❖ Opinion

Proposals could restrict estate-planning strategies

May 19, 2009 10:11 AM

In prior columns I have written on estate tax strategies that allow business owners to transfer more assets to their families and less to the IRS. Now, the Obama administration and Congress are considering restricting some of these strategies.

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Two under examination are Grantor Retained Annuity Trusts (GRAT) and minority discounts obtained by transferring closely held business interests.

GRATs

GRATs allow a business owner (the "donor") to transfer closely held stock, real estate, or marketable securities to a GRAT for a minimum of two years. If the donor receives an annual annuity from the GRAT, the transferred asset or at least its appreciation, will pass to the donor's family at the end of the GRAT term at a reduced value and is removed from the donor's estate. The asset value is reduced for gift tax purposes because of the retained annuity. Obviously, the greater the annuity and the longer the GRAT term, the greater the reduction in value of the transferred asset for gift tax purposes. In fact, it is possible to "zero out," meaning eliminate, the gift tax.

One catch: the donor needs to survive the term of the GRAT. Thus, an 80-year-old business owner would not choose a 20-year GRAT. In fact, regardless of age, many business owners choose two-year GRATs to capture any savings possible, and then simply do repeated two-year GRATs with the same assets (so called "rolling GRATs").

Under the Obama plan, GRATS less than 10 years in duration would be prohibited, meaning the donor must live 10 years to remove the asset from the donor's estate. A separate proposal in Congress would not tinker with the length of the GRAT, but would require a minimum gift imposed on the donor, perhaps as much as 10 percent of the transferred asset (thus eliminating zeroed-out GRATs).

Transfers of closely held business interests

Taxpayers and the IRS have battled for years over the ability of business owners to transfer their business and investment interests to family members at discounted values. With the appropriate appraisals, the discounts applicable to such transferred interests can range between 20 percent and 50 percent.

Consider this example. Dad owns a business worth $1 million. He transfers a 49 percent interest to his daughter. The value for gift tax purposes is not $490,000, but $294,000 ($490,000 x 40 percent discount). At a 45 percent federal tax rate, the savings is $88,200.

The IRS has won recent court cases where it challenged taxpayers on such transfers. However, the IRS often prevails

because of taxpayer greed (if taxpayers seek to discount all their assets); lack of a business purpose (personal assets transferred, such as a residence); procrastination (so-called "death bed" planning — transfers shortly before death); failure to observe formalities (co-mingling assets, not creating proper accounts and record keeping); or the retention of total or too much control.

The retention of control can run afoul of "applicable restrictions," which are provisions in the operating agreements designed to limit control — and thereby enhance the minority discount. If these applicable restrictions are more restrictive than state law provisions, the IRS can ignore them, ignoring or reducing the minority discount. See Section 2704 of the Internal Revenue Code.

The Obama Administration would give the IRS another weapon through a statutory change. In addition to existing "applicable restrictions" under Section 2704, the proposed law would ignore certain restrictions between family members, whether or not they are consistent with state law. Under the proposed law, in the example above, the 49 percent interest Dad gave to his daughter would not be eligible for a 40 percent discount.

There already is existing uncertainty because it is unknown whether the president and Congress will pass "permanent" estate tax legislation addressing the exemption amount and the estate tax rate. Whether these proposals work their way through Congress and ultimately become law is also uncertain.

These proposals, if enacted, will likely carry the date of enactment as the effective date. Thus, acting before certain planning opportunities are eliminated is the third reason business owners should act now to transfer wealth to future generations. The already existing two reasons are derived from current financial times that have reduced asset values and interest rates.

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