Planning for Affluent Clientele under New Tax, Reporting, and Regulatory Rules

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The past year has been particularly challenging for affluent clients and their advisors because great uncertainty regarding taxes and regulation demanded a hiatus in much financial planning. For now, however, the planning landscape is fixed, albeit for a short period of time, and planning opportunities abound. This article provides a brief review of the new changes in laws that affect financial planning and how best to plan in light of them.

Changes to the Federal Estate, Gift, and Generation-Skipping Transfer Tax Laws

On December 17, 2010, President Barack Obama signed into law the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the “2010 Tax Act”). In addition to extending many of the income tax benefits of the 2001 Act, the federal wealth transfer tax highlights of the 2010 Tax Act include:

- **Increased exemption.** Under the 2010 Tax Act, an individual can transfer up to $5 million during life or at death, free of federal gift, estate, and generation-skipping transfer tax liability. By comparison, in 2009, individuals could transfer up to $3.5 million free of estate and generation-skipping transfer tax liability, while transfers in excess of $1 million resulted in gift tax liability. Beginning in 2012, this $5-million exemption will be indexed for inflation.

- **Lower rates.** The 2010 Tax Act also reduces the federal gift, estate, and generation-skipping transfer tax rate to 35 percent. By comparison, the 2009 federal gift, estate, and generation-skipping transfer tax rate was 45 percent.

- **Exemption portability.** In addition to increases in exemptions and reductions in tax rates for federal gift, estate, and generation-skipping transfer taxes, the 2010 Tax Act also introduced the concept of exemption portability. Under prior law, the unused exemption amount of a deceased spouse could not be utilized by the surviving spouse. Under the 2010 Tax Act, the unused exemption amount of a deceased spouse is portable and can be utilized by the surviving spouse (for federal estate tax or gift tax purposes but not for generation-skipping transfer taxes). For example, assume that a deceased husband uses only $2 million of his $5-million exemption amount. Under the 2010 Tax Act, the deceased husband’s remaining $3 million of unutilized exemption may be utilized by his surviving wife. As a result, she would have $8 million to utilize in exempting transfers from federal estate tax. In addition to reducing the potential for federal estate tax liability on the death of the surviving spouse, portability also can simplify estate planning for many taxpayers because it may obviate the need for estate equalization and credit-shelter or by-pass trust planning.\(^1\)

- **Sunset.** The 2010 Tax Act affords significant federal wealth transfer tax benefits, but it is important to note that the 2010 Tax Act is set to expire on December 31, 2012. Thus, planning in 2012 will be fraught with much of the same uncertainty seen in 2010 absent any legislative action. If neither Congress nor the president act before 2013, the federal estate tax and gift tax exemption amount will revert to $1 million. Further, the federal generation-skipping transfer tax exemption also will revert to $1 million, though it would be indexed for inflation. The federal gift, estate, and generation-skipping transfer tax rates each would increase to their prior 55-percent levels. Lastly, exemption portability would cease. Given the short-term certainty of the increased amounts, affluent clients should engage in wealth transfer planning promptly while the certainty of these favorable terms is available.

Will and Trust Planning

Incorporating flexibility into one’s wills and trusts, the core of a client’s plan, is critical in light of the changes brought about by the 2010 Tax Act. Flexibility will provide executors and trustees with the ability to address problems raised by a moving estate tax exemption, state death taxes, and exemption portability.

- **Moving exemption.** Traditional creditor shelter planning for married couples may be necessary for spouses whose aggregate gross estates exceed $10 million. To the extent that the exemptions continue to rise and exceed the aggregate gross estate, some couples no longer may need credit shelter planning. However, due to the obvious uncertainty about the timing of death, estate value, tax rates, and exemption amounts, core planning documents must consider multiple possibilities and be drafted with the greatest flexibility.

