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THE UNFORTUNATE $20-MILLION ESTATE WHEN THINGS GO WRONG

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A sobering reality is confronting many Americans in general, but there is a niche that has unique and serious planning problems—and we are not referring to all those who are going bankrupt, losing their homes to foreclosure, or filling out forms for unemployment benefits.

"If it wasn't for bad luck, I wouldn't have no luck at all."

–"Born Under a Bad Sign," by Booker T. Jones/William Bell

They won't be getting much sympathy from the one in seven Americans living in poverty, nor from the vast majority of Americans with less than $1 million in total assets, but those with $20-million estates may have the most to lose in a short time if they aren't extremely vigilant right now—and over the next several years.

Here we examine the unique circumstances and context of the $20-million estate, what can go wrong, and some defensive measures for keeping things under control.

Next month, we will continue with a more in-depth treatment of the estate planning techniques that make the most sense in light of the likely direction for the economy and the tax code over the near term, as well as much farther into the future.

Receding Wealth

What could possibly go wrong with a $20-million estate? These days there are a lot of people who must think they were born under a bad sign. Their estates have been ravaged by the recession and the real estate bubble.

Melting ice caps are troubling, but an estate that drops by 40% on paper is alarming! For a $20-million estate, dropping 40% (due to portfolio and real estate values) means the estate is suddenly worth $12 million.

Once you lose $8 million, even on paper, you never forget it. The result can be a paralyzing fear of risk at a time when there are few safe investments. In theory, someone with $20 million in liquid assets who put all the funds in money market accounts currently getting a 0.7% return would earn a whopping $140,000 annually before paying income taxes. But staying on the sidelines is also risky. Look at a fictional estate before and after the recent recession.

A Hypothetical Family

Meet Mr. and Mrs. John Dough. Both have inherited quite a bit of wealth. Both have postgraduate degrees. Mr. Dough is employed as an efficiency expert for a widget company and earns $250,000 annually. Mrs. Dough spends her time traveling, decorating the Dough homes, and supervising the Dough children, nanny, gardeners, and household staff.

The estate had been chugging merrily along in 2007 with $20 million of assets, including $15 million throwing off 5% returns from various investments and producing $750,000 of taxable income, plus $5 million in a family home, a vacation home, a family condo, and a fourth home that was inherited. With Mr. Dough's $250,000 of wages, the family has a cool $1 million of annual taxable income from which it pays $450,000 in income taxes. The family also maintains its lifestyle with expenses of $450,000, leaving the estate growing by $100,000 in new value, plus additional growth in equity.

Suddenly the estate is rocked by the stock market falling 40% and then, in a slightly delayed reaction, the real estate bubble bursting. On paper, the assets of our hypothetical estate fell to $12 million, and income from most of the assets was entirely erased. The family had just the one wage earner's income of $250,000 for 2009.

Flash forward to 2010. The stock market and real estate have partially recovered. The $20- million estate that fell to $12 million on paper has climbed back up to $16 million, of which $12 million produces income and assets worth $4 million are mostly homes and possessions producing only expenses. But the rolling recession has also caught up with the widget industry, and Mr. Dough has been laid off.

Of the $12 million of assets that could produce income, $6 million are producing losses on paper, but the losses can't be used to offset gains without selling the underlying assets. The other $6 million are producing an average of 1.5% of returns, with some of the assets in bank accounts producing 0.7% returns, some in dividend stocks providing 2% returns, and some in a managed account that is producing 4% returns in theory but, when all the commissions and management fees are added in, turns out to be closer to 3% in practice. With an overall return on the $6 million for the year averaging 1.5%, there is a mere $90,000 of taxable income.

Granted, these are just fictional assumptions, but there are

many estates with fact patterns that are not that different. In this situation, the income for the family has gone from $1 million to $90,000 in just a couple of years. After taxes, that may amount to $60,000 of income. Obviously, with less income there is no longer a $450,000 tax bill, but if the family stays current on its other expenses and maintains its lifestyle, it would have to spend $450,000. Instead of having an estate that is growing by $100,000 in new assets, plus lots of equity growth each year, the estate is running $390,000 in the red.

