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Discounts and Leverage Transactions

for Unmarried Taxpayers

As a result of *The American Taxpayer Relief Act of 2012* ("ATRA") the amount of the estate tax exemption for decedent's dying in 2013 is $5,250,000, and is indexed for inflation. For those estate owners who will still face an estate tax liability after taking account of this exemption, techniques which leverage the exemption to shelter larger amounts are especially valuable.

Leveraging Transactions - When valuing property for gift tax and estate tax purposes, we are required to use the "fair market value" of the property transferred. That term is defined generally as "the price at which the property would change hands between a willing buyer and a willing seller, both being reasonably aware of all the surrounding facts and neither being under a compulsion to buy or sell." There are certain transactions which allow one to be charged with making a relatively small taxable gift, while removing a much larger value from their taxable estate.

Valuation Discounts - Fundamental to most "leveraging transactions" is the manner in which transferred property is valued for gift tax and estate tax purposes. When determining the "fair market value" of assets such as real estate and closely held corporations and partnerships, we are generally required to secure a valuation opinion from a qualified independent appraiser. Where the asset is a 100% ownership interest in real estate or a company, the appraised value will reflect the price at which we would expect a 100% interest to change hands. However, where the asset in question is less than a 100% interest, the appraiser must take that into account in valuing the interest that is being transferred (even where the family owns 100% collectively.)

It is well recognized that a willing buyer will not pay the same price for a fractional interest in property, or a minority interest in a closely-held business, as might be paid for a 100% interest. Courts have uniformly recognized that fractional and minority interests are subject to being "discounted" for tax valuation purposes, and Congress has specifically refused to overrule such discounts in recent tax legislation. The magnitude of the discount depends upon the facts and circumstances of each case, but discounts in the range of 25% to 35% are not uncommon. A recent case from the Tax Court offers a clear example of the beneficial impact of even small gifts in a discount environment.

Example: Taxpayer owned two properties in California, referred to as the "beach" and the "ranch." Their combined fair market value was about $12 million. Shortly before his death, Taxpayer made a gift to a trust for children and grandchildren of a 5% undivided interest in each of these properties. Because the transferred property

represented a fractional interest for which there is no readily available market, it was valued with (approximately) a 40% discount at $360,000. No gift tax was payable. Shortly thereafter, Taxpayer died and his estate included the remaining 95% undivided interest in these properties. Again, because the property being transferred represented a fractional interest, it was valued (with a discount) at about $7 million. As a result of the small gift and the resulting impact on valuation, using only $360,000 of his exemption, the amount on which the family was ultimately taxed was reduced by about $4.6 million.

Such valuation discounts can often be achieved where the estate owner's wealth is represented by assets such as real estate and closely-held business interests. In addition, such results can be realized without compromising the estate owner's control of the property or the business, or the income which he/she expects to enjoy therefrom.

Under the present rules governing valuation of property for gift tax purposes, it is possible to "create" such valuation discounts within the family for other assets using a specially designed business entity best known as a "family limited partnership." Think of such a partnership as the family's investment company. It can hold diverse investment assets under centralized management and control, and spread the economic benefits among numerous family members by distributing fractional partnership interests. Those partnership interests can have different voting rights, and can be subject to restrictions on any transfer outside the family. Such an entity can also protect those assets from the claims of most creditors, and can shield the family members from liability arising from business activities conducted in the partnership. For valuation purposes, the fair market value of a gift of a fractional partnership interest will be determined with discounts taking account of the lack of any ready market for the sale of such an interest, restrictions on a partner's right to transfer the partnership interest, and any lack of full voting rights.

Examples of Leveraging Transactions - Beyond the benefits of valuation discounts, most leveraging transactions seek to reduce the gift tax value of what has been transferred by either (i) the estate owner's retention of some valuable (but temporary) interest in the transferred property, or (ii) the transfer of a temporary interest to charity. For purposes of the following examples, we will assume that Mrs. Taxpayer (i) is a widow age 62 and has an estate valued at $10 million, (ii) owns 100% of a limited liability company ("LLC") which, in turn owns a warehouse property appraised at $4 million which produces pre-tax income of $400,000 annually, (iii) that we expect the value of the estate to appreciate during her 20 year life expectancy at 4% annually, and (iv) the rate of inflation over that period is 2.5% annually.

Grantor Retained Annuity Trust ("GRAT") - In a GRAT, Mrs. Taxpayer ("T") transfers property to a trust (of which T can be the trustee), and retains the right to receive an annuity (a defined amount) from the trust for a specified period of time. At the end of that time period, the trust property passes to her children (or a trust for them.)

