Ways To Reduce The Tax Bite

*The Editor interviews **Ivan Taback**, Partner, Proskauer Rose LLP.*

Editor: Please give our readers a brief overview of your background and practice area in the firm.

Taback: I am a partner in the Personal Planning Department of Proskauer Rose and a member of the firm's Private Investment Funds group. I have a large concentration of clients who are principals in private equity and hedge funds. The concentration of my practice is in the federal estate, gift, and generation skipping transfer tax areas. I counsel clients in connection with their personal estate planning, particularly planning with privately held business interests.

Editor: How does your estate planning for executives of private equity and hedge funds differ from estate planning for other high net worth individuals?

Taback: The fund managers, namely the principals of the general partners of the funds, have a unique asset – their "carried interest" in the fund itself. Planning wealth transfer with a carried interest brings into play a very complicated section of the Internal Revenue Code (IRC) dealing with gift taxes. When engaging in estate planning for private equity fund managers, we have to be more careful than we otherwise might be with regular investment assets because of the nature of the carried interest and how it is treated under the Code.

Most fund managers hold two interests in a fund. They have a carried interest and a capital interest. Their carried interest is typically held through the general partner of the underlying fund. When there are the two types of partnership interests, the IRC has specific rules for dealing with gifts of either of those interests. If a holder of these interests does not respect the Code's provisions, there could be severe adverse gift tax consequences. The specific code section is Section 2701 of the IRC which provides that if you own more than one class of interest in a partnership and you are deemed to have "control" over the fund, you cannot transfer a portion of your carried interest as a gift or sell it to certain family members without transferring the same proportionate share of your capital interest (and perhaps other economic interests) in the fund.

Editor: Would this apply to a general partner in any partnership with a carried interest as well as a capital interest?

Taback: It would apply to any general partner who has both a carried interest and a capital interest. It only applies if that general partner is deemed to have control over the underlying entity for purposes of Section 2701. For those purposes, control is a broadly defined term of art. For most of our clients they would be deemed in control of the fund for the purposes of this broad definition.

Editor: If the proposal currently circulating through the halls of Congress regarding taxing hedge funds and private equity funds at the corporate tax rate passes, would this change your approach to estate planning for these fund owners?

Ivan Taback

Taback: I do not believe so, because either way there is going to be income taxation. The primary purpose of the planning I engage in is to shift the growth in valuation of their initial investments to the next generation without having to pay a substantial amount of estate or gift taxes. There will be income taxes regardless of the estate planning structure. My planning focuses on relieving the burden of what is now a 45 percent federal estate tax rate on the transfer of those assets to the next generation. An increase in income tax rates may result in a greater use of what are known as "grantor trusts" for estate planning.

Editor: What are the social and economic benefits of allowing private equity funds to escape the burdens of the corporate tax rate?

Taback: There is a tremendous benefit to the economy of having private equity funds providing a source of capital to be reinvested in either existing businesses or new companies which will succeed. All that success should help the economy.

Editor: In former times, wealthy individuals placed many of their assets in offshore trusts. Is that still the case today?

Taback: A U.S. citizen is subject to U.S. estate taxes on his worldwide property. He is also subject to gift taxes on any transfers he makes that are completed gifts. There is not much that one can do as a U.S. citizen to reduce the estate tax burden by moving assets offshore.

Editor: How useful are such trust arrangements as Grantor Retained Annuity Trusts ("GRATS")?

Taback: GRATS are an incredibly useful tool. In fact, we published an article on GRATS entitled "GRATS: Heads You Win, Tails You Break Even." GRATS are one of the few estate planning devices to which there does not appear to be any downside whatsoever. We do many GRATS and they are a virtually risk free way to transfer to the next generation the appreciation on assets placed in the GRAT.

A GRAT is an irrevocable trust to which a person transfers assets but retains an annuity payable back to him from the GRAT for a certain number of years. The goal is to transfer the appreciation on the assets you put into the GRAT to the next generation. For example, if I put in $100 worth of assets, in order for it to be a zero gift GRAT, I have to take back an annuity the present value of which is equal to the $100 that I put in. This way I take back an equivalent value of what I put in, and there is no gift. The IRS says that in addition to taking back what you put in, you have to take back an additional interest amount, the AFR, based on a Treasury rate of interest. For July 2007 the AFR is six percent. We do a tremendous amount of these transactions since they are a popular way of transferring assets.