From Bad to Worse

This is where the estate can start to unravel. How will the $390,000 shortfall be addressed? One approach is to borrow money and incur debt expenses in future years. Another approach is to sell off assets and deplete cash reserves. Both of these options are highly unattractive. If you are selling assets that are, for instance, currently depressed in value by 20%, the sale of $390,000 is like giving up an asset that would be worth more than $500,000 when the market recovers. This amplifies the loss of $390,000.

On the other hand, borrowing $390,000, even at favorable rates of 5%, could mean points of close to $4,000 and annual interest of $19,500. Over four years, plus points, that would mean $82,000 in extra expenses. And what happens if there are four successive years like this? The estate is going to be diminished by $1.6 million, which had a likely value of more than $2 million in a better market.

Once an estate starts diminishing, it cannot recover to its former level when markets and real estate values improve. From $16 million it will slip to $14 million. If there is a sudden family need or expense, the estate has no cushion and will have to sell off assets. An illness, an accident, or a lawsuit can happen at any time. With multiple properties, there are always new expenses. If future expenses increase, and the remaining estate produces less revenue, assets will erode even faster. An estate like this is only one or two bumps in the road from no longer being a sustainable estate that runs in the black and grows in perpetuity or at least for multiple generations.

Underwater Investments

Here is another scenario that is quite plausible and equally alarming. A family with $20 million in assets did some ambitious leveraged investing while things were going well during 2000 through 2007. They purchased an office building, an apartment building, and a strip mall.

The new assets are worth $10 million, and they were purchased with $9 million of mortgages at 7% interest. Mortgage payments come to about $81,000 monthly. The buildings were supposed to be throwing off total net returns of $84,000. The game plan was to acquire the properties and allow the buildings themselves to finance the purchase over time. In theory, the rents would cover the expenses and the debts and provide a margin for error of $48,000 per year. In a few years, higher rents would produce larger profits. In 15 years, when the buildings were hopefully worth $20 million, the family would own them free and clear, and this would add to the family's previous estate of $20 million, which hopefully would also be doubling. This would have been a win-win-win across the board under previous conditions.

But now, a few years into the investments, the buildings have dropped in value to $7.5 million, there are numerous rental vacancies, and the empty spaces all require an infusion of capital to attract new tenants. Several of the existing tenants are in arrears and are demanding rent abatements. One has declared bankruptcy, and eviction proceedings are languishing in the courts. The buildings are producing a net of $55,000 monthly, leaving a monthly shortfall of $26,000. After pumping more and more personal funds into the buildings to the tune of $500,000, the family is tapped out. The buildings are "underwater," in that their value is lower than the mortgages on them.

With the buildings in default, the family is forced to sell them at a loss and make up the difference from personal funds because they provided personal guarantees on the mortgages. Overall, the estate's $20 million was reduced to $19 million by the building purchases and to $14 million by the recession. Now it is losing another $3 million in value, due to the buildings not performing as expected, and is left with an $11-million estate of which only half is invested productively.

Estate Implications: For estates, an underwater asset raises a number of planning issues. The premise of an existing estate plan might be to give out a series of liquid assets as bequests to charities, nieces and nephews, longtime friends, a longtime secretary, a loyal nanny or household staff member, and so on, and then leave the big family property to immediate family.

Revisiting that equation for some estates could presently mean that the liquid assets are exhausted and the most important family beneficiaries are being handed a negative asset. So a very simple will review must address priorities of who is to actually benefit from the estate.

A second implication of a negative asset—or an asset that is heavily encumbered—is whether or not the estate will pay off mortgages and back taxes on the asset that is being transferred. Many wills contain standardized tax apportionment language that leaves a lot to be desired. As a practical matter, the facts that exist and the testator's intent can be translated into plain English so that there is no second-guessing after death. Is the estate to pay off the mortgage on a house or property that is given to a particular beneficiary? Is the remainder of the estate to pay estate taxes attributable to the

real property that is given to a particular beneficiary, or should that come out of the beneficiary's share? A will should spell this out plainly and not rely on differing interpretations of its boilerplate language.

Le Coup de Grâce

Not to be a whiner, but there is no bad situation that a heavy tax burden can't make worse. As opposed to billionaires who have passed away in a timely fashion when there is no Federal estate tax, or those estates under the taxable level, the $20-million estate, or what is left of it, is very much in the taxable range of the estate tax that is likely to apply in 2011 and beyond.

