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How To Leverage Depreciated Assets Into A Multimillion Dollar Legacy

The United States and global economies may be in the midst of one of the longest and deepest recessionary periods since the Great Depression. With the economy the way it is, taxpayers are concerned about a host of issues and are asking themselves and their advisors a lot of questions.

- ✓ Can we no longer plan on a charitable legacy to our favorite institutions?
- ✓ How will we leave any assets to our children and grandchildren?
- ✓ How do we protect our assets from the volatility/uncertainty of the market?
- ✓ Can we insulate our assets from creditors, litigators and potential adverse divorce settlements?
- ✓ How can we recover the losses sustained over our remaining life expectancy?
- ✓ How do we solve the dilemma of our reduced risk tolerance versus our limited time horizon to recover financially?

The concerns are daunting—but there is hope.

The Greek physicist and mathematician Archimedes said that with a long lever and a proper fulcrum, one can move the world. It is possible to leverage one's way to economic and financial solvency and achieve estate planning objectives with devalued assets. And life insurance can be used as a fulcrum to create wealth when combined with asset devaluation and discounting techniques.

The current economic environment has

created a renewed emphasis for high-net-worth taxpayers to concentrate on viable wealth creation strategies, credible wealth distribution techniques and tested asset protection devices. Wealthy taxpayers have concerns about capital preservation and risk mitigation, and they have a desire to freeze estate assets for estate tax purposes. They will be relieved to learn that devalued assets can be used as a launching pad to accomplish estate and financial planning objectives with minimum risk.

Though market volatility has substantially depressed asset values, it is just one piece of the estate planning puzzle. Another piece is the potential for even greater shrinkage of asset values (as much as 62 percent) due to federal and state estate/inheritance taxation. Estate taxation is not going away for high-net-worth estate owners. Just consider the current proposals in Congress to maintain the estate tax bracket marginal rate and exemption equivalent at 45 percent and \$3.5 million, respectively.

Since the federal government phased out taxpayer subsidies for state estate taxes paid in 2001 with the Economic Growth & Tax Reform/Reconciliation Act (EGTRRA), roughly half the states "decoupled" from the federal estate tax system and created their own estate tax schedules and their own credits/exemptions. Thus, state estate taxes are another factor that needs to be considered. A taxpayer may incur state taxation

when there is no federal estate taxation if the state has a much smaller exemption amount than the federal exemption, as is the case in New Jersey, where there is a \$675,000 state exemption versus \$3.5 million federal exemption.

Perhaps we can apply Archimedes' leverage principles by repositioning and leveraging distressed assets during life to reverse the shrinkage and devaluation that may occur during life and at death. We are talking about tax effective, lifetime gift transfers that incorporate discounting, leveraging and asset protection strategies. Lifetime repositioning strategies are needed because testamentary asset transfers cannot be protected from creditors, insulated from income and estate taxation, discounted for transfer tax purposes, or leveraged into new wealth creating opportunities. If your client dies with all of his assets within the estate, it is too late to use these planning techniques and assets may be further depleted by state and federal estate tax liabilities.

To bring these techniques to life, let's consider how a \$10 million investment or business asset that has lost 50 percent of its value during the 2008-2009 recession can be repositioned, converted and enhanced by 71 percent. It may be possible to transform a \$5 million depressed asset that may be subject to additional estate tax shrinkage into a \$16 million income and estate tax-free, creditor-protected family legacy.

Unfortunately, Congress has not yet acted to reinstitute a unified estate and gift tax credit/exemption as a way to simplify the tax code and facilitate lifetime asset transfer planning. Thus, to make a lifetime transfer strategy tax effective, the \$1 million cap on tax-free lifetime asset transfers needs to be circumvented when the testamentary exemption is \$3.5 million.

Effective asset discounting strategies can neutralize the lifetime cap. Discounting and leveraging in estate planning is comparable to Archimedes' proverbial lever and fulcrum principles in physics. The objective is to transfer discounted assets with minimum or no gift taxation into a family trust, where the assets can then be leveraged into a multimillion dollar tax-

free legacy through life insurance.

Family Limited Partnerships (FLPs) as well as certain types of grantor trusts can be used to further devalue already depressed asset values to minimize or avoid gift taxation. And, historically low applicable federal rates (AFRs) (4.01 percent in November 2009) can be used to even further devalue assets that are repositioned into a grantor retained income trust or FLP for gift tax purposes.

A properly structured FLP can be the centerpiece of a high-net-worth client's financial plan in recessionary economic times. However, care must be taken to structure and document the FLP in accordance with state statutes and to follow the guidelines promulgated in relevant tax court case rulings.

Asset devaluation or discounting permits greater values to be transferred tax-free to family asset protection dynasty trusts under the current \$13,000 annual gift exclusion and the \$1 million lifetime tax-free exemption. The tax effectiveness of lifetime transfers is magnified exponentially when market depreciated assets (which are expected to appreciate in the future) can be further discounted for transfer tax purposes.

