Leveraging the annual gift tax exclusion in legacy planning

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Accumulating abundant wealth and then transferring a portion at or before death to beneficiaries without excessive federal transfer tax burdens remain desired goals of many individuals. Prudent long-term investment strategy and transfer taxation planning remain key considerations in achieving those goals.

This paper focuses primarily on transfer taxation planning and presents a case inviting the reader to determine the efficacy of gifting family limited liability company (FLLC) membership interests under the annual gift tax exclusion. The scenario consists of a hypothetical, high-wealth, married couple who founded and co-manages a FLLC investing in marketable securities. The couple has embarked on a long-term strategy of gifting membership interests to their children and grandchildren at valuation discounts, which leverage the annual gift tax exclusion.

The issues implicit in the case remain relevant to wealth transfer planning as long as the potential exists in the foreseeable future for the incurrence of large tax liabilities on these transfers. Realistically, chances for repeal or a significant reduction seem remote in light of the mounting current federal budget deficits. Thus, the need for prudent wealth transfer tax planning remains convincing unless and until this outlook changes significantly for the better.

Key words: LLC, Wealth Transfer Taxes, Legacy Planning

INTRODUCTION

Most individuals strive to produce and accumulate wealth during their lifetimes to afford comfortable lifestyles, raise and educate their children, provide financial legacies and for other reasons. As death remains certain and wealth does not accompany the individual on the journey, any residual assets must pass on to beneficiaries after applicable estate expenses and wealth transfer taxes, especially federal estate and perhaps generation skipping transfer (GST) taxes. Even if the individual transfers wealth before death, these transfers remain subject to gift taxation at rates which have typically paralleled those of estate taxes. Over most of the period since the Great Depression, wealth transfer taxes have exerted a substantial financial claim, especially on high-wealth individuals.[1]

Prospects for a permanent elimination or a substantial reduction of wealth transfer taxes appear bleak for the foreseeable future. In view of the mounting federal budget deficits, the U.S. Congress will likely retain all of the wealth transfer taxes and rates as scheduled under existing law, if not amend the laws to generate even more revenue. Thus, careful transfer tax planning remains compelling to minimize the tax collector's claim on wealth transfers.

REVIEW OF FEDERAL WEALTH TRANSFER TAXATION

This current year (2010) represents a watershed period for federal wealth transfer taxation. Under the Economic Growth and Tax Relief Reconciliation Act (EGTRRA) (2001), individuals' wealth transfer tax liabilities gradually declined through 2009.[2] Then, for this year only (2010) EGTRRA repealed both the estate[3] and GST taxes.[4] The law, however, kept the gift tax in force for 2010, reduced the maximum rate to 35 percent (from 45 percent, 2009)[5] and continued the $1,000,000[6] lifetime exemption from the prior year.

Starting next year (2011), however, the three transfer taxes will essentially revert to pre-EGTRRA provisions and rates without Congressional intervention.[7] Maximum marginal rates, for all, will go as high as 55 percent,[8] compared to their maximum rates of 45 percent during 2009. Moreover, the 2009 estate and GST tax exemptions of $3,500,000 will decline respectively to $1,000,000 and $1,000,000 adjusted for inflation

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[1] STAFF OF J. COMM. ON TAX'N, 110 CONG., HISTORY, PRESENT LAW, AND ANALYSIS OF THE FEDERAL WEALTH TRANSFER TAX SYSTEM 6 (Comm. Print 2007), available at http://www.jct.gov/x-108-07.pdf.

[2] See Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, §§ 501-581, 115 Stat. 69-93 (2001) (hereinafter EGTRRA).

[3] I.R.C § 2210.

[4] I.R.C. § 2664.

[5] I.R.C. § 2502 (a).

[6] I.R.C. § 2505 (a).

[7] EGTRRA § 901, Stat. 150.

[8] For pre-EGTRRA estate, gift and GST tax rates, respectively, see I.R.C. §§ 2001, 2502 and 2641, Tax Management Library (BNA) Internal Revenue Code--Background Notes, available at http://taxandaccounting.bna.com/btac/.

after 1997 (estimated to equal $1,350,000 in 2011).[9] The gift tax exemption will remain unchanged at $1,000,000.[10] Thus, short of dying and escaping asset transfer taxes in 2010, prudent planning becomes even more advisable with tax rates scheduled to resume at levels equal to or higher than those imposed over the past decade.

