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Planning Potpourri

Use your 1040 to identify planning opportunities Thought you were done with your CPA after 4/15? Bad move. Now's when the good stuff can be done. Call your CPA and book an appointment to review your recently filed 1040. Instead of focusing on getting a return done, pick your CPAs brain about what he or she can see in your return and back up data that can help you plan better. CPAs have a lot more talent then just plugging numbers into tax return input sheets. Importantly, CPAs have independence that can help identify things that you're just going to miss because simply its your stuff and you're too involved. Few clients take advantage of this type of follow up. Their loss. The following are just a smattering of the myriad of ideas. Find out upfront whether your CPA is being objective or selling a product.

Business Entities. Do you have a home business or rental property on Schedule C or E that should be restructured as an LLC?

Residency. Did you report state income tax as a resident of the correct state? Are there any planning opportunities? Can you take steps to bolster your position as to the state in which you reside for income tax purposes? If you allocate earnings between states have you maintained a calendar?

Documentation. Are you keeping adequate documentation for your deductions? Are there some things you can do better? Are you noting business details on the back of business credit card receipts?

Computerization. Are you still using a manual checkbook? Have your CPA get you into the electronic age. It will make it easy to back up and secure your data, simplify recordkeeping.

Deductions. Can you plan to bunch itemized deductions to exceed the thresholds for deductibility better in the future?

IRA. Have you funded an IRA, can you convert to a Roth, are your beneficiary designations current?

0 Insurance overview. Do you have enough life and disability insurance based on your assets and earnings? Your 1040 and the work sheets supporting it can give your accountant insight as to the appropriate levels of coverage. Are all your properties and assets covered adequately for liability and risk?

Asset allocation. Are your investments generally reasonable? Do you have too many accounts in too many places? PP

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Practical legal stuff... in plain English

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PRACTICAL PLANNER

Martin M. Shenkman, CPA, MBA, JD

Grantor Retained Annuity Trusts (GRATs)

Summary: Grantor Retained Annuity Trusts ("GRATs") are a popular estate planning tool for shifting value to heirs with little gift tax impact. The current economic environment makes GRATs great. If Tony the Tiger were an estate planner, they'd be GRRRRRAT!

What Are GRATs.

GRATs are grantor retained annuity trusts. It is an estate planning technique used to transfer value from say parents to kids with little or no gift tax. Here's how it works. You transfer assets to the trust. The trust pays you a specified annuity for a set number of years and your kids (remainder beneficiaries) get whatever is left. The value of the gift is the value of the property you transfer to the trust, less the value of the annuity. Thus, the value of this annuity reduces the value of the gift. Most GRATs are structured with a modest gift value. Any appreciation in the value of the property after you transfer it to the GRAT, over the 7520 rate, is excluded from your estate if you survive until the end of the GRAT term. If you don't all the property is taxed in your estate, but that would have been the case had you not tried the GRAT. Thus, there is no downside to trying this technique.

Declines in Interest Rates Impact the Use of GRATs.

Interest Rates: Lower interest rates increase the value of the annuity retained by you as the grantor, and therefore reduce the value of the gift to your kids through the GRAT (the remainder in a GRAT). Rates are near historic lows, which bodes well for using GRATs now to plan. From August 2006 to April 2008, the interest rate required to be used in determine the impact of a wide range of tax planning transactions, called the Code Sec. 7520 interest rate, has dropped from 6.2% (August 2007) to a mere 3.4% in April 2008.

Example August 2006: If you established a GRAT, at age 70, with a $1 million dollar gift in August 2006 that paid an 8% annuity and that was intended to last 12 years. The value of the $1 million gift would be reduced by the present value of the $80,000 annual payments to you for 12 years which is $663,336. Thus, value of the gift you would have made would have been $336,664. This would have meant that you would have used up about 1/3rd of the $1 million lifetime gift exclusion you are entitled to.

Example April 2007: Assume instead that you want to establish a GRAT in April 2008, at age 70, with a $1 million dollar gift that paid 8% and that was intended to last 12 years. The value of the $1 million gift would be reduced by the present value of the $80,000 annual payments to you for 12 years which is $777,552. This is substantially higher than the same calculation made in August of 2006 because the now lower interest rates make the worth of that payment stream (annuity of $80,000/year for 12 years) greater. Thus, value of the gift you would make now under the same facts would be $222,448. This means that you would have used only about 20% of the $1 million lifetime gift exclusion you are entitled to. The decline in interest rates has made the gift tax leverage you can squeeze out of a GRAT more favorable.