For example, business/investment assets devalued by 50 percent through market deflation can be converted to FLP interests and perhaps be further devalued by up to 40 percent via minority and limited marketability discounts. That effectively enhances the available \$13,000 gift exclusion to \$21,555 per family trust beneficiary and effectively increases the \$1 million lifetime exemption to \$1,666,666. Split gifting between spouses can double the exclusion/exemption values. The following case study demonstrates the tax effectiveness of valuation discounting with depressed-value assets.

Jack Martin is the owner of a closely held business. He would like to convert his depreciated \$5 million rental property (formerly worth \$10 million) into a \$33 million legacy for his three children and five grandchildren. His financial planner proposes that Jack reposition, convert and leverage

the rental property in the following way.

1. Reposition rental property by re-titling the asset to an FLP. The \$5 million rental property earns 8 percent (\$400,000 per year). The capital account of the FLP subsequently documents that Jack now owns \$5 million of appraised general and limited partnership interests. Since most clients desire to maintain control of their assets, Jack and his wife, Maria, each retain a 1 percent general partnership (GP) controlling interest along with a 98 percent limited partnership (LP) interest.

2. Create a Martin family dynasty asset protection trust to purchase a \$33 million life insurance policy on Jack, who is 54. He would have to gift \$256,000 to the trust for premium payments. Jack desires both a cost-effective and tax-effective strategy to avoid any future gift tax consequences. One-half the life insurance premium, \$128,000, is equal to 32 percent of the \$400,000 FLP income stream. Jack would like to have the Martin FLP pay all of the Martin trust premiums. This can happen by making the Martin trust a limited partner. Since partnership income is distributed on a pro rata basis to partners, Jack will initially make his family trust a 32 percent LP. A 32 percent limited partnership equals \$1.7 million partnership units and creates and provides the family trust an income stream of \$128,000.

A professional appraisal indicates that the \$1.7 million partnership interests could be discounted by 40 percent, using tax court-approved accounting principles, to \$1.02 million. Jack and his spouse decide to transfer the 32 percent LP interest to their family trust without gift taxation by combining their split annual exclusion gifts that are equal to \$208,000 (\$13,000 exclusion times 2 times 8 trust beneficiaries) with a portion of Jack's \$1 million lifetime exemption to transfer the remaining LP value of \$802,000 (\$1,020,000 minus 208,000) to his family dynasty trust. The family dynasty trust is now a 32 percent LP of the Martin FLP and has \$128,000 of the \$256,000 premium payment toward a \$33 million life insurance policy.

3. Use income from the Martin dynasty

trust to pay premiums for a life insurance policy on Jack (classified as a “grantor” trust—IRC Section 677(a)(3)). This means any trust income is taxable to the grantor, Jack, and not to the family trust.

4. Sell additional discounted LP interests to the Martin family dynasty trust to generate \$128,000 for the additional premium needed. This can be done without income or capital gains tax consequences because of the “pass through” tax nature of the defective grantor trust.

The Martins sell an additional \$2.6 million of limited partnership interests to their trust and receive an installment interest only promissory note from the trustee. The \$2.6 million LP interest is also discounted by 40 percent to a \$1.5 million sales price. The promissory note interest that Jack receives as grantor is not subject to ordinary income taxation and is based on the current month’s AFR (4.01 percent in November 2009).

Jack can select the lowest of three AFRs: the current month or the two previous months. He selects the May AFR. Jack would receive \$53,700 per year of tax free interest (\$1.5 million times .0358) from the

trust. Since the family trust is now an 86 percent limited partner, its pro rata income share from the Martin FLP is increased by \$216,000 to \$344,000 (\$400,000 times 86 percent). This is more than enough to pay the \$244,000 premium on the \$33 million life plan, plus the \$60,150 interest payment to Jack. Since the income from the FLP assets has been consistent over the years, the Martins are confident that it will continue and that the family dynasty trust income will always be available to pay policy premiums and interest payments to Jack.

The Martins began with a \$5 million recessionary loss on the fair market value of their rental property and leveraged that 660 percent into a \$33 million income- and estate-tax-free legacy. The only tax consequence is that the family trust partnership income is taxable income to Jack under the grantor trust rules. This pass-through feature of trust income tax to Jack can be viewed as an additional tax-free gift by the Martins to their family trust beneficiaries. Trust assets do not have to be depleted to pay income taxes.

It has been said that Isaac Newton’s

theory of gravity literally dropped out of the sky when an apple fell on his head. **Make sure your clients don’t have to be similarly struck before they learn about the theory of life insurance leverage.** Then help them apply that leverage to their own estate planning problems to grow their wealth into something greater than they might possibly imagine. ☺

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