In addition to the gift tax exemption, federal wealth transfer taxation provisions allow an annual gift tax exclusion. This feature has no counterpart in estate and GST taxation. Under current (2010) law, taxpayers may transfer $13,000 annually[11] (married couples may exclude $26,000 annually under split gifting[12]) and thus escape taxes on these wealth transfers altogether. These annual gift tax exclusion limits, also indexed for inflation, could increase during 2011. In addition to wealth transfer tax savings, utilizing the annual gift tax exclusion may also shift income to family members with lower marginal personal income tax rates, thus lowering the overall family income tax burden.

LONG-TERM STRATEGY TO REDUCE WEALTH TRANSFER TAXES

Just as individuals seeking to accumulate substantial sums of wealth usually employ long-term investment strategies, they should likewise implement protracted planning strategies to minimize wealth transfer taxes. Often overlooked, the above-described annual gift tax exclusion constitutes a straightforward and effective tool for reducing assets subject to transfer taxation. While the amounts of the allowable annual exclusion may seem nominal at first glance to wealthy individuals, the wealth removed annually from an estate also removes future compounded annual returns that would have accumulated. As a result, over the long term, wealth transfers and attendant transfer tax savings can accumulate to significant dollar amounts.

To complement an annual gifting strategy, individuals may find it cost beneficial to establish a form of business organization—the limited liability company (LLC)--and gift its membership interests, instead of the typical cash, marketable securities, real estate, etc. This tax planning strategy often allows donors to leverage their annual gift tax exclusion and thus substantially increase tax savings. As explained in more detail later, gifting LLC membership interests provides potential valuation discounts not available by gifting the underlying LLC assets. Because of these discounts, donors can effectively remove more wealth from their estates annually than otherwise allowed by the maximum gift tax exclusion.

When employed as a gift leveraging tool, however, the LLC must have a bona fide, non-tax purpose as its primary reason for existence. Otherwise, the Internal Revenue Service (IRS) may challenge the entity as a "sham" designed merely to save wealth transfer taxes. The courts have recognized nontax purposes, such as perpetuation of a particular investment philosophy, [13] promotion and encouragement of joint management of consolidated family wealth[14]and promotion of family harmony.[15]

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[9] See *id*. at I.R.C. §§2010 and 2631for the allowable pre-EGTRRA exemptions for estate taxes and GST taxes, respectively.
[10]See *id*. at I.R.C. §2505.
[11]I.R.C. §2503 (b).
[12]I.R.C. § 2513 (a).
[13] *Estate of Shutt v. Commissioner*, 89 T.C.M. (IntelliConnect) 1353 (2005).
[14] *Estate of Mirowski v. Commissioner*, 95 T.C.M. (IntelliConnect) 1277 (2008).
[15] *Estate of Stone v. Commissioner,* 86 T.C.M. (IntelliConnect) 551 (2003).

A favorite tool in recent years and one of the IRS's most effective for attacking membership interest gifting has been IRC § 2036. Under this estate tax provision, the agency may attempt to disregard transfers of property to the LLC for membership interests (funding) and return the property to the decedent's estate, thus nullifying any gifting strategy. The agency may argue that the decedent retained "possession or enjoyment of, or the right to income from the property"[16] or "the right … to designate the persons who shall possess or enjoy the property or the income therefrom."[17] The IRS may attempt to apply comparable treatment to LLC assets underlying gifted membership interests.[18] In short, the IRS realizes the potential for taxpayer failure to respect the validity of the LLC and to deal with it at arm's length and has responded with many challenges. Thus, professional legacy planners and taxpayers must exercise care in crafting wealth transfer strategies using a LLC.

Beyond transfer tax savings opportunities, the LLC may offer other estate planning benefits as well. For example, the LLC may help reduce donor estate administration and probate costs, aid parents after death in keeping assets bequeathed to family members intact over the long term and facilitate asset transfers to family members at minimal transfer costs (mainly appraisals) through gifting membership interests.