Life Expectancy: Hey, does it make any sense for a 70 year old to wager a tax bet on outliving a 12 year GRAT? If you're taking your baby aspirin every day it might. The life expectancy for a 70 year old is 16 years, four years more than your 12 year GRAT tax bet! The probabil-

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Checklist: Sell Insurance

Summary: How many ways can your brother-in-law, Larry, sell insurance to your family business? "Let me count the ways." To often the only insurance used is to fund a cross-purchase arrangement if a shareholder dies. There are a myriad of additional uses of life and disability coverage in the business context. Besides, your brother-in-law has his eye on a new Lamborghini. He can sell you insurance…

√…to compensate children not receiving business interests in order to avoid conflict with children receiving business interests. Insurance can be the "big equalizer".

√ …to fund payment of estate tax (e.g. a survivorship policy combined with by pass/QTIP trust planning to hold business on death of owner/active spouse).

√…on the active spouse's life to compensate surviving spouse for loss of income resulting from death of active spouse.

√…on the active spouse's life to compensate surviving spouse for loss of asset if business is bequeathed to the children in the business on first spouse's (i.e., active business spouse's) death.

√…on the active spouse's life

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...Grantor Retained Annuity Trusts (GRATs)

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ity of living to life expectancy is a hair over 51% using the Sec. 1.72 Tables. Since these tables are based on data derived from annuity sales contracts they tend to reflect data for a healthier cohort of people (since people who buy annuities tend to be a bit healthier than those who don't). Using the IRS Table 90CM life expectancy is for 13.9 years, with a bit under a 49 probability of living to that age. There is some dispute over the factors that correlate with greater longevity. Some commentators suggest that wealth provides better access to health care. Other commentators advocate that intelligence correlates with longevity. Not meaning to be elitist, but most of the cats with GRATs tend to be long on wealth and brains, so their life expectancies are likely longer than even the 1.72 Tables (but we'll leave those nuances to actuaries like Barry).

How Have Declines in Stock Prices Impacted the Use of GRATs?

Stock Prices: Any appreciation in the value of the property after you transfer it to the GRAT, over the 7520 rate embodied in the calculations is excluded from your estate. If you feel stock prices have taken most of their downside hit already, now is an opportune time to set up a GRAT. Stock market prices have declined substantially. The S&P 500 has lost most of the gain it realized during this period. In August 2006 — 1,270 and in April 2008 — 1,370.

Example August 2006: Assume in August 2006, at age 70, you established a GRAT with a $1 million dollar gift that paid you an 8% annuity annually, and that was intended to last 12 years. For gift tax purposes the value of the $1 million gift of stocks would be reduced by the present value of the $80,000 annual payments to you for 12 years, which is $663,336. Thus, the value of the gift you would have been $336,664. This would have meant that you would have used up about 1/3rd of the $1 million lifetime gift exclusion you are entitled to. However, if the mediocre market performance from August 2006 through April 2007 continued for the entire 12 year term of the GRAT the plan would be pretty near a wash. Little would be left in the GRAT for the kids beyond the amount of the gift.

Example April 2007: Assume the same facts but that instead that you establish a GRAT now with a $1 million dollar gift in April 2008. Further assume (or pray!) that the market has discounted the possible recession (or actual recession, depending who you listen to) so that it's nothing but an escalator ride up from here. Or maybe the market will continue to resemble a ride at Great Adventure, but you've invested with the ultimate stock picker and realize 10% returns over the 12 year life of the GRAT. By year 12 the GRAT pot, after paying you $80,000/year, will be worth over $1.4 million (don't you love compounding!). From a tax perspective, that's a grand slam.

Some Additional Thoughts.

Wall Street types will tell you that the only way to fly with GRATs is to use short term rolling GRATs. Each year you use a high pay out 2 year GRAT and set up a new GRAT each year thereafter. This approach can be used to capture upside volatility with no significant downside risk. While there is clear merit to this application (See Practical Planner, March 2007) in appropriate circumstances, and for appropriate assets, a longer term GRAT than that can be appropriate.

If the remainder beneficiaries of your plan are people whose relationship falls outside the scope of how the tax law defines "family" for these purposes (e.g. a niece) then you can use a variation, a "Grantor Retained Income Trust". With GRITs, unlike GRATs, you get gravy and the value of the remainder is determined under more favorable assumptions.