For gift tax purposes, the amount given is (a) the fair market value of the property transferred to the trust, less (b) the present value of the retained right to

receive the annuity. If T funds the GRAT with a 90% non-voting interest in the LLC, which is valued with a 40% discount factor, then the fair market value of the property transferred to the GRAT is ($4 million x 90% x 60%) $2.16 million. If T retains the right to receive the net income of ($400,000 x 90%) $360,000 for 6 years, the actuarial present value of that annuity (using the IRS factors for January 2013) is slightly more than $2 million. The resulting taxable gift, then, is ($2.16 million less $2 million) ≈ $160,000. Mrs. Taxpayer files a gift tax return and uses $160,000 of her exemption, paying no gift tax.

Now, one of two things must happen:

If Mrs. Taxpayer dies during the following 6 years (the trust term) then she has not completed the transfer of the property so it is still included in her taxable estate, and her $160,000 of exemption used is restored. The family did not benefit from the GRAT, but it is no worse for her having tried.

or, If Mrs. Taxpayer lives for the 6 year term of the GRAT, then the trust property passes to her children (or a trust for them) and is entirely removed from her estate. Based on our assumptions, the appreciated value of that property at her life expectancy, which has been removed from her estate in exchange for her use of $160,000 of her exemption, is about $7.88 million, and the estate tax savings benefit to the family is about $3.1 million.

Prepared For Mrs. Taxpayer 01/20/2013

Present Adjusted Gross Estate:	$10,000,000	
Present Value of LLC Interest Transferred to Trust:	$2,160,000	40% discount
Amount of Annuity Payable to Grantor:	$360,000	annually
Term of Trust (years):	6	91.1% Probability of Survival
Mrs. T's Age (nearest birthday):	62	

GRANTOR RETAINED ANNUITY TRUST ILLUSTRATION

	OPTION #1 Do Nothing	OPTION #2 GRAT
Taxable Estate (beginning)	$10,000,000	$10,000,000
Present Value of LLC Interest Removed from Estate	$0	$3,600,000
Amount of Taxable Gift	$0	$152,656
Gift Tax Payable	$0	$0
Taxable Estate at Life Expectancy *[Note #1]*	$21,911,231	$14,023,188
Estate Tax due at life expectancy	**($5,323,398)**	**($2,229,243)**
Taxable Value Removed From Estate *[Note #2]*		**$7,888,043**
Net Estate Tax Saved *[Note #2]*		**$3,094,155**

[Note #1] - including appreciation and taxable gifts *[Note #2] - computed at life expectancy with appreciation*

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Installment Sale to Family Trust - A close cousin to the GRAT technique is an installment sale of property to a specially designed trust. Where necessary, the trust can be designed so that this transaction will not result in recognition of any gain for income tax purposes. Mrs. T transfers the 90% LLC interest to the trust, in exchange for which the trust's promissory note (in the face amount equal to the fair market value of the transferred property) is transferred to Mrs. T. Mrs. Taxpayer's estate, then, would contain the promissory note from the trust, and the 90% LLC interest (and its future appreciation) would be out of the estate immediately without regard to how long T might live.

For gift tax purposes, the amount given is (a) the fair market value of the property transferred to the trust, less (b) the present value of the stream of payments to be received under the promissory note. If T sells to the trust the same 90% non-voting interest in the LLC described above for the GRAT, then the fair market value of the property transferred to the trust is the same $2.16 million. If the promissory note bears interest at a rate at least equal to that required by the IRS at the time of the transaction, then the present value of the payments due under the note will equal the face value of the note. As a result, the value of the gift would be zero.

Henceforth, Mrs. T's estate is "frozen" as to this asset and includes only the unpaid balance of the promissory note. Even if Mrs. T was to die shortly after implementing this transaction, only the promissory note balance (representing the discounted value of the LLC interest) is included in her estate. As the trust uses its income to make payment on the debt, that balance decreases.

It is generally accepted among practitioners that one should not make an installment sale to a naked trust. That is, if the transaction is to be honored as a bona fide debtor-creditor transaction, then the purchaser should have some equity at stake beyond the LLC which is purchased. Conventional wisdom is that 10% equity is sufficient.

Therefore, let us assume that Mrs. T first makes a gift to the trust of a 10% LLC interest, which is valued at ($4 million x 10% x 60%) $240,000. Subsequently, T sells the remaining 80% of the LLC interest to the trust in exchange for the trust's promissory note in the face amount of $1.92 million, payable over 5.5 years, bearing interest at 0.83% per annum (in January 2013.)

The 90% LLC interest is immediately removed from T's estate, without regard to how long she might live. Instead, she has used $240,000 of her exemption and her estate includes only the promissory note, with a face amount of $1.92 million. As a result, the valuation discount is "frozen" and not subject to being recaptured if she fails to live for a certain period. At the end of the 5.5 year term of the note, the entire value of the 90% LLC interest has been transferred to the children's trust with no gift tax cost.

