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**Opinion****Tax cut extension provides unique gifting opportunity for wealthy business owners**

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**John Dedon**

The law signed by President Obama to extend the Bush income tax cuts came with a surprise estate and gift tax benefit for high-net worth business owners — a \$5 million gift and death tax exemption. Thus, business owners can protect \$5 million from estate tax upon death (or \$10 million for a married couple).

For most of us, the ability to protect \$5 million from estate tax is sufficient. However, many business owners have assets that exceed that amount. Moreover, the law is only for two years, leaving us with the same uncertainty in 2012 that we faced in 2010. Further, many states, such as Maryland, only allow a \$1 million exemption. (Fortunately Virginia currently has no estate tax).

Thus, rather than wait until death, many business owners should take advantage of the extraordinary wealth transfer opportunities available due to tax-free gifting of up to \$5 million of assets. Most of us in the estate tax world were surprised when the estate tax exemption was increased to \$5 million. However, we were shocked when the law allowed for gifts of up to \$5 million. While increasing the gift exemption to \$5 million for two years, Congress left untouched for now gifting strategies, such as GRATS and intra-family discounting of assets.

The bottom line? High-net worth business owners should strike while the estate and gifting law is in their favor. There are a number of strategies available, many of which I have written about in the past, such as GRATS and gift/sale techniques to intentionally defective trusts. Set forth below are three strategies that take advantage of gifting and the advantage of life insurance to protect and leverage the assets for the family and future generations.

The common denominator in all three strategies includes: 1) an Irrevocable Trust; 2) transferring assets into the trust; and 3) a portion of the transferred assets, or a portion of the income generated from the transferred assets, is used to purchase a life insurance product. Because an irrevocable trust is used to own the assets, the assets are protected for the children and future generations in perpetuity from estate tax and also from creditors and failed marriages.

The transfer to the irrevocable trust constitutes a completed gift, and the donor takes advantage of the \$5 million gift

exemption. Thus, when the insurance is purchased inside the trust, there are no further gift tax consequences. The advantages of purchasing life insurance by the trust include diversifying and leveraging the trust assets; providing liquidity upon death to pay death taxes; and providing tax-free cash accumulations inside the insurance policy, which could be tapped by the trust beneficiaries during the insured's life.

Case 1: Mr. Donor, age 59, owns a government contracting company worth \$15 million. Assume it is an S corporation, but it could be a limited liability company (LLC). He creates a class of non-voting stock. The stock is discounted for tax purposes because of market and minority discounts by 35 percent, to \$9.75 million. He transfers 40 percent to an Irrevocable Trust, which he created as a grantor trust to last in perpetuity for future generations. The value of the stock gifted, \$3.9 million, and all appreciation is removed from Mr. Donor's estate. The trust uses a portion of the dividends from the 40 percent stock interest transferred to the trust to purchase life insurance. Assume the dividend is 8 percent, which would generate on 40 percent of the \$15 million stock transferred to the trust \$480,000 annually. The annual insurance premium paid by the trust is \$300,000. Upon Mr. Donor's death, the insurance proceeds are paid to the trust estate tax free. If Mr. Donor is a healthy 59 year old, the death benefit would be in the range of \$15 million. If the insurance is needed to pay estate tax, the policy may insure both Mr. and Mrs. Donor, and the death benefit would be greater.

Case 2: Mr. Donor, age 59, gifts \$5 million cash to the trust. One-half of the contribution is invested in marketable securities, and one-half is used to purchase a single pay insurance policy. If Mr. Donor is a healthy 59 year old, the death benefit purchased with a \$2.5 million single premium payment would be in the range of \$7 to \$8 million.

Case 3: Mr. Donor, age 59, gifts \$5 million cash to the trust. Instead of needing an insurance policy with a large death benefit, he purchases a policy designed with a minimal death benefit and a large cash value. The insured is Mr. Donor's 35-year-old daughter, not Mr. Donor. The trust invests \$1 million in marketable securities and uses \$4 million for the insurance premium. However, the premium is paid in five payments of \$800,000 to avoid income tax on the withdrawals of the cash value in the policy, i.e., to avoid a "modified endowment policy." If the policy earns 6 percent a year, and daughter did not withdraw amounts for 10 years, starting at age 45 she could receive roughly \$170,000 income tax free until she was 85. If daughter dies, there would be a death benefit for her children of initially \$15 million that would decrease over daughter's life.

The combination of the \$5 million gifting amount, Irrevocable Dynasty Trusts created as Grantor Trusts, and life insurance provide powerful wealth transfer opportunities for high-net worth business owners, but possibly only for the next two years.

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