- **State death tax.** Although the 2010 Tax Act increased the exemption for federal wealth transfer taxes, some states have not responded in kind and have decoupled from the federal laws. For married couples, a state death
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Structured and administered properly, an FLLC can provide significant federal wealth transfer tax benefit through valuation discounts. That is, the value of an FLLC’s assets may be discounted (generally 25–35 percent) to take into account lack of marketability and control. Although there was much speculation in 2009 and 2010 that Congress would seek to curtail valuation discounts, the 2010 Tax Act did not impose any such limitations. Such limitations may be the subject of future legislative efforts, but properly structured and implemented FLLCs still are available planning tools that should be considered to utilize a client’s increased gifting exemption of $5 million.

Annual exclusion planning. The discounts afforded to FLLC interests may provide clients with leveraged gifting opportunities, especially if coupled with the federal gift tax annual exclusion. However, this technique carries some risk. In the 2010 case Price v. Commissioner, the taxpayer attempted to shelter gifts of partnership interests under the annual exclusion. For a gift to qualify for the annual exclusion, the donee must have a present interest in the gifted property. A present interest is an unrestricted and noncontingent right to the immediate use, possession, or enjoyment of the property itself. However, in Price, the partnership agreement prohibited partners from transferring or selling the interests. As a result, the U.S. Tax Court determined the donee did not have an unrestricted and noncontingent right to the immediate use, possession, or enjoyment of the property itself because the donee was not entitled to any distributions nor was the donee able to derive any economic benefit from the interest by selling the gifted interests. As a result of Price and its predecessor cases, advisors should consider reviewing the operating or partnership agreement of an FLLC before making a gift in which the annual exclusion is sought. Specifically, the governing agreement should provide the donee with some ability to derive current economic benefit (e.g., rights to specific income distributions or capital account redemption).

Series LLC proposed regulations. A series limited liability company is a special form of a limited liability company that provides liability protection across multiple series, each of which theoretically is protected from liabilities arising from the other series. Further, where a series LLC held many series, the series LLC structure could result in administrative and maintenance cost savings as compared to a structure comprised of multiple separate legal entities. Due to the unique nature of the series LLC and its recent availability, little guidance has been available about how series LLCs are to be treated for federal income tax purposes.

Under an entity theory, each series was treated as a separate entity, thereby necessitating filings for the series LLC and each series under the series LLC. Alternatively, under the holding company theory, the series LLC was viewed as a single parent company that owned multiple series, which were viewed as disregarded entities. Under this theory, a single tax filing for the series LLC would appear to suffice. On September 13, 2010, the Treasury released proposed regulations that sought to clarify the tax reporting for and classification of, a series LLC. In general,
the proposed regulations effectively apply the entity theory where owners are associated with each individual series. Although the proposed regulations do not expressly define what it means to be associated, an owner is associated with a series when that owner's rights, duties, powers, and obligations are specific to the series. Where the series are treated as separate entities, the classification of each series for tax purposes is to be determined under the so-called “check the box” regulations (Treasury Regulation Sections 301.7701-1 through 4). The general effect of the proposed regulations is that each series will file separately and each member of each series will receive a separate K-1 statement of income or loss.

Grantor Retained Annuity Trusts

Another advanced planning technique that was in the congressional crosshairs that was in the congressional crosshairs was the grantor retained annuity trust (GRAT). A GRAT involves the gift of property to an irrevocable trust that pays the grantor an annuity for a term of years. At the end of the term, the trust terminates and distributes the property to the trust beneficiaries (typically the grantor’s children). The value of a gift for gift tax purposes is typically the value of the gifted property. However, the client’s retained annuity interest in the gifted property reduces the value of that gift. A reduction in the value of the gift reduces the amount that is subject to gift tax while allowing any potential appreciation on the gifted property to escape taxation. Under current law, the value of the annuity could be structured such that the value of the gift is zero based on the discount rate and its underlying actuarial presumptions under the Code.

During 2010, Congress sought to impose two limitations designed to curtail the benefits of a GRAT. The first limitation imposes a minimum remainder value (generally at least 10 percent) thereby preventing clients from structuring GRATs in a gift tax-free manner because any remainder value would be subject to gift tax. The second proposed limitation sought to impose a minimum GRAT term (generally at least 10 years). An increased GRAT term would decrease the probability that a GRAT will produce wealth transfer tax savings.