Assuming again that Mrs. Taxpayer lives for her normal life expectancy, the appreciated value of that property which has been removed from her estate in

exchange for her use of $240,000 of her exemption, is about $7.88 million, and the estate tax savings benefit to the family is about $3.1 million.

Prepared For Mrs. Taxpayer 20-Jan 2013

Present Adjusted Gross Estate:	$10,000,000			
Present Value of LLC Interests Transferred to Trust:	$240,000	by gift	and	$1,920,000 by sale
Amount of Annual Installment Payable to Mrs. T:	$360,000	annually		
Term of Promissory Note (years):	5.5	years		
Mrs. T's Age (nearest birthday):	62			

Installment Sale to Trust

		OPTION #1 Do Nothing	OPTION #2 Inst. Sale
Taxable Estate (beginning)		$10,000,000	$10,000,000
Present Value of LLC Interest Removed from Estate		$0	$3,600,000
Amount of Taxable Gift		$0	$240,000
Gift Tax Payable		$0	$0
Taxable Estate at Life Expectancy		$21,911,231	$14,023,188
Estate Tax due at life expectancy		($5,323,398)	($2,264,181)
Taxable Value Removed From Estate	*[Note #2]*		**$7,888,043**
Net Estate Tax Saved	*[Note #2]*		**$3,059,217**

[Note #1] - including appreciation and taxable gifts [Note #2] - computed at life expectancy (or measuring year) with appreciation

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Qualified Personal Residence Trust ("QPRT") - There is an express provision of the current tax law which allows for substantial "leveraging" of the gift tax exemption through the value of a personal residence. Under this arrangement, Mrs. T is allowed to transfer a personal residence (either her principal residence or a second home) to a trust, retain the exclusive use and control of the property for a given number of years (the trust term), and then have the value of the property pass to her children. If she dies before the end of the trust term when the value of the property passes to the children, the trust terminates and the property is returned to her (her estate).

For gift tax purposes under this arrangement, Mrs. T would make a taxable gift equal to (i) the present value of the transferred interest in the home, less (ii) the value of her retained right to use the property for the given number of years, less (iii) the actuarial value of the possibility that she might die during the term and the property will be returned to her estate.

Suppose Mrs. T owns a vacation home with a current appraised value of $950,000. Assume that she gives a 95% interest in that home to a QPRT, retaining all rights of use of the property for a period of 9 years. The fair market value of the 95% interest given to the QPRT (valued with a 20% discount for the fractional interest) is $722,000. The value of her retained rights to use the property for 9 years and possibly have it return to her if she dies during that period (using the IRS' valuation factors for January 2013) is $159,605. The net reportable gift for gift tax

purposes, then, is ($722,000 less $159,605) $562,395. Mrs. T will report that on a gift tax return, use that amount of her exemption, and no gift tax will be paid.

After this transaction, one of two things must happen.

If Mrs. Taxpayer dies during the following 9 years (the trust term) then she has not completed the transfer of the property so it is still included in her taxable estate, and her $562,395 of exemption used is restored. The family did not benefit from the QPRT, but it is no worse for her having tried.

or, If Mrs. Taxpayer lives for the 9 year term of the QPRT, then the trust property passes to her children (or a trust for them) and is entirely removed from her estate. Based on our assumptions, the appreciated value of that property at her life expectancy, which has been removed from her estate in exchange for her use of $562,395 of her exemption, is about $1.98 million, which is about 350% of the exemption amount used. The estate tax savings benefit to the family is about $566,038.

Prepared For Mrs. Taxpayer January 20, 2013

Present Adjusted Gross Estate:	$10,000,000	
Present Value of Home:	$950,000	vacation residence
FMV Interest transferred to trust	$722,000	95% fractional interest with 20% discount
Assumed appreciation rate:	4.00%	
Mrs. T's age (nearest birthday):	62	

QUALIFIED PERSONAL RESIDENCE TRUST ILLUSTRATION

		OPTION #1 Do Nothing	OPTION #2 QPRT- 9 yrs	OPTION #3 QPRT- 14 yrs
Taxable Estate (beginning)		$10,000,000	$10,000,000	$10,000,000
Present Value of Home Removed from Estate		$0	$902,500	$902,500
Amount of Taxable Gift		$0	$562,395	$455,127
Gift Tax payable		$0	$0	$0
Taxable Estate - yr 20	[Note #1]	$21,911,231	$20,496,137	$20,388,870
Exemptions - yr 20	[Note #2]	($8,602,736)	($8,602,736)	($8,602,736)
Estate Tax due - yr 20		($5,323,398)	($4,757,360)	($4,714,453)
Appreciated value of Home Removed From Estate	[Note #2]		**$1,977,489**	**$1,977,489**
Net Reduction in Taxable Estate	[Note #2]		**$1,415,094**	**$1,522,361**
Net Preserved for Family	[Note #2]	**$16,587,833**	**$17,153,871**	**$17,196,778**
Amount Saved by Trust	[Note #2]	**$0**	**$566,038**	**$608,945**
Actuarial Probability of Surviving Trust Term			85.2%	72.5%