In addition to its benefits as an estate planning tool, individuals must also evaluate the efficacy of the LLC as a form of business structure in light of their individual circumstances. The LLC —a hybrid between a sole proprietorship or partnership and a corporation—has emerged over recent years as a popular form of organization suitable for conducting a wide variety businesses, including investing operations. Its advantages as a business form include operational flexibility, the option of "pass-through" income taxation like a partnership in most instances, and limited personal liability for owners and managers from entity debts and other obligations. On the other hand, limitations include obligations for significant fees and taxes in some states, e.g., California and Texas,[19]risk of dissolution upon loss of a member without the majority or unanimous vote of remaining members[20] and operating environment uncertainty uncertainty as a relatively new structure with limited case law and precedent.

CASE SCENARIO

The case below provides the reader with an opportunity to evaluate the efficacy of a legacy planning strategy consisting of gifting LLC membership interests to descendants under the annual gift tax exclusion. The issues implicit in the case remain relevant to wealth transfer planning as long as the potential exists for the incurrence of large wealth transfer tax liabilities and both the annual gift tax exclusion and the LLC remain legal strategies for tax avoidance.

At the advice of their professional advisor a hypothetical married couple, Jim and Judy Planner, co-manage Planners Investments, LLC, a family entity, hereinafter referred to as the FLLC. The Planners—both successful physicians--founded the assumed FLLC

[16] IRC §2036 (a) (1).
[17] IRC § 2036 (a) (2).
[18] See, for example, *Mirowski v. Commissioner*.
[19] David J. Cartano, Federal and State Taxation of Limited Liability Companies, CCH ¶305.01 (2009).
[20] *Id*. at ¶305.07.

seven years ago primarily as an investment business entity. Secondarily, the entity was formed as a complementary legacy planning tool for gifting assets to their descendants.

The specific purposes for forming the entity stem from practical non-tax considerations. First, the Planners want to protect family assets from creditors, including some protection against descendants' divorced spouses' litigation claims. Second, they wish to provide legacies to their descendents on an equal basis (gifting FLLC membership interests ensures respective interests of future equal value, which may not result with gifting specific underlying assets). Third, they seek investing efficiencies and effectiveness associated with keeping all legacy assets in a single large family pool, rather than fragmenting those assets. Finally, they want to perpetuate their buy-and-hold investment philosophy for the life of the FLLC. The Planners solely and fully fund their business with a portion of the cash derived from their professions, which entitles them to proportional FLLC membership interests, and like rights and claims to capital and income.

From conception, the Planners have observed all fiduciary duties and have complied fully with all FLLC formalities to lend it creditability as an entity separate and distinct from its owners. For example, under their leadership the FLLC maintains its own banking and brokerage accounts, renders professionally prepared financial statements and files timely state and federal tax returns, holds formal membership meetings and follows an official, written operating agreement.

As part of their estate plan, four years ago Jim and Judy began controlled annual gifting of FLLC membership interests equally to their descendants—three children and three grandchildren. While donees do not participate in the general management of the FLLC, they possess the right to vote in proportion to their holdings on key FLLC policies, along with Jim and Judy. Members must cast majority votes to change current policies, which, for example, prohibit (1) additions of members outside the family, (2) sales or other disposals of FLLC assets, other than in the ordinary course of business; (3) dissolution or liquidation of the business (4) disproportional allocations of FLLC capital gains and losses and ordinary income and losses and (4) payout of cash distributions (the entity reinvests all returns). These policies are included in the FLLC operating agreement.

As noted earlier, gifting FLLC membership interests may offer special tax benefits because of potential valuation discounts in determining the fair value of the gifts. While taxpayers may qualify for many different types of valuation discounts, minority and marketability discounts remain commonplace. The former applies because the donee receives diminished ownership influence, and the latter because of illiquidity, with no actively traded market in membership interests. The Planners have used 40 percent valuation discounts rates to date, as established by professional appraisal. Thus, the effective maximum annual fair value of the wealth removed from the combined Planners' estates under split gifting would approximate $43,333 ($26,000/.60) per descendant, compared to only $26,000 absent the discounts.

The Planners' transfers of membership interests provide descendants with gifts that possess economic value after a term. To ensure this value according to the operating agreement, donees may first offer to sell, or otherwise dispose of their interests at fair value to other family members after one year. If that fails, donees may return their interests to the FLLC for redemption at fair value. This provision also allows the

Planners to retain at least some control over family wealth beyond managing the underlying FLLC investments. The Planners, however, anticipate no sales or other disposals or redemptions by donees.

The Planners intend to continue co-managing the FLLC indefinitely and to bequeath any ungifted FLLC interests to their children and grandchildren. They demand only that their descendants continue to follow their buy-and-hold investment philosophy. They remain indifferent about perpetuating the business and actually expect their descendants to liquidate it within five to ten years after receiving the bequests. Up to this point, no family member has shown any interest in managing and perpetuating the business. (The expected lag in liquidation would allow family members to benefit from the income tax advantages associated with installment liquidations.)

At the Planners' present ages of 65, their life expectancies equal 19 years, using the "combined sex and all race" life expectancy tables (U.S. Center for Disease Control 2008). Against this backdrop, we assumed that the FLLC will accumulate and invest cash and gift descendants for 19 more years from today and then liquidate over a period of 7 years. Thus, the Planners should continue to manage the FLLC for many years into the future, barring mental incapacity, serious physical illness or premature death.

The Planners remain committed to providing their descendants with ample financial resources to sustain their current upper, middle-income lifestyles. They plan to provide a legacy of either.

(a) a FLLC portfolio valued at $8,000,000 (in today's dollars of purchasing power) at their (the Planners') deaths **or**

(b) a FLLC portfolio that will generate $1,500,000 income (annuitized) per year (again in today's dollars) during the assumed FLLC installment liquidation period. Moreover, they plan to maximize the annual federal gift tax exclusion allowable until their deaths. If necessary, they will invest additional cash in the FLLC to achieve these goals.

When the FLLC was formed in 2002, the Planners chose to invest the FLLC assets in a moderately aggressive way without seriously considering the risk/return profiles of alternative portfolios. At the time, they were lured by the excellent average long-term historical returns on stocks and decided to take the plunge with a stock-dominated portfolio after attending some seminars and reading a few books and articles on investment management. They experienced excellent overall results from 2002 through 2007. With the large losses experienced in the bear market in most asset classes in 2008 (e.g., the S & P 500 Stock Index, declined around 37 percent in real, price-adjusted, terms), however, they lost most of their accumulated returns. After a partial portfolio recovery in 2009 and early 2010, the Planners began to fear the prospects of a "double-dip" recession, and another reversal of their portfolio gains and sought independent advice about the suitability of their present portfolio strategy. In turn, they decided to engage a professional planner to address the advisability of shifting to a more conservative portfolio strategy.

In any event, the Planners plan to continue investing in low cost index mutual funds and applying a buy and hold strategy, as implied by modern portfolio theory, except for an annual rebalancing to maintain a fixed percentage asset allocation or mix. They value the sound investing principles of portfolio diversification, risk control and minimization of investing costs.

QUESTIONS

Aside from the estate planning and transfer tax benefits, why might the Planners have chosen to create a separate business entity to hold their legacy assets?

Does a more effective form of legacy planning arrangement exist for the Planners to gift assets to their descendents? If so, identify the alternative strategies and explain why they would prove preferable? Explain.

Is the Planners' FLLC actually a business as defined under the federal income tax code and regulations? If not, will the condition potentially increase IRS scrutiny of the FLLC as a means of saving wealth transfer taxes or marginalize other legacy planning benefits the Planners seek?

Do the Planners qualify as legitimate owners and managers of an investment business entity with their limited investment experience and background? If not, do potentially adverse transfer tax planning consequences loom as a result? Explain.

Have the Planners respected the validity of the FLLC and dealt with it in an arm's length manner to avoid excessive risks of the IRS voiding their transfers of cash (funding) to the FLLC and returning them to their estates upon death?

Do the Planners' family relationships to donees or do powers they retain over the gifted membership interests pose undue risks that the IRS will nullify the gifts, i.e., bring the assets attributable to the gifted interests back to their federal estates upon death?

Have the Planners' used valuation discount rates exceeding those typically allowable in gifting membership interests of a FLLC with underlying assets consisting of marketable securities? Does the operating agreement provision confining gifted ownership interests to the family adversely impact the level of valuation discounts? Explain.

Does the Planners' consultation with a professional portfolio advisor suggest a lack of investment business ownership and management qualifications and thus render their LLC a mere sham designed to save wealth transfer taxes in the eyes of the IRS? Explain.

Does a purely passive buy-and-hold investment philosophy disqualify the LLC for not possessing a significant and legitimate reason for existence or must a more active investment management involvement exist? Why or why not?

The Planners delayed gifting membership interests until three years after founding their FLLC. Does this delay improve the credibility of their wealth transfer tax planning strategy? Explain

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