of Time. The result would be to force a contestant to challenge each Instrument, which would be both expensive and more difficult.

XI. Putting the Team Together.

A. Who Are the Players? The attorney, accountant, investment advisor, insurance professional, family counselor, family office director, succession planner and trustee. Make sure the players who have excellent reputations and are experienced problem solvers in the wealthy client arena. For example, the insurance professional should be experienced in engineering insurance products to meet the needs of ultra high net worth individuals.

B. Loyalty and Existing Relationship vs. the Need for Expertise. Remember, it is Always Easier to Make Some One Look Bad Than it is to Make Them Look Good. Remember, Remember, Clients Never Forget a Bad Referral.

C. How Do You Make it Work? Communicate, have a quarterback, and have the client buy in to the team approach.

D. Team Meeting Should Occur Annually to Review Estate Plan, Performance of Assets, Changes in Family Dynamics, Changes in Trust and Tax Laws, Compliance with Details to Avoid Responsibilities Falling Through the Cracks, Monitor Professionals to Make Be Certain They Are Doing Their Jobs.

L:\DOCS\017\01\15C145602.WPD Final v.2
Comerica Speech 3/3/11