The Hollywood GRAT Pack: Wealth Planning in the Entertainment Industry - Fall 2007

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Wealth Planning in the Entertainment Industry

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It is not uncommon to hear the phrase "it's rags to riches to rags in three generations" used in the context of wealth planning, and it is often the task of wealth planners to preserve a family dynasty beyond this historic breaking point. In the entertainment industry, however, it is all too often rags to riches to rags in *one* generation. Before you know it, you are reading (or watching a program on VH1 or E!) about an entertainer who made his or her way out of a troubled life; climbed through the Hollywood ranks; and experienced a life of fortune, fame, and excess, only to end up broke and filing for bankruptcy (or, sadly, something worse). That is why it is necessary to counsel our entertainment clients from early on in their careers about the importance of wealth planning and to guide them in structuring their lives in a way that protects their wealth for generations while minimizing their tax exposure. There is no reason 15 minutes of fame cannot turn into a lifetime of comfort.

Wealth planning for entertainers is a unique responsibility, unlike wealth planning for any other industry, and it presents unique challenges. First, you are typically dealing with creative personalities whose sense of mortality and concern for future security can be somewhat different than those of the average wealthy client. In addition, the lifestyles of entertainers are often ultra luxurious and, at times, self-destructive. So understanding the psychology of the business and its talent is a must. Second, the career span of an entertainer is typically much shorter than that of other wealthy individuals. This means that a significant amount of thought needs to be put into post-career planning. Third, the income streams of an entertainer can be complicated and involve a variety of sources such as primary source or direct income (i.e., guaranteed, or up-front, income relating to his or her performance), secondary source income (i.e., from personal appearances, endorsements, promotions, etc.), royalty streams, and contingent/bonus income (often based on the success of a project). Finally, entertainers often own less common types of assets, including copyrights, shares in a loan-out company, artwork, aircraft, and yachts. Once these various nuances in an entertainer's life are understood, then, and only then, can you plan for the entertainer's future and take advantage of the planning opportunities available to entertainers.

Take, for example, investing in an independent (non-studio financed) film. Many clients involved in the entertainment industry invest in independent films, especially those playing leading roles or involved in the production of the film. What typically occurs is that a company (usually a limited liability company, or LLC) is formed to finance the production and investors are offered noncontrolling interests in the LLC. As a member of the LLC, an investor will be entitled to a percentage of the gross revenue generated from exploitation of the film. If the film is successful, the investor not only will recoup his or her initial investment, but also will receive additional income from the performance of the film and possible long-term returns through the continued exploitation of the film in ancillary markets (e.g., DVD, video, pay-per-view and on-demand sales, licensing, and merchandising). The question is, will the movie be successful?

It is no secret, and the old adage goes, that movies do not make money. If clients are investing in a film, as with most risky investments, then they are probably willing to lose the money that they are investing. And if they are making an investment that they are willing to lose, chances are that your clients don't need the money that they are investing or the potential return on the investment. When it comes to wealth planning, an individual has three "pots" of money: (1) the money they need, (2) the money they absolutely do not need, and (3) the money that they may need but are not sure about. With regard to money that a client absolutely does not need, generally speaking, it is a good idea to either transfer such amount or, at least, freeze its value by transferring the future appreciation on such amount to future generations, family members or charity, thereby permanently removing wealth that is not needed from your client's estate and avoiding your client having to pay a costly U.S. estate tax on such amounts. In addition, if the wealth transferred for the benefit of your client's family is held in trust, such amount can provide protection against the claims of creditors and divorcing spouses. Moreover, if properly drafted, your client can remain a beneficiary of the trust and have potential access to the funds in the event they are needed. All in all, your client can save taxes while providing for his or her family's future.

When it comes to investing in films, if the film is successful, the potential appreciation in the investment is great. Therefore, one may wish to freeze the value of the investment and pass the appreciation to the client's children or other family members. One method of accomplishing this without incurring any gift tax on the transfer would be to place the shares of the LLC (i.e., your investment in the film) in a grantor-retained annuity trust (commonly referred to as a GRAT).

