Hawaiian Business Compass

by Yamaguchi & Yamaguchi, Inc.

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Yamaguchi & Yamaguchi, Inc.
Real Estate Appraisers & Consultants
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Special Edition

As a follow up to the "Protect your Assets" article published in our Spring newsletter, I am honored to co-author this Special Edition with my colleague Charlie Dombek CPA MBA from The Optimal Financial Group headquartered in Williamsburg, Virginia. Charlie is a nationally-recognized CPA and is one of the foremost authorities on tax planning and mitigation. His clients include professional athletes, entertainers, healthcare professionals, internet marketers and other successful closely-held business owners.

Unlike most CPAs who focus on compliance issues and have a historical emphasis, Charlie is best known for the tax savings he is able to achieve for his clients through constant planning, coaching and ongoing guidance.

Here are some highlights from "Protect Your Assets"

- There are many different purposes and uses for a professional real estate appraisal that may impact your net worth.
- Estate Planning and Trust Valuation; Act now Before the Bush Tax Cuts Expire at the end of the year.
- Date of Death Valuation; Get Them Done on a Timely Basis - Time Changes Circumstances

The article relayed a high sense of urgency for those who can benefit from the favorable Bush Tax Cuts and associated liberal estate tax exemptions. Do not procrastinate. Contact your professional advisors now. It is critical that your CPA, Tax Attorney, Financial Planner and Valuation Expert have adequate lead time to execute and complete your planning before the end of the year.

Slash Your Estate Taxes In 2012 By Making Lifetime Gifts - Act Now Before It's Too Late!

Charlie Dombek & Jon Yamaguchi

The Problem

Due to the expiration of the Bush Tax Cuts on December 31, 2012, this year most likely represents the last opportunity to make large outright gifts of appreciated assets to relatives without incurring estate taxes. When Congress signed into law the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010, they created a window of opportunity for gifting by individuals. This opportunity arises because the Act increased the Federal gift tax exemption from $1 million to $5 million for the years 2011 and 2012. These limits which represent a five-fold increase, are by far the highest they have been since the establishment of the estate tax. Married couples taking advantage of these liberal exclusions can save nearly $3 million in future estate taxes by making gifts before year end. Unfortunately, all gifts must be completed by the close of business on December 31, 2012 in order to benefit from the one-time increased exemptions. At the end of this year when the Bush Tax Cuts expire, the estate tax exemption reverts from $5 million to $1 million and the rate assessed to the excess increases from 35 percent to 55 percent.

The Benefits of Making Large Gifts Now

Affluent Americans who take advantage of the short window of gifting opportunity have the ability to save millions of dollars in future taxes. Assuming no change in law, a married couple making a gift of $9 million in 2012 would be exempted from any gift tax. If that same gift was made in 2013, they would pay nearly $4 million in unwanted gift taxes. Although it is possible that Congress will act to extend or modify the current exemptions, gambling on this outcome is akin to betting on a losing horse. Moreover, the uncertainty that comes with a presidential election year makes the likelihood of a further extension highly unlikely.

There are a number of added benefits to making large lifetime gifts this year. Gifting appreciated assets not only shelters the current value of the gift from taxation, all future appreciation in the asset occurs outside of the individuals estate who made the gift. For example, if stock currently valued at $3 million is gifted and appreciates to $4 million when the donor dies, then the $1 million in appreciation in the stock portfolio is removed from the donor's estate.

There are a number of gifting techniques that can leverage the value of the increased 2012 exemptions. Gifts of interests in

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closely held corporations, LLCs and family partnerships can be discounted due to lack of control, lack of marketability and lack of liquidity. These discounting techniques which are prescribed by the IRS can reduce the value of gift by 30 percent or more. The use of Irrevocable Trusts also allows donors to reduce the value of a gift for estate taxes and to ensure that any future appreciation occurs.

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Family Limited Partnerships and Family LLCs

A family limited partnership or family LLC is a legal entity most often formed to manage family wealth and to serve as a building block for wealth transfer planning. The appropriateness of establishing a family partnership is dependent on many variables, including the willingness of the owner to part with a portion of his or her ownership interest and the identification of assets with appreciation potential.

Senior family members, typically parents, contribute assets to the family limited partnership in exchange for general and limited partnership units. Generally, no gain or loss is recognized by an individual upon his or her contribution of appreciated assets to a partnership. After formation, the parents often retain the role of general partner and transfer partial ownership of their assets - via limited partnership interests or LLC membership interests - to children, other family members or trusts for their benefit (the limited partners). The donor, as general partner, retains control over the partnership assets, controls cash flows to the limited partners, determines the ability of the limited partners to transfer their interests and may even be entitled to a management fee. While almost any type of property can be placed in a family limited partnership, the assets assigned most frequently are those with appreciation potential, such as marketable securities, real estate, family businesses and interests in non-family businesses.

The IRS has ruled that family limited partnerships must be established for valid, underlying business reasons, not for the sole purpose of minimizing taxes. Acceptable business reasons can include enhancing the management of a family-owned enterprise, promoting family involvement in investment decisions for a portfolio of securities and ensuring sound decisions regarding family-owned property. In recent years, the IRS has increased its audit activity for gifts of limited partnership interests in an effort to attack perceived abuses of discounting techniques.