[Note #1] - including appreciation but not adjusted taxable gifts

[Note #2] - at assumed life expectancy with appreciation

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Many people find the QPRT to be quite attractive, because (1) it doesn't require them to give up anything now, and (2) it's virtually a "no lose" situation from a tax planning viewpoint. However, especially where the residence given to the trust is one's principal home, one may be concerned about having to give up their home at

the end of the term. In fact, you're allowed to do some things which probably reduce that problem to a manageable level.

First, in this case, Mrs. T gave less than her entire ownership in the home to the QPRT, and retained a 5% ownership interest for herself. Under Georgia law, every joint owner of property has an equal right to occupy the home along with every other joint owner, without being required to pay rent. Her retained 5% interest, then, would entitle her to continue to occupy the home as long as she may like.

Second, Mrs. T can retain the right to lease the 95% interest in the home from the children (or the trustee of a trust for them) and pay them fair market rent based on the value of the home at that time. In many cases, the rent is no more than Mrs. T is spending for the property taxes, insurance, and maintenance of the property anyway. That would leave all the future appreciation in the hands of the children without her having to share possession of the home.

Charitable Lead Annuity Trust ("CLAT") - The CLAT is an especially attractive transaction for leveraging the value of one's exemption for people who are committed to make substantial charitable gifts during their lives. This technique rewards the taxpayer for a commitment to make such charitable gifts, by increasing the amount which can be preserved for the family free of estate tax after death.

Suppose Mrs. Taxpayer regularly makes various charitable donations in a total amount of $60,000 annually. By creating a CLAT and giving it property from which those annual donations can be funded, she may be able to transfer the remainder of that property to her children upon her death with little or no tax cost. If we look back at Mrs. T's LLC which owns the warehouse property (described under the GRAT and Installment Sale discussions above), she might use an LLC interest to fund a CLAT.

Alternative #1 - Mrs. T might give a 15% LLC interest to the CLAT, with the CLAT directed to distribute $60,000 per year to charity for <u>6 years</u>. At the end of the 6 year period, the remaining trust property would pass to her children (or a trust for them.) The fair market value of the 15% LLC interest given to the CLAT is ($4 million x 15% x 60%) $360,000. The value of the 6 year annuity to charity, for which a charitable deduction is allowed, is about $349,000. Mrs. T's net taxable gift, then, is only ($360,000 less $349,000) $11,000. At the end of the 6 year period, that 15% interest in the LLC represents underlying property value of about $759,000, which has been removed from Mrs. T's estate and transferred to the children using only $11,000 of her exemption.

Alternative #2 - Mrs. T. might give a 45% LLC interest to the CLAT, with the CLAT directed to distribute $60,000 per year to charity for <u>Mrs. T's lifetime</u>. Upon

Mrs. T's death, the remaining trust property would pass to her children (or a trust for them.) In this case, the CLAT will receive 45% of the LLC's net income ($180,000 per year) while distributing only $60,000 annually to charity. The trust will pay income tax on the remaining $120,000 of annual income, and will accumulate and reinvest the balance at an assumed 3% annual return (about 1.65% after taxes.) The fair market value of the 45% LLC interest given to the CLAT is ($4 million x 45% x 60%) $1.080,000. The present value of the $60,000 annual annuity payable to charity for Mrs. T's lifetime is about $1,065,000. Mrs. T's net taxable gift, then, is only ($1,080,000 less $1,065,000) $15,000. At Mrs. T's life expectancy, the 45% LLC interest (with the trust's accumulated income reinvestment account) represents underlying property value of about $5.1 million, which has been removed from Mrs. T's estate and transferred to the children using only $15,000 of her exemption.

Note that the CLAT produces such attractive results because Mrs. T. is already committed to making these charitable gifts during her lifetime. As a result, the annual payments to charity are not a "cost" of the transaction. If one were not already committed to such gifts so that the charitable annuity was a cost, then the result would be much less attractive to the family.

The Income Tax Cost of Making Gifts. It is also important to recognize that some gifts of low-basis property can result in substantially more overall tax liability in the family than simply keeping the property until death and including it in the taxable estate. For more, read this section in the article titled "*Gift and Estate Tax System Overview*" on this web site.

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and

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