Editor: What about Charitable Lead Trusts and Charitable Remainder Trusts?

Taback: For individuals who are charitably inclined, Charitable Lead Trusts and Charitable Remainder Trusts are ways to potentially move assets to the next generation at a lower estate tax cost and benefit charitable causes. They can be viable estate planning techniques as well.

Editor: Another tax-saving device often mentioned is the split dollar insurance policy.

Taback: Split dollar insurance policies are not as prevalent as they were in the past since the IRS issued new regulations addressing them a few years ago. They were often used to confer income tax benefits, many of which are no longer available. Split dollar insurance, while still useful in certain circumstances, is not quite as prevalent as it used to be.

Editor: What about setting up Family Limited Partnerships?

Taback: FLPs are interesting animals. They historically were used to transfer assets to the next generation (or even lower generations) at a discounted value for estate and gift tax purposes. The problem is that you had many people abusing this type of transaction – individuals who created partnerships on their death beds for the sole purpose of saving estate taxes. The IRS has been attacking these partnerships over the last several years. That being said, FLPs can still have a lot of benefits, but they have to be carefully structured and implemented, especially in light of all the recent cases dealing with this subject. This is an area where clients must tread carefully but can still benefit themselves and their heirs with proper advice.

Editor: Should partnerships, especially the Private Equity and Hedge Funds, purchase key man insurance, or are there better ways to compensate for a successful manager's sudden demise?

Taback: I believe that key man insurance is an excellent way to compensate for a successful manager's sudden demise. Insurance is very often a solution to an otherwise complicated situation when a key person dies. If you have a very successful, highly regarded fund manager, someone whose presence was there to drive capital into the fund, if that person passes away, that fund stands the risk of losing existing capital and the ability to raise new capital. Key man insurance may be an easy way for that fund to be compensated for the lack of capital in the short term.

Editor: What jurisdictions in the U.S. offer the most favorable estate tax treatments of wealthy individuals?

Taback: Each U.S. citizen is subject to the federal estate tax. There are certain states like Florida where there is no state-level estate tax. That contrasts with other states such as New York which has an estate tax which can be at a rate of up to 16 percent. An individual who dies as a domiciliary in Florida could have a substantially lower tax burden on his estate than an individual who dies as a domiciliary of New York.

Editor: What is the status of the estate tax?

Taback: We are in 2007, only two and a half years away from the scheduled repeal of the federal estate tax in 2010. Although many practitioners do not believe the estate tax will be repealed, I believe we will see estate tax reform that will make the estate tax exemption somewhere between $3.5 and $5 million per person and perhaps even a lower tax rate than the present federal rate of 45 percent. I do not believe that the estate tax will ultimately be repealed. That being said, two and a half years is not a long time. One has to be aware that the estate tax repeal is a possibility at this point. It is important to meet with personal planners to make sure that one's estate plan takes into account the current law and a possible repeal of the estate tax.

During 2010 if the estate tax is repealed, in 2011 the estate tax returns with only a $1 million per person exemption from the tax and with the highest marginal estate tax rate of 55 percent. Today, the estate tax exemption is $2 million per person and the highest tax rate is 45 percent.

Although the estate tax is scheduled to be repealed, Congress will be replacing the estate tax with a capital gains tax for that year. Currently, there is a step-up in cost basis upon the death of an asset owner. That means that whoever inherits the assets receives a cost basis equal to the fair market value of those assets at the date of death. If they later sell those assets, the capital gains tax will be much lower because of the stepped-up basis. When the estate tax repeals in 2010, the step-up rules will repeal, except for some limited exemptions. So if an individual inherits assets and later sells those assets, they may have to pay a higher capital gains tax based on original cost of the asset.

There has been discussion about adding preferred sections in the estate tax rules for individuals who own family businesses as well as family farms. I think that the future reform of the estate tax is going to be more global than targeting those specific individuals and that we will see some reform on the overall estate tax with respect to the amount of the unified credit against the tax as well as overall tax rates.

Please email the interviewee at itaback@proskauer.com with questions about this interview.