Watch out for whipsaw. If you contribute a majority interest in an entity to a GRAT and smaller slices of the same entity are used to meet required annuity payments a greater discount may apply to these thinner slices then to what you put in. Negative leverage. Not a good thing.

GRATs, like all tax acronyms, need to be cared for to assure compliance with the many requirements.

Busted GRATs will be common for those GRATs hit by the sub-prime downdraft. Depreciated equities may be paid out to meet the annuity.

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...Checklist: Sell More Insurance

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to pay estate tax so that the business can be transferred and bequeathed to the children in the business on first spouse's (i.e., active business spouse's) death.

√...on the active spouse's life as key-person protection to help pull the business through the tough time of losing an active principal, to hire a replacement executive, pay headhunter fees, training costs, help the business survive the loss of a rainmaker, etc.

√...to fund a stock redemption purchase of a deceased shareholder's shares.

√...to fund a stock cross-purchase of a deceased shareholder's shares by the surviving shareholder.

√...to diversify the assets of the principal of a closely held business and accumulate wealth outside of the business.

√...insurance held in an irrevocable life insurance trust to provide a means of growing an asset which is protected from the liability and/or malpractice claims of the business.

√...as a perquisite for employees.

√...to cover the estate tax cost gap if the business owner dies before the grantor retained annuity trusts ("GRAT") or sales to defective grantor trusts ("IDIT"), or other estate planning techniques, are effective. Example: Business owner's estate planner includes a five and ten year GRAT to shift a significant portion of the value of the closely held business to her heirs. Use 5- and 10-year term policies to fund the estate tax cost if the grantor dies before each GRAT terminates.

√...protect the often overlooked risk that more than one shareholder will die/retire/become disabled, etc. in one year. Most shareholder agreements ignore the risk of multiple payouts. A combination of disability buy out and life insurance may address this.

√...use disability insurance to coordinate with the salary and benefits continuation period under the shareholders' agreement.

√...use disability buy out insurance to fund the payment of the repurchase of shares from a disabled shareholder.

√...use life insurance to offset the risk that the overly aggressive or improperly documented gifts of business interests will be successfully challenged by the IRS on audit. If gifts are not reported on a gift tax return and "adequately disclosed" the period in which the IRS can audit those gifts (statute of limitations) never ends.

√...use life insurance as key person insurance to insure the lives of the younger generation members who are taking over the business.

√...use a new life insurance policy to replace an existing insurance policy/plan tainted by the transfer for value rule. The transfer for value rule, in its simplest application, is triggered where a life insurance policy is traded or sold for something of value. The result will be that the proceeds will be taxable as ordinary income upon receipt.

√...use a new 3-year term life insurance policy to cover the risk of dying within three years of transferring an existing life insurance policy to an insurance trust (in which case the transferred insurance will be in your estate absent a provision qualifying it for the marital deduction. PP

Recent Developments

Summary: New IRS Ruling – if you have a grantor trust (e.g., GRAT, IDIT, etc.) you MUST visit your tax consultant and be sure you're in compliance. This is another head spinner but an important one. We'll simplify (a lot) to get you through it. Grantor trusts are trusts for which the income is taxed to you, the person setting up the trust (grantor). This is really important in the context of a number of key estate planning transactions. For example, if you sell a large part of your real estate development business to a dynasty trust, if that trust is not characterized as a grantor trust, that sale could trigger gain for income tax purposes. A common mechanism to achieve grantor trust status is to provide that the grantor can substitute trust property in a non-fiduciary capacity for other property of equivalent value. This mechanism creates a host of concerns, a critical one of which is whether the IRS would argue that this right would pull all trust assets back into your estate. The new ruling, Rev. Rul. 2008-22 indicates that this power alone (that doesn't mean you can't trip up elsewhere) won't cause estate inclusion (under IRC 2036 or 2038) if a list of requirements are met. The grantor expressly cannot be trustee. But what about the grantor serving as an investment adviser? The grantor has to certify in writing that the substituted property is of equivalent value. Under state law the fiduciary has the obligation to ensure that the properties are of equivalent value. The trustee must have a duty to invest and manage trust assets impartially as to the various beneficiaries (no shifting of benefits). What happens if the assets include family business interests from which perquisites and salaries are paid to family in the business? The trustee must have an unrestricted discretionary power to acquire, invest, reinvest, exchange, sell, etc. trust property in accordance with standards provided by local law. How this may be applied with a trust investment adviser serving, or if the grantor is the investment adviser, or if the trust has restrictions on selling a family business, is not