So You're Rich – Now What?

An Interview with Stanley N. Bergman, Senior Partner, and Amelia S. Renkert-Thomas, Associate, Withers Bergman LLP, New York

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EDITORS' NOTE *A senior principal and founding partner of Bergman, Horowitz & Reynolds, P.C. (the U.S. predecessor of Withers Bergman), Stanley Bergman holds an A.B. from Dartmouth College, an M.B.A. from the Tuck School of Business at Dartmouth, and a J.D. from the University of Michigan. His practice focuses on all phases of tax law, international and domestic trusts and estate planning, charitable giving, business law, and pensions.*

Amelia Renkert-Thomas, who rejoined Withers Bergman LLP in 2003 after managing her family's fifth-generation manufacturing business for 12 years, currently divides her time between the New York and New Haven offices. She holds a B.A. from Yale University, a J.D. from Harvard Law School, and an L.L.M. from Case Western Reserve University School of Law. Her practice focuses on estate planning and succession planning for owners of closely held businesses.

COMPANY BRIEF *Withers Bergman LLP is the world's first international law firm dedicated to the personal, business, and philanthropic interests of high-net-worth individuals, their families, and their advisers. The firm, known as Withers LLP in Europe, has offices in New York, New Haven, London, Milan, and Geneva, and will open an office in Greenwich, Connecticut, in late spring 2006.*

In today's world, wealth is being created at unprecedented levels. What does this mean for your practice?

Bergman: Withers Bergman's client base includes an increasing number of individuals and families who are preparing for major liquidity events – such as the sale of a business to a multinational corporation or a business going public. For a client facing a major liquidity event, effective and timely tax planning can minimize or postpone current income taxes.

A client recently came to our New York office who had sold his business to a *Fortune* 500 company for more than $400 million in stock. His objective was to build a diversified portfolio, so that his children and grandchildren would be well provided for, and to create a substantial charitable legacy now and upon his death. Like many entrepreneurs we work with, he had spent most of his career building the business, and he hadn't taken much time to plan for wealth. Since the client's basis in the stock was close to zero, selling it outright would have resulted in an upfront tax bill of about $88 million. Our planning focused on monetization strategies that permitted the sale of the stock and diversification of the portfolio without immediate gain recognition, and created tax-efficient charitable vehicles.

How can appreciated stock be sold without recognizing gain?

Bergman: Contrary to the myths out there, deferring gain doesn't require an investor to seek out risky tax shelters. There are a number of strategies for deferring gain that simply utilize existing provisions of the Internal Revenue Code. The key is to work closely with the client to understand his particular situation and needs. For example, we have been able to achieve the significant deferral of more than $100 million of gain for another client simply by restructuring several of his existing investment partnerships, thereby harnessing the partnership-tax rules that permit a shift of basis among partnership assets. In other words, by carefully structuring his investment holdings, this client has a choice about when to recognize gain and in what amount.

Timing is important, because the current tax rate for gains on most capital assets held for more than one year is 15 percent, but this favorable rate is scheduled to return to 28 percent in 2008. We help clients analyze whether it makes more sense to recognize gain at a lower rate currently, or defer it and pay it later at a higher rate. In this instance, the client's tax rate was 22 percent including state tax, and deferrals could be achieved for 40 years without cost, so the client opted for deferral, since earnings on the deferred taxes will be greater than the tax ultimately due.

Renkert-Thomas: Clients with charitable interests have a number of options for deferring gain. The Internal Revenue Code and regulations specifically permit split-interests trusts benefiting charitable and noncharitable beneficiaries, i.e., the client and his spouse. One option for a client with a substantially appreciated single stock holding is to contribute the stock to a charitable remainder trust [CRT]. Generally, a CRT provides the client and his spouse with an income stream for a term of years or their joint lives, after which time the remaining assets pass to one or more charitable organizations. The CRT can be structured so that as little as 10 percent of the value of the assets originally contributed to the CRT passes to charity. The real advantage of the CRT is that the trustee can sell the stock without triggering the gain, and can reinvest the proceeds in a diversified portfolio.

There are several variations on the CRT that provide for a smaller payment to the noncharitable beneficiaries in the early years, with larger payments later on. One of these variations is called a "net income makeup charitable remainder unitrust" or NIMCRUT. With a NIMCRUT, distributions in early years are limited to the actual income received. If the NIMCRUT invests in assets with substantial appreciation potential but limited income distributions – for example, hedge funds – there is the potential to build a substantial tax-advantaged investment portfolio to benefit the client in later years. A charitable lead trust [CLT] works the opposite way:

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Distributions go to charity for a term of years, and the assets remaining at the end of the term pass to noncharitable beneficiaries. A CLT can be a tremendously powerful tool for shifting assets to children without incurring gift tax.

Many entrepreneurs build their businesses with the goal of selling them, generating tremendous wealth – and tremendous tax bills. Others build their businesses for future generations, but face large estate-tax bills on their deaths. How can you help them?

Bergman: Timing is everything with liquidity transactions. We've been talking about income-tax deferral strategies, but estate-tax reduction strategies are equally important. Many successful entrepreneurs who sell their businesses find that with the wealth comes the potential for an estate-tax bill that can exceed 50 percent – or 75 percent, if significant transfers to grandchildren are contemplated.

