Proper estate planning in relation to real estate holdings

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Business owners and entrepreneurs spend substantial time and resources developing and implementing detailed business plans to assure the success of their businesses during lifetime. Surprisingly however, very few adequately plan for how their business and other assets will be distributed upon their death. In addition to family disharmony, the failure to plan often costs heirs a great amount of money due to the diluted value of their business and the requirement to pay a large amount of unnecessary estate tax.

Furthermore, businesses such as real estate that involve a large amount of illiquid assets are particularly vulnerable. With the estate tax at 45%, these estates usually do not have enough liquid cash to pay the required taxes and expenses at death. Consequently, in order to pay the estate tax and settlement expenses, either a loan must be arranged, or assets must be sold. But what if market conditions are not ripe due to a credit crises or a faltering economy? In such situations reasonable cost loans may not be obtainable and valuable assets may need to be sold at substantially reduced prices. As a result, the family loses both the asset and the income it should have generated; a disastrous situation.

Proper estate planning can alleviate much of this problem by ensuring that those assets in which the entrepreneur has worked so hard during lifetime to accumulate are not subject to a forced sale, but rather can be passed on to future generations in an orderly manner and with minimal administrative cost and estate tax. The process however is not without challenges. First, entrepreneurs do not like to give up control of their assets. Second, there is often a mistaken belief that giving up ownership of assets also means giving up the income on those assets. Finally, they never seem to have the time or desire to think about their own mortality.

In responding to these challenges, it is important to note that one must neither own an asset to control it, nor to receive its income. Accordingly, planning for illiquid assets (including real estate) employs techniques that are designed to allow the entrepreneur the ability to give away the future appreciation of assets without transfer tax, while retaining the income on those assets, and the corresponding lifestyle that he, or she, is accustomed to. The following are some of the general concepts that can be utilized in formulating the estate plan. Typically these concepts are used in combination with each other in such as way as to accomplish the specific goals and objectives of the client.

Family Limited

Partnership (FLP) / Family Limited Liability Co. (FLLC)

The FLP or FLLC is the most frequently used ownership entity for real estate owners and developers. Although different in legal status, they are very similar in operation and provide a level of asset protection for the owner, while providing income and losses to flow through to corresponding partners or members. In addition to these valuable business benefits, use of a FLP or

FLLC also provides several estate planning benefits, including the ability to remove assets from the owner's estate (along with any future appreciation thereon) without giving up control. Usually this is accomplished through a gifting program of ownership interests to children or grandchildren while keeping control over management of, and access to, the assets. This strategy enhances management efficiency and eliminates the loss of control that sometimes occurs in a systematic gift-giving program.

Irrevocable Life
Insurance Trust

Life insurance is an important tool in any estate tax plan, but is especially useful for estates with potential liquidity issues. Life insurance proceeds create needed liquidity to pay taxes and expenses, as well as providing cash for beneficiaries. Often however, the benefits of the insurance are greatly reduced because the policy is owned outright by the insured.

Although life insurance passes to beneficiaries free of income tax, unless structured correctly, the proceeds will be includable in the estate of the insured and subject to estate tax. In order to prevent this adverse result any life insurance policy currently owned, as well as any additional life insurance to be purchased, must be contributed to, or purchased by, an irrevocable trust (called an "ILIT"). Placing the insurance into an ILIT will ensure that the life insurance will not be included in the insured's estate and that the insured heirs will have the necessary liquidity to pay taxes and expenses, thereby avoiding a forced sale of assets. In structuring ILIT's, one must be careful to make sure that there are no "incidents of ownership" that may be attributable to the insured. Otherwise, the life insurance proceeds will be considered to be owned by the insured and includable in his, or her, estate.

Defective Irrevocable Trust

This type of irrevocable trust is designed to be "defective" for income tax purposes but not "defective" for estate tax purposes. Also referred to as a "Defective Grantor Trust", it includes provisions to ensure that all contributions to the trust are completed gifts for estate and gift tax purposes thereby removing these assets from Grantor's estate. In addition, this structure allows the trust to be disregarded for income tax purposes, thereby taxing all income on the assets to the grantor (i.e., the real estate owner).

Planning for illiquid assets usually involves the combination of the FLP /FLLC with life insurance inside of the defective grantor trust. Earnings from income producing property may be used partially to fund insurance premiums with any remaining earnings either retained in the trust, or distributed out to the owner. This type of planning takes time and requires the use of complex planning techniques, but the results can be powerful, saving substantial dollars in the estate, while providing needed liquidity in a tax-efficient and orderly manor.

Grantor Retained Income Trusts

Another frequently used tool in planning for illiquid estates is the Grantor Retained Income Trust ("GRIT"). The GRIT may take the form of an annuity ("GRAT"), or a unitrust ("GRUT"). Either form can be provide a favorable means of removing rapidly appreciating property from a client's estate while passing on substantial wealth to children and future generations. In addition, when properly structured, the desired result may be accomplished with minimal or no gift tax payable by the grantor.

As long as the Grantor outlives the term of the trust, none of the assets inside the trust will be included in the grantors estate. In the event that the grantor dies during the term of the trust

however, the fair market value of the remaining trust assets will be included in the grantor's estate. Consequently, careful planning is required when determining the term of the trust. Nonetheless, because the cost to set up a GRAT or GRUT is minimal and the potential benefits are substantial, they are frequently used when dealing with large estates, and are often combined with FLP's and FLLC"s to obtain maximum discounting of assets going into the trust, while magnifying the value of the remainder interest passing to the beneficiaries outside the estate.

Clifford Cohen is a tax and estate planning attorney at Capobianco & Cohen, Washington, D.C.