In the worst-case scenario, where the 2011 levels of taxation arise automatically with a $1-million exemption, a $20-million estate that manages to pass entirely to a surviving spouse and then get taxed entirely in the surviving spouse's estate would have a tax of $10,295,000. Even if the estate has been diminished and partially distributed, a $10-million estate would be hit with a tax of $4,795,000.

There are also pitfalls regarding the carryover basis or stepped-up basis, for which the outcome remains uncertain. State death taxes exist in various estates, and maneuvers to avoid those states must be monitored. After the next round of Federal estate tax revisions, a wave of state taxation may follow. There is even a possibility of the state death tax credit being resurrected at some point.

Building and Maintaining Wealth

A family that takes wealth for granted may soon lose it. Some basic suggestions:

1) Even a $20-million estate should have a budget and live within its means. Spending must be reduced. Refinance mortgages, stop leasing vehicles, stretch every dollar as though it were your last.

2) Replace unproductive portfolio assets. Don't limit yourself with no risk, but structure an intelligent portfolio with hedges, tax sheltered bonds, dividends, recession resistant stocks and good bargains to produce income for current needs.

3) Offset capital losses and gains in selling assets.

4) Sell or rent out unused residential properties.

5) Pay down debt on investment properties so that they are truly self-sustaining.

6) Build a smarter growth portfolio of stocks with dividends, recession-proof blue chips, gold, tax free bonds, and some carefully selected growth stocks for the long haul.

7) Cultivate a new career, job, or income-producing endeavor and spend time productively.

Even assuming that estates can regroup and grow, the traditional hurdles of transfer taxation are likely to be back in action starting sometime in 2011.

Congress has become hard to predict. However, it has long been projected that it will not only reinstate the estate tax but also that the exemption levels will be around $3.5 million or $5 million and will then be indexed for future inflation. If that is the case, the $20-million estate is going to face huge transfer taxes.

Basic Strategies

For a married couple, a typical plan would take advantage of the full exemption for each spouse but the $20-million estate would still have about $10 million that needs to be transferred to the next generation (and that needs to be sheltered).

Lifetime transfers in trust using the annual gift tax exclusion and gift splitting can move a sizable portion of assets. These funds can be placed in a *Crummey* trust

Purchase of life insurance by the trust can be highly valuable. If sufficient wealth is situated in family trusts, it can be used to purchase life insurance and those proceeds will not be included in the parent's estate.

Since assets are currently at low values that are likely to appreciate in the future after a wave of inflation, this may be a good time to transfer certain assets.

In addition to outright transfers to the next generation or transfers in trust to one or more future generations, low asset values also make this a suitable time for estate freezing techniques such as family limited partnerships.

With state transfer taxes becoming a significant tax burden in their own right, every estate must also anticipate future planning of domicile. If a change of domicile is planned for the future, the ownership of real property should be set up in a manner that keeps those assets from triggering a state transfer tax to the extent possible.

Ownership of real property held in an LLC, for example, would suffice to be considered ownership of personal property in most instances. However, there is some concern that this area remains dynamic with more states adding their own transfer taxes and others tightening their rules. It is possible that some states may legislatively attempt to pierce the corporate veil of single member LLCs for purposes of assigning ownership of real estate for death tax purposes.

Funding of 529 plans to finance future tuition bills can be a highly valuable strategy.

In other words, all of the techniques traditionally used and all of the newer techniques from the past decade are back on the table. These simple, classic approaches were once the mainstay of estates under $1 million that once faced taxation and many estate plans have grown complacent

Unique Challenges

Going back into the estate planning mode based on estate taxation won't affect some estates that were never updated in the first place. Wills from a few years ago may have a QTIP trust, a two trust bypass, and a failsafe in the form of a disclaimer trust.

Nevertheless, every estate should be reviewed anew in 2011. There is too much changing and no estate can be taken for granted. This is the time for estate tune ups and vigilance.

We live in a different time now where there may be deflation and recession, sideways drift, stagflation, and wild inflation. Tax rules are changing. In anticipation of everything from mayhem to malaise in 2011 and thereafter, we are going to march though the entire arsenal of estate planning strategies, apply them to the $20-million estate, and see which may have some application in various scenarios.

There may be some very useful classics such as bypass trusts, ILITs and disclaimers but even a modest estate may hugely benefit from the beneficiary defective inheritor's trust (BDIT®) approach. This creative approach is not merely for the super rich. This discussion will be continued in next month's issue of *The Estate Analyst*.

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