Thursday, October 7, 2010

Estate Tax Planning Is Asset Protection Planning

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In troubled economic times professionals and their clients both spend more time thinking about "creditor protection" planning, sometimes referred to as "asset protection" planning. However, single purpose planning is not wise: a transfer made to hinder a creditor is fraudulent. Therefore, it is comforting to know that many structures that reduce the value of assets for estate tax purposes also have the effect of making those same assets less attractive to a currently unforeseeable claimant. The personal residence is often a family's most emotionally significant asset. Happily, Congress created a new way to transfer residence equity to the heirs at a reduced transfer tax (estate and gift tax) cost: the qualified personal residence trust (QPRT). For example: Assume Dad is 65 and owns a home worth $1,000,000, free and clear. He transfers the home to a QPRT and retains the right to live, rent-free, in the home for 20 years (until age 85). If he survives to age 85, the QPRT ends, the home is transferred to an irrevocable trust for the benefit of his children and he must pay fair rent to continue living in it. If he dies before age 85, the QPRT ends, and the home reverts to his estate. In other words, the children's trust only receives the home if he survives the term. What is the value of the gift Dad made when he transferred the home to the QPRT? $282,130.

Why was the value of the gift reduced from $1,000,000 to $282,130? First, due to the time value of money, the children's trust will not receive the $1,000,000 for 20 years, which reduces the gift from $1,000,000 to $672,971. Second, because if Dad dies before the end of the 20-year term, the QPRT terminates and the home reverts to his estate. That reduces the $672,971 to $282,130. In other words, the QPRT has both present interest and mortality components.

The QPRT's creditor protection benefit derives from the fact that Dad only retained a right to live in the home rent free for a fixed number of years. Assume that five years into the 20 year term Dad is sued, the plaintiff obtains a $500,000 judgment and Dad has no other assets. What will the creditor do? The creditor cannot obtain the home, because Dad does not own it. The creditor might ask the judge to remove Dad from the residence. However, under the terms of the QPRT, that would not allow the creditor to insert the creditor's own tenant from whom the creditor might obtain rent. Instead, once Dad is no longer in the residence, the QPRT trustee must sell it. So the creditor must wait while the trustee sells the residence. No one knows how long that might take. Then the trustee must invest the funds. The trustee will need time to determine an investment strategy. Then the trustee must calculate the annuity to pay Dad. That will require analysis and discussions with counsel. If the QPRT trustee follows the terms and makes the annuity payments to Dad, the creditor can move to attach the payments. However, what if the trustee fails to make the annuity payments? The creditor must now go to court to enforce the terms of the QPRT. Now, transferring the home to the QPRT has made the creditor's life a difficult one.

Similar results can be obtained with other assets. Assume Dad has an income producing property that he owns through a limited liability company, to provide a measure of protection in case someone is injured. However, the LLC does not protect Dad if he is sued, because a judgment creditor can foreclose on Dad's membership interest. So Dad decides to engage in estate tax planning. He sets up an irrevocable trust for his children. He gives a 10 percent LLC membership interest to the new irrevocable trust. His lawyer prepares an operating agreement under which the children's trust has the right to acquire his membership interest for a long-term, interest only note if his interest is ever subject to a charging order. See Corporations Code Section 17302(c)(2). For estate tax purposes Dad has now established a situation in which his membership interest will be subject to a substantial valuation discount for lack of marketability. A future (currently unforeseeable) judgment creditor would not be able to obtain Dad's membership interest; instead, the creditor would be left with a long-term, interest only note. That is a desired result, making what the creditor can realize much less attractive.

Better results can be obtained with other structures. Assume Dad is 65, the income producing property is worth $1,000,000 and is generating $50,000 per year. Dad contributes the property to the same LLC. Dad sells the remaining 90 percent LLC interest to the children's trust. The 90 percent interest is valued as follows: $1,000,000 x 90 percent x 75 percent (to allow for a 25 percent discount) = $675,000. The children's trust now owns 100 percent of the building and is entitled to 100 percent of the $50,000 per year cashflow. It pays for the 90 percent using a private annuity. Given Dad's age, the annual payments needed for his life expectancy would be $47,221.62 per year, below the children's trust's income from the property. The estate tax benefit is that upon Dad's death, the children's trust's obligation to continue making payments ceases, and nothing is included in Dad's estate. In other words, the estate tax benefit is complete estate tax exclusion, an estate tax miracle. The creditor protection benefit is that the creditor can only get a stream of payments that may disappear at any moment (upon Dad's death). That is the type of situation that will motivate any creditor to settle for pennies on the dollar.

In troubled economic times professionals and their clients both spend more time thinking about "creditor protection" planning, sometimes referred to as "asset protection" planning.

Professionals and their clients need to explore the creditor protection benefits of estate tax planning. Like all planning, timing is the key: the farther in advance it is done, the stronger the benefits will be.

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