Family Limited Partnerships and Family LLCs have been useful tools in estate planning due to the ability to discount the value of the non-controlling interests in the entity. Valuation discounting begins with an analysis of the fair market value of the underlying partnership assets. The analysis is a fairly simple process for marketable securities, as compared to determining the fair market value of a closely held business or a real estate asset. Once the fair market value of the assets has been determined, a discount analysis is performed to arrive at the fair market value of the interests being gifted. The two discounts applied most often in the family limited partnership/LLC context include minority/non-controlling interest and lack of marketability. Generally, the minority interest discount corresponds to the degree of control or influence inherent in the transferred interest, whereas the lack of marketability discount corresponds to the transferred interest's degree of liquidity. The two are interrelated because a minority interest tends to be harder to sell and is therefore less marketable.

In determining the appropriateness and level of each discount, the rights of the limited partners/members as delineated by state law and the partnership agreement, are reviewed. Specific attention is focused on the relevant provisions that restrict transfers and withdrawals by limited partners. Since limited partners exercise no control over partnership assets and the marketability of their interests are often limited, the value of a limited partnership interest is discounted for gift tax purposes.

When implementing a gifting program, it is highly important to have accurate valuations performed by industry experts that will stand up to the scrutiny of the IRS.

Irrevocable Trusts

Grantor Retained Annuity Trusts and Intentionally Defective Grantor Trusts "IDGT" are two of the sophisti
cated Irrevocable trust techniques typically used by wealthy individuals to increase the value of the estate tax exemptions. With an IDGT, a grantor sells an asset with potential for appreciation at its fair market value to the trust in exchange for a promissory note that is structured with a very low interest rate. With the exception of the low interest, this technique removes all future appreciation in the asset from the grantor's estate. Moreover, the sale of the asset from the grantor to the trust is not subject to any level of current income taxation which is an added benefit of this technique. The "defective" nature of these types of trusts simply means that the tax liability on any income generated from the underlying asset is paid for by the grantor, rather than by the trust. This feature essentially creates an additional gift to the trust equal to the taxes paid by the grantor, rather than having the taxes paid from, and reduce the corpus of the trust.

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A Grantor Retained Annuity Trust "GRAT" is another technique designed to transfer the appreciation on assets contributed to the trust with little or no gift tax. In this type of trust, an annuity is paid to the grantor over a chosen number of years in exchange for the gift of an appreciating asset. The annuity is calculated as a percentage of the fair market value of the assets contributed to the trust. At the termination of the trust, any remaining assets in the trust will pass to the remainder beneficiaries of the trust (i.e., typically children and grandchildren). The taxation of income earned by a GRAT is identical to that of an IDGT where the grantor pays tax on the income generated by the trust.

Which Assets Should I Give Away?

Choosing the right assets to give away is a highly important part of a successful gifting strategy. There are a couple of key issues that donors must consider. First, donors should identify assets with a high potential for appreciation. Donors should select assets for giving where the income or cash flow from those assets is not needed to support their lifestyle needs. Moreover, donors should select those assets that they typically will never sell like legacy real estate or interests in closely held family businesses. The best choices for gifting are those illiquid tangible assets like real estate, artwork and collections that are secular investments and which do not generate any current income. Lastly, assets that have recently declined in value that have good long term appreciation potential are also excellent candidates for gifting. Real estate assets in many markets fall into this category and should be considered as prime candidates for gifting in 2012.

Valuation Issues

When implementing a gifting program, it is highly important to have accurate valuations performed by industry experts that will stand up to the scrutiny of the IRS. Suppose you put a closely held business in a family limited partnership and you give away interests worth $5 million. Your gift tax return gets audited and the IRS says the interests are worth $7 million. Now you are left with either having to sell the company or come up with the cash to pay the gift tax of $700K. This situation illustrates the importance of the need to engage valuation experts that are experienced in properly appraising those assets you plan to gift. State or County tax assessment estimates are not considered appraisals and should not be utilized to justify the value of a real estate asset for gifting. When it comes to real estate, you must utilize appraisal companies that have a long history and a core competency in performing estate valuations. Likewise, closely held business interests should be performed by CPA's who are certified as valuation experts.

Conclusion

With the length of time necessary to engage counsel and perform accurate valuations many individuals are running out of time to implement a gifting program for 2012 that can take advantage of the liberal exemptions. Individuals should begin the gifting process by identifying those assets that meet the criteria we have outlined. Closely thereafter, donors should have these assets valued by competent appraisers and meet simultaneously with their financial planner and estate attorney. Remember, the Bush Tax Cuts expire on December 31, 2012 and there is no assurance that the $5 million lifetime exemption for gifts and estates will continue beyond that date. Make your plans now!

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Charlie began his career in the late 80's at Big Four national accounting firm Ernst and Young. He holds an MBA from the College of William and Mary, along with a Bachelor of Science in Accounting from Virginia Tech. He is a highly recognized author and a regular speaker at financial and investment workshops throughout the country.

Upcoming Summer-Fall Issue

A copy of the Spring newsletter can also be found on our website: www.hawaiianbusinesscompass.com

Feature articles in our Summer Issue include:

- Dispute Resolution by Clyde Matsui
- The Strike Zone of Appraisal Valuation by Jon Yamaguchi
- The Hawaii Resort Market by Ricky Cassiday
- Hawaii Commercial Market Summary by Co-Star

And as always *Simply... Stephanie (Hawaii)* by Stephanie Yamaguchi will be fun and full of surprises; rumor has it that she will be interviewing a world famous chef from Hawaii. Stay Tuned! ~ Jon Yamaguchi

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