What Is a GRAT?

A GRAT is an estate planning mechanism that allows for the future appreciation of an asset to be transferred at virtually no tax cost. More importantly, the use of GRATs has been approved by Congress, so there is little risk involved. The concept of a GRAT is fairly straightforward: essentially, an individual (commonly referred to as a grantor) transfers assets to an irrevocable trust and retains the right to an annual payment, or annuity, for a particular number of years. Once that term of years is up, all of the remaining assets in the trust are paid to the remainder beneficiaries named in the trust (typically another trust for the benefit of the grantor's family). For gift tax purposes, the grantor is treated as having made a gift on the date that the assets are transferred to the trust in an amount equal to the difference between the value of the assets transferred and the value of the retained annuity payments. The Internal Revenue Service ("IRS") publishes monthly interest rates that are used in determining the value of the retained annuity payments. Therefore, it is possible to structure your GRAT such that the value of the assets transferred and the value of the retained annuity are virtually equal, resulting in no gift being made and, therefore, no gift tax being owed. In addition, the annuity payments can be made in kind (i.e., by repaying you a percentage interest in the LLC that you contributed).

The reason that a GRAT can work so well with a film investment is because of the unlikelihood that the film will be a success, which will ultimately affect the value of the investment on the date it is transferred to the GRAT. (It is important that you get a professional appraiser to value your interest in the LLC before transferring it to a GRAT; that value should carry with it a significant discount for lack of marketability and control, not to mention the uncertainty that the film will make money.) If the film is a success, then the amount of appreciation that will be passed on after the GRAT terminates can be enormous, and may even result in future royalty streams being paid for the benefit of the grantor's family over an extended period of time. If, on the other hand, the film is a flop, then the investor is in no worse of a position than had he or she not transferred his or her interest to the GRAT (save some administrative costs). Here is an illustration:

Investor purchases 20 units of FILM LLC for $1 million. Assuming FILM LLC's budget is $10 million, Investor will own 10 percent of the company. While in the preproduction phase, Investor transfers all 20 units of FILM LLC to a GRAT that has a term of three years. To keep the illustration simple, assume that no discount is applied to Investor's 20 units on the date they are transferred (which is unlikely), so that the value is $1 million. At the end of the three-year term, any appreciation in the value of FILM LLC will be distributed to a trust for Investor's family. Within that three-year period, however, FILM LLC will have completed the film, which will have had a theatrical release and may already be receiving income from DVD sales and other ancillary markets. If the film was a success and grossed $300 million in the box office, the value of Investor's 10 percent interest in FILM LLC will have appreciated greatly, well beyond the initial $1 million. Conservatively, if FILM LLC was now valued at $50 million, a 10 percent interest in the company would be worth approximately $5 million—that's $4 million of appreciation passing out of Investor's estate to his family virtually *tax free*. That's a transfer tax saving of nearly $2 million! Not to mention a significant income stream from continued royalties paid to FILM LLC also may be passed on to Investor's family.

Conclusion

So you can see by way of example the power of wealth planning early on in an entertainer's life. GRATs are an excellent planning tool, but they are just one of many opportunities and methods of preserving wealth for future generations while minimizing transfer tax exposure. Sammy Davis Jr. once said, "The success of the Rat Pack . . . was due to camaraderie, the three guys who work together and kid each other and love each other." I like to think that the success of entertainers is equally the result of camaraderie and teamwork—the collective efforts of the entertainer and his or her family of trusted advisors. It is our responsibility to ensure our clients' financial stability and success by recognizing opportunities and counseling them from the early stages of their careers on wealth planning issues. This way, our clients can sit back, smile for the cameras, and raise their martini glasses knowing that their wealth and legacy will be preserved, as members of the Hollywood GRAT pack.