We advise many principals of hedge funds and private-equity funds. Indeed, we will open an office in Greenwich, Connecticut, in the spring of 2006 to serve this market better. With hedge funds, as with any new business, a client who does his estate planning at the beginning, before the value of the business explodes, can move significant assets out of his estate. Many hedge fund principals invest in the fund "side by side" with their investors. By having the principal establish a family trust, gift all or a portion of his capital contribution to the trust, and then having the trust invest in the fund with the principal or in his stead, we can shift all or a portion of the future appreciation of the fund out of the client's estate for tax purposes. If the client allocates a portion of his generation-skipping transfer tax [GST] exemption to the trust, the trust can benefit multiple generations without gift, estate, or generation-skipping taxes. Furthermore, if the family trust is established in a jurisdiction that recognizes perpetual trusts, the principal can create a true dynasty trust.

Renkert-Thomas: Utilizing family trusts as part of estate-tax reduction planning can generate surprising benefits, thanks to inconsistencies between the income-tax and gift/estate-tax rules. The planning Stanley discussed for hedge-fund principals works just as well as a family-business succession-planning strategy and for real estate and investment portfolios. The founder/owner gifts some of his interests to a family trust for the benefit of his children and grandchildren, then the trust buys additional interests in exchange for an installment note. If the trust is structured properly, the assets transferred to the trust will be out of the founder/owner's estate for estate-tax purposes. In addition, the sale of the appreciated shares to the trust won't trigger a capital-gains tax, because the trust is not recognized as being separate from the founder/owner for income-tax purposes. The founder/owner receives an income stream. The owner also pays the family trust's income taxes – in effect, making further tax-free gifts to the trust. Meanwhile, the shares held in the trust are protected from creditors – including divorcing spouses.

You work with a substantial number of foreign clients. What trends are you seeing there?

Bergman: Withers is expanding its global presence, with targeted teams focusing on issues of importance to both Western and Eastern European, Asian, Middle Eastern, and Latin American clients. Our international clients typically have assets and interests in multiple jurisdictions, and their planning requires the synthesization of the tax laws of several countries. Many of our non-U.S. clients have a substantial connection to the United States – a U.S. vacation home, a child attending a university here, a business based here. These clients face many of the same issues facing our U.S.-based clients – the need to structure their holdings in a tax-efficient manner, the need for effective estate planning so that wealth benefits multiple generations with minimum taxation – but they also face some unique issues that require careful planning.

Foreign families with substantial business holdings often don't realize the draconian reach of the anti-deferral rules.

For example, the U.S. taxes its citizens and residents on their worldwide income, not just on U.S.-sourced income. Furthermore, the U.S. taxes income from certain foreign corporations owned by U.S. persons, known as "controlled foreign corporations" or CFCs, and some types of foreign-investment vehicles owned by U.S. persons, known as "passive foreign-investment companies" or PFICs, under stringent regimes known by international tax practitioners as the "anti-deferral rules." Foreign families with substantial business holdings often don't realize the draconian reach of the anti-deferral rules until a child or other family member comes to the United States, not just triggering U.S. income tax on the child's U.S.-earned income, but also bringing the anti-deferral rules into play with respect to the income generated by the family's non-U.S. business interests.

What advice do you offer to foreign families in this situation?

Renkert-Thomas: It is important to plan before the U.S. casts its tax net over the family assets. We represent a Mexican client with substantial non-U.S. business holdings. The youngest son plans to matriculate in the M.B.A. program at a major U.S. university next fall, and plans to work on Wall Street following graduation. Our Latin American planning team, which is based in our New York office and has been working with a number of clients in Mexico, Brazil, and throughout Latin America, is working with this family to restructure its business holdings to avoid triggering the anti-deferral rules.

Bergman: For our international clients, a simple move can create complex issues. For example, a client who is a French citizen and who has a large family with interests in France, the United States, the U.K., and several other countries, recently decided to move to the U.K. Our U.S. and London offices have been working together to determine the optimal way to restructure the family's trusts and business holdings to minimize U.S., U.K., and local income and inheritance taxes. Such a project requires close examination and analysis of the existing tax laws of each country, as well as new tax laws currently under consideration, in order to protect the family's heirs in each country.

For this family, the answer was to migrate several trusts to the United States, while keeping others in the U.K. and several other jurisdictions.

Renkert-Thomas: As Stanley points out, international families with substantial assets face a labyrinth of tax issues. With the largest team of U.S. and U.K. tax specialists in the world, Withers Bergman has the knowledge and expertise in-house to develop multi-jurisdictional planning models and structures to help resolve those issues efficiently and cost-effectively. For example, our teams in London, New York, and New Haven have constructed will and trust models for dual U.S./U.K. citizens that take full advantage of the unified credit for U.S. estate-tax purposes, as well as the nil-rate band for U.K. inheritance-tax purposes. The models meet the requirements of both U.S. and U.K. tax and trust laws.

Bergman: Another example may pertain to a U.S. family resident in France. Under certain circumstances, a bequest to a U.S. spouse is tax free under U.S. law, but taxable under French law. Failure to plan properly may not only incur French taxes, but may also create a U.S. tax liability, since the money used to pay the French tax is subject to U.S. estate tax. This is another example of the importance of advance planning. ●

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