Importantly, the 2010 Tax Act did not impose either of these limitations, though it is likely that these limitations will be discussed once again in future legislation. Therefore, the short-term, zeroed-out GRAT remains a viable wealth transfer technique for the time being and should be considered as a useful tool to take advantage of the current increased gift exemption of $5 million.

Foreign Account Tax Compliance Act (FATCA)

In this global age, more clients own foreign accounts or assets as a result of international business operations or diversified planning. FATCA, which was introduced as part of the Hiring Incentives to Restore Employment Act of March 18, 2010, greatly expands the disclosure requirement and increases penalties associated with foreign accounts and assets. More specifically, FATCA imposes informational return and reporting requirements on those:

- holding “specified foreign financial assets,” which include foreign hedge funds, private equity funds, and other entities valued at more than $50,000
- shareholders of passive foreign investment companies
- foreign financial institutions with U.S. customers
- foreign nonfinancial entities with substantial U.S. owners

In addition, the new FATCA failure-to-file penalties include:

- $10,000 minimum, increasing by $10,000 for each 30-day period following notification from Treasury, up to a $50,000 maximum;
- Section 6662 penalties for substantial understatement of income are increased for these assets from 20 percent to 40 percent; however
  - there is a reasonable cause exception for penalties.

FATCA also increases the statute of limitations on assessment of these penalties by extending the three-year statute to six years if it involves more than $5,000 of income regardless of whether there is substantial understatement.

2011 Voluntary Disclosure Initiative

For those who have not complied with the foreign account and asset filing requirements, whether under FATCA or previous reporting regimes, a (slight) reprieve may be available. On February 8, 2011, the IRS announced a second voluntary disclosure initiative to provide taxpayers with an opportunity to disclose unreported income from offshore accounts in exchange for reduced penalties and avoidance of criminal prosecution. Under this initiative, taxpayers would be subject to a penalty equal to 25 percent of the total amount in their foreign bank accounts in the year with the highest aggregate account balance covering the 2003 to 2010 time period. Certain taxpayers would be subject to reduced 5- and 12.5-percent penalties. Additionally, taxpayers still will be responsible for any back-taxes and interest for up to eight years, as well as any accuracy-related and/or delinquency penalties. Under the standard penalty provisions, a penalty equal to 50 percent of the amount in the foreign bank accounts would be imposed in addition to criminal prosecution. The new voluntary disclosure initiative will be available through August 31, 2011. Any client who is not in compliance with the foreign account reporting rules should be strongly advised to come forward and disclose, because the results differ dramatically if the IRS gets to the client first.

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Dodd-Frank Act Impact on Family Offices

In addition to the new tax-related laws of 2010, the new Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) may impose significant administrative and reporting obligations on family offices if those family offices must register as investment advisors.

Before Dodd-Frank, family offices were exempted from registering as investment advisors by reason of the private advisor exception. Under the old law private advisors included those advisors who had 15 or fewer clients. The new act defines “private advisor” to include those managing less than $100 million in assets. Thus, barring any other exception, families that are managing assets in excess of $100 million may have to register as investment advisors, which would require the family offices to adopt institutional practices such as formal business plans, policies and procedures, ethics codes, employee background checks, and external edits. However, the ultimate impact of Dodd-Frank on family offices is yet unclear because the new law requires the Securities and Exchange Commission to define “family office” to be consistent with prior guidance.

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Endnotes

1 In order to maximize each spouse’s basic exclusion and to effectively defer the payment of estate tax until the death of the second spouse, a will or trust typically funds an amount equal to a decedent’s unused exclusion into a credit shelter trust. The balance of the decedent’s estate passes to the surviving spouse in a trust qualifying for the marital deduction. The credit shelter trust is designed to escape estate taxation at the death of the surviving spouse. However, if a spouse does not have assets sufficient in value to fully fund their credit shelter trust with the exclusion amount, it is advisable to “equalize” the estates by having the wealthier spouse gift sufficient assets to the other spouse in order for that spouse to maximize their exclusion amount. With the advent of exemption portability, this no longer will be necessary because the surviving spouse now will benefit from the predeceased spouse’s unused exclusion. However, as discussed above, advisors should note that exemption portability is only available through 2012 unless